



***Office of the Auditor General***

**Follow-up to the 2011 Audit of Procurement Practices –  
Hedging Activities**

**Tabled at Audit Committee – October 8, 2015**



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## **Executive Summary**

### **Introduction**

The Follow-up to the 2011 Audit of Procurement Practices – Hedging Activities was included in the Auditor General’s 2013 Audit Plan.

The key findings of the original 2011 audit included:

- The City’s approach to hedging of natural gas prices resulted in it paying \$2.1 million dollars more than it would have if it had purchased the gas directly from the supplier.
- The losses will continue unless the City changes its approach to procuring natural gas. In addition, hedging transactions for diesel in 2009 resulted in an overall loss of \$267,000.
- The 2010 diesel hedges resulted in a savings of approximately \$5 million.
- The Finance Department should play a key role in the acquisition of natural gas in the future.
- The City does not do performance benchmarking against market rates in order to establish if the hedging efforts have resulted in lower prices.
- The information provided to Council on hedging practices should be improved.

### **Summary of the Level of Completion**

The table below outlines our assessment of the level of completion of each recommendation as of December 2013.

**Table 1: OAG’s assessment of level of completion of recommendations**

<b>Category</b>	<b>% Complete</b>	<b>Recommendations</b>	<b>Number of Recommendations</b>	<b>Percentage of Total Recommendations</b>
Little or no action	0 to 24	n/a	n/a	n/a
Action Initiated	25 to 49	n/a	n/a	n/a
Partially Complete	50 to 74	1, 3	2	33%
Substantially Complete	75 to 99	2, 4	2	33%
Complete	100	5, 6	2	33%
<b>Total</b>			<b>6</b>	<b>100%</b>

The table below outlines management’s assessment of the level of completion of each recommendation as of February 2014 in response to the OAG’s assessment. These assessments have not been audited.

**Table 2: Management’s assessment of level of completion of recommendations**

Category	% Complete	Recommendations	Number of Recommendations	Percentage of Total Recommendations
Little or no action	0 to 24	n/a	n/a	n/a
Action Initiated	25 to 49	n/a	n/a	n/a
Partially Complete	50 to 74	1	1	17%
Substantially Complete	75 to 99	2, 3, 4	3	50%
Complete	100	5, 6	2	33%
Total			6	100%

### Conclusion

Finance department is now providing greater oversight as it pertains to natural gas forward agreements. Finance management has met with the Chair of the OCEPG twice during 2013. In addition to the Senior Project Manager Engineering (Chair of OCEPG); the Officer, Senior Investment, Treasury Unit; and, the Manager, Strategic Sourcing and Supply Chain Management, Supply Branch now also attend the OCEPG Steering Committee’s meetings as additional City representatives.

At the time we conducted the follow-up audit in December 2013, Public Works expected the draft Energy Management and Investment Strategy report and Corporate Utility Procurement policy to be tabled at Environment Committee in April 2014. We noted that the drafts we reviewed did not fully follow the approach outlined during the April 2013 meeting between Deputy City Treasurer, Corporate Finance; Manager, Treasury; Chief Procurement Officer; and, Senior Project Manager Engineering (Chair of OCEPG). However as these were still in draft form, we recognize there may be further changes to both documents before they are submitted.

We found that Council is informed of the level of financial implication (savings) resulting from favourable hedging positions but that they are not provided the same information (losses) from unfavourable positions. Recent losses resulting from the drop in natural gas prices should be fully disclosed to Council. For the period November 2009 to November 2012, the City had a natural gas total cost loss of \$2.6 million.

The December 31, 2012 *Notes to the City's Consolidated Financial Statements* (i.e., notes 13(h)) provided a listing of natural gas forward commitments totalling \$10.7 million for 2013 to 2017.

### **Acknowledgement**

We wish to express our appreciation for the cooperation and assistance afforded the audit team by management.

The following section is the detailed follow-up report.



## ***Detailed Follow-up report***

### **Introduction**

The Follow-up to the 2011 Audit of Procurement Practices – Hedging Activities was included in the 2013 Auditor General’s Audit Plan.

### **Key findings of the Original 2011 Audit**

The primary objective for the commodity price hedging activity is to reduce the financial risk by providing price stability and protection against the effects of adverse market conditions.

#### **Diesel Fuel**

The diesel fuel purchased by the City is largely used by its public transportation fleet (such as OC Transpo buses) and its municipal fleet. The volume of diesel utilized by the City is approximately 48 to 50 million litres annually.

There is currently annual reporting to Council for diesel hedging activities. However, the City does not compare performance benchmarking against market rates in order to establish if the hedging efforts have resulted in lower prices. We reviewed the effectiveness of the hedge transactions entered into during 2009 and 2010 and observed that while 2009 resulted in an overall ineffective position of \$267,000, the results of 2010 hedges were effective in the magnitude of approximately \$5 million.

#### **Natural Gas**

The City participates in a cooperative purchasing arrangement with 17 participating entities: Ottawa Carleton Energy Purchasing Group (OCEPG). The objective of the OCEPG is to strategically procure natural gas on the open market to achieve savings for its members. OCEPG includes school boards but not hospitals. Natural gas expenditures, in 2011, were approximately \$14.5 million for the cooperative as a whole, of which the City accounts for approximately \$4.4 million, or 30%, of the consumption.

The OCEPG has entered into several forward contracts at unit prices of 14.63 to 31.40 cents per m<sup>3</sup>. Over the next several years, the City’s committed portion is between \$3.46 million in 2013 and \$0.42 million in 2017. The current market rate, as of April 2012, is 8.2 cents per m<sup>3</sup>.

Management has indicated that while the City, through the OCEPG, has entered into long-term supply contracts of natural gas at fixed prices, there are no ‘financial agreements’ entered into to fix prices, and thus they are not considered, by definition, financial hedges for the supply of natural gas. It is our opinion that the purchase of natural gas to be delivered at a future date at a defined price meets the conceptual intent of hedging activities, and inherently provides forward buying activities which exposes the City to significant risks, and in this particular case, given the circumstances of the current market trends, has already cost the City approximately \$2.1 million between June 2011 and May 2012.

**Disclosure in Financial Statements**

We found that the City's Consolidated Financial Statement Notes for 2010 and 2011 did not contain a note to disclose the contractual obligations and commitments which the City had with respect to natural gas. It is our opinion that consideration, given the significance of the transactions, should be given to the Notes of the Financial Statements.

**Status of Implementation of 2011 Audit Recommendations****2011 Recommendation 1**

**That the City evaluate whether the hedging, or forward buying, activities related to natural gas are meeting the inherent City's objectives of managing and mitigating financial risks associated with the hedging activities.**

**2011 Management Response**

Management agrees with this recommendation.

The evaluation of the existing Energy Management and Investment Strategy approved in October 2008 (ACS2008-BTS-RPM-0041) will be performed in conjunction with the report to be prepared in accordance with management's response to Recommendation 3. This evaluation will take into account the objective to obtain both budget certainty and to minimize the commodity's adverse market price fluctuations. This recommendation will be implemented by the end of Q3 2013.

**Management Representation of Status of Implementation of Recommendation 1 as of July 1, 2013**

In April 2013, the Chair of the OCEPG, the Chief Procurement Officer, the Manager of Treasury Services and the Deputy City Treasurer Corporate Finance met to begin discussions regarding the approach to preparing a report in Q1 2014, which will include an evaluation of the existing Energy Management and Investment Strategy approved in October 2008 (Ref N<sup>o</sup>: ACS2008-BTS-RPM-0041). Management has also continued to assess the market situation on an ongoing basis and can confirm that the City has not entered into any new forward purchasing contracts since March of 2012.

**Management: % complete** **10%**

**OAG's Follow-up Audit Findings regarding Recommendation 1**

The draft 2014 Energy Management and Investment Strategy report made available to us in December 2013 had not been fully reviewed by Finance Department and was pending Public Works' management final approval. Finance Department informed us that they had seen an early draft of the Corporate Utility Procurement Policy. The draft provided to us by Public Works is still at a preliminary stage. As such we recognize and expect there may be further changes to both documents.

The drafts we reviewed did not fully follow the approach outlined during the April 2013 meeting between Deputy City Treasurer, Corporate Finance; Manager, Treasury; Chief Procurement Officer; and, Senior Project Manager Engineering (Chair of OCEPG).

The following lists each approach as per the summary of the April 2013 meeting, and the OAG's assessment of each one:

1. *Assess whether natural gas forward contracts are meeting Council's financial objectives.*  
OAG assessment: Addresses achieving budget certainty for a minimum of 24 months in advance; does not address fiscal responsibility.
2. *Identify risks associated with forward contracts.*  
OAG assessment: Preliminary draft Utility Procurement Policy (UPP) – electricity and natural gas risks.
3. *Identify a process that can be used to address significant price movements.*  
OAG assessment: Not addressed in draft 2014 Energy Management and Investment Strategy (EM&IS); or, Preliminary draft Utility Procurement Policy (UPP). Draft UPP describes: for natural gas, the maximum % of current consumption for a specific number of years forward; and, the % of total annual electrical consumption at one time as a strategy.
4. *Determine if the City should discontinue the practice altogether from a policy perspective.*  
OAG assessment: Not addressed in draft 2014 EM&IS; or, Preliminary draft UPP. Draft 2014 EM&IS outlines present practice and requests approval to continue hedging of natural gas. Electricity not mentioned.
5. *If so, determine ongoing relationship with OCEPG, perhaps each member of the group makes their own decisions.*  
OAG assessment: Not addressed in draft 2014 EM&IS; or, Preliminary draft UPP.
6. *Determine feasibility of selling off existing contracts.*  
OAG assessment: Not addressed in draft 2014 EM&IS; or, Preliminary draft UPP.
7. *Seek independent advice to prepare an overview of the future natural gas market expectations.*  
OAG Assessment: Not addressed in draft 2014 EM&IS; or, Preliminary draft UPP. Management informed us that they discussed retained a 3<sup>rd</sup> party and obtained 3 proposals from independent consultants (Sept. 2013) to assess best practices. PW found these to be meta-analysis and opted to undertake the analysis internally as part of the EM&IS report and will present the option to Council to allocate funding to a third party consultant to undertake a secondary comprehensive analysis, if required.

The 2008 EM&IS report provided the consumption and cost history of natural gas from 2001 to 2008. It also indicated that the City's consumption would increase due to several new major facilities. The 2014 drafts we reviewed did not update consumption and cost information. It also did not provide the status of the contracts that are in place. Lastly, the 2008 report noted a total cost saving of over \$1.9 million for the City over the 2001 to 2008 period; however, the current report does not provide Council with this information.

It is important that Council be informed of the level of financial implication that results from both favourable and unfavourable positions. It is our opinion that this should be done prior to requesting their approval to continue to hedge 80% or so of the natural gas portfolio. A complete evaluation should highlight to Council the benefits as well as the risks to the City.

The *2012 Purchasing Year in Review* received by City Council on May 22, 2013 included a Natural Gas Strategy. It provided the forward price versus the Enbridge price of natural gas but did not translate the information in savings or conversely additional costs incurred by the City. We requested and obtained the information from Public Works who advised that for the period November 2009 to November 2012, the City had a total cost loss of \$2.6 million.

Management advised us that in March 2012, OCEPG put three setpoints in place with the broker/agent. They were instructed that should any of these setpoints were met, that they were to initiate a request for quotation to the 3 suppliers on record at that time. Those remained on the books until September 2013 when one setpoint was reached and gas was purchased on September 26, 2013. The purchase was just a normal procedure of an outstanding request.

***OAG: % complete*** ***50%***

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**Management Representation of Status of Implementation of Recommendation 1 as of February 27, 2014**

Management agrees with the OAG's follow-up audit findings. A report will be brought forward in Q2 2014 that discusses whether the hedging, or forward buying, activities related to natural gas are meeting the inherent City's objectives of managing and mitigating financial risks associated with the hedging activities.

***Management: % complete*** ***50%***

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**2011 Recommendation 2**

**That the City track performance of all hedges against market rates on a regular basis and report to Council.**

### **2011 Management Response**

Management agrees with this recommendation.

Management believes that annual reporting would be sufficient given that a hedging program, by its nature, must take a longer-term view. Reporting annually provides an opportunity to compare purchases and market rates year-over-year. This provides a clearer context and allows for easy comparisons as opposed to using smaller snapshots within a year which may give misleading views of seasonal variation.

The reporting will be included with the annual purchasing report – Purchasing Year In Review. The 2012 report will be brought forward to Committee and Council in Q2 2013.

### **Management Representation of the Status of Implementation of Recommendation 2 as of July 1, 2013**

The 2012 Purchasing Year in Review report received by Council on May 22, 2013 (Ref N<sup>o</sup>: ACS2013-CMR-FIN-0022) included a discussion on the Natural Gas Strategy and showed a comparison of performance vs. market rates. The report also included an update on the Diesel Fuel Hedging program against Council's policy requirements.

**Management: % complete** **100%**

### **OAG's Follow-up Audit Findings regarding Recommendation 2**

Management has defined "regular basis" as reporting annually to Council. We confirmed management's representation; sections 13 and 14 of the 2012 *Purchasing Year in Review* received by City Council on May 22, 2013 included both a Diesel Fuel Hedging Strategy & Financial Agreements and Natural Gas Strategy.

A comparison of performance vs. market rates for natural gas is provided from January 2006 to January 2013. Only the forward price versus the Enbridge price is provided for natural gas. Translating this information for Council in terms of savings or losses incurred by the City due to forward agreements may be more meaningful.

Conversely, the report conveys that the City had a mark-to-market value for diesel fuel of almost \$1 million in the City's favour as at December 31, 2012. We believe it is important that Council be informed of the level of financial implication that results from both favourable and unfavourable positions.

The City had a total cost saving of over \$1.9 million over the 2001 to 2008 period. We requested and obtained the information from Public Works who advised that for the period November 2009 to November 2012, the City had a total cost loss of \$2.6 million.

We understand that the 2013 *Purchasing Year in Review* should be provided to City Council in April 2014.

**OAG: % complete** **95%**

**Management Representation of Status of Implementation of Recommendation 2 as of 27 February 2014**

Management agrees with the OAG's follow-up audit findings. Financial implications will be reported in the next *Purchasing Year in Review* report being tabled in Q2 2014.

***Management: % complete*** **95%**

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**2011 Recommendation 3**

**That the City, through a new and comprehensive exercise, identify all risks associated with the hedging strategy and request authority from Council to continue.**

**2011 Management Response**

Management agrees with this recommendation.

Management will prepare a report for Council consideration by the end of Q3 2013. This will be the five-year anniversary of Council's receipt of the Energy Management Strategy (October 2008) regarding electricity and natural gas, and the Corporate Policy for Commodity Price Hedging (By-law 2008-426 - November 2008).

**Management Representation of the Status of Implementation of Recommendation 3 as of July 1, 2013**

In April 2013, the Chair of the OCEPG, the Chief Procurement Officer, the Manager of Treasury Services and the Deputy City Treasurer Corporate Finance met to begin discussions regarding the approach to preparing an updated Energy Management and Investment Strategy, which will include an assessment of the risks associated with entering into forward purchasing contracts for natural gas as well as an update to the Corporate Utility and Procurement Policy. Public Works will be bringing this report forward to Council in Q1 2014.

***Management: % complete*** **20%**

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**OAG's Follow-up Audit Findings regarding Recommendation 3**

The draft 2014 Energy Management and Investment Strategy report made available to us in December 2013 had not been fully reviewed by Finance Department and was pending Public Works' management final approval. Finance Department informed us that they had seen an early draft of the Corporate Utility Procurement Policy. The draft provided to us by Public Works is still at a preliminary stage. As such we recognize and expect there may be further changes to both documents.

- The preliminary *draft Utility Procurement Policy: Benefits section* makes note that the City saved substantial costs with forward purchasing in the past but does not balance the statement by providing how much loss.
- The *2008 Energy Management and Investment Strategy* noted a total cost saving of over \$1.9 million for the City over the 2001 to 2008 period; however, the current report does not provide Council with this information for 2009 to 2013. We requested and obtained the information from Public Works. They

advised that for the period November 2009 to November 2012, the City had a total cost loss of \$2.6 million.

- The preliminary draft *Utility Procurement Policy: Risks section* enumerates risks associated with electricity and natural gas hedging.
- At present the City does not have any electricity purchase agreement and, per Public Works, are not currently contemplating any.

The *draft 2014 Energy Management and Investment Strategy* report (planned to be tabled in April 2014) requests City Council's approval for Public Works to continue forward purchasing activities of the Natural Gas portfolio. However, it does not address any possible future electricity purchasing agreements.

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***OAG: % complete*** ***50%***

**Management Representation of Status of Implementation of Recommendation 3 as of 27 February 2014**

Management agrees with the OAG's follow-up audit findings. A report will be brought forward in Q2 2014 that presents alternative options and the related risks and benefits.

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***Management: % complete*** ***75%***

**2011 Recommendation 4**

**That, if the City continue to hedge, the City should review the methodology and practices used to govern these activities, particularly as they relate to natural gas.**

**2011 Management Response**

Management agrees with this recommendation.

The review of the purchasing practices with respect to natural gas will assess whether a process can be put into place that addresses significant price movements in the price of the commodity.

This recommendation will be implemented by the end of Q3 2013.

**Management Representation of the Status of Implementation of Recommendation 4 as of July 1, 2013**

The Energy Management and Investment Strategy report scheduled for Q1 2014 will fully address the methodology for hedging practices. In the interim, the Chair of the OCEPG, the Chief Procurement Officer, the Manager of Treasury Services and the Deputy City Treasurer Corporate Finance have agreed to meet on a quarterly basis to solicit feedback and provide updates on the process development and, to determine the procurement strategy for the following period.

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***Management: % complete*** ***75%***

**OAG's Follow-up Audit Findings regarding Recommendation 4**

A draft *Energy Management and Investment Strategy* report and draft *Corporate Utility Procurement Policy* are being prepared to be presented to Committee and Council in early 2014. In the interim, the Chair of the OCEPG, the Chief Procurement Officer, the Manager of Treasury Services and the Deputy City Treasurer Corporate Finance have met twice during 2013. In October 2013, the Officer, Senior Investment, Treasury Unit and the Manager, Strategic Sourcing and Supply Chain Management, Supply Branch started to attend the OCEPG Steering Committee's meetings as additional City representatives in addition to the Senior Project Manager Engineering (Chair of OCEPG).

OCEPG's October 2, 2013 minutes indicate that the Terms of Reference of the OCEPG Steering Committee were sent for legal review.

***OAG: % complete*** ***75%***

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**Management Representation of Status of Implementation of Recommendation 4 as of 27 February 2014**

Management agrees with the OAG's follow-up audit findings. A report will be brought forward in Q2 2014 that will fully address the methodology for procuring natural gas.

***Management: % complete*** ***75%***

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**2011 Recommendation 5**

**That the Finance Department take a more active oversight role in the activities related to long-term natural gas contracts.**

**2011 Management Response**

Management agrees with this recommendation and will begin implementation in Q1 2013.

**Management Representation of the Status of Implementation of Recommendation 5 as of July 1, 2013**

Finance management began taking an oversight role in Q1 2013 by agreeing to meet quarterly with the Chair of the OCEPG to determine the procurement strategy for natural gas for the City of Ottawa. In addition, staff from Procurement and Treasury provide advice on an ongoing basis as required. This recommendation has been fully implemented.

***Management: % complete*** ***100%***

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**OAG's Follow-up Audit Findings regarding Recommendation 5**

Finance department has taken a more active oversight role in 2013. Firstly, Finance management (i.e., Deputy City Treasurer, Corporate Finance; Manager, Treasury; and, Chief Procurement Officer) have started to meet with the Chair of the OCEPG. During 2013, this occurred in April and again in September.

In addition OCEPG minutes of October 2, 2013 welcomed four new members of which two were additional City representatives, namely the Officer, Senior Investment, Treasury Unit and the Manager, Strategic Sourcing and Supply Chain Management, Supply Branch now attend the Steering Committee's meetings.

**OAG: % complete** **100%**

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**2011 Recommendation 6**

**That the City consider, in conjunction with the external auditor, on a go forward basis, that the City's Consolidated Financial Statements Notes reflect the City's commitments relating to future natural gas contracts and record the disclosure regarding diesel fuel hedging.**

**2011 Management Response**

Management agrees with this recommendation and will consider this for the Financial Statement for the year ending December 31, 2012.

**Management Representation of the Status of Implementation of Recommendation 6 as of July 1, 2013**

Note 13 to the 2012 Consolidated Financial Statements approved by Council in June 2013 included a listing of commitments under natural gas forward contracts.

This recommendation has been fully implemented.

**Management: % complete** **100%**

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**OAG's Follow-up Audit Findings regarding Recommendation 6**

We confirmed that the December 31, 2012 Notes to the City's Consolidated Financial Statements (i.e., notes 13(h)) listed natural gas forward commitments of \$10.7 million for 2013 to 2017.

**OAG: % complete** **100%**

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### Summary of the Level of Completion

The table below outlines our assessment of the level of completion of each recommendation as of December 2013.

**Table 3: OAG’s assessment of level of completion of recommendations (Repeat of Table 1 in Executive Summary)**

Category	% Complete	Recommendations	Number of Recommendations	Percentage of Total Recommendations
Little or no action	0 to 24	n/a	n/a	n/a
Action Initiated	25 to 49	n/a	n/a	n/a
Partially Complete	50 to 74	1, 3	2	33%
Substantially Complete	75 to 99	2, 4	2	33%
Complete	100	5, 6	2	33%
<b>Total</b>			<b>6</b>	<b>100%</b>

The table below outlines management’s assessment of the level of completion of each recommendation as of February 2014 in response to the OAG’s assessment. These assessments have not been audited.

**Table 4: Management’s assessment of level of completion of recommendations (Repeat of Table 2 of Executive Summary)**

Category	% Complete	Recommendations	Number of Recommendations	Percentage of Total Recommendations
Little or no action	0 to 24	n/a	n/a	n/a
Action Initiated	25 to 49	n/a	n/a	n/a
Partially Complete	50 to 74	1	1	17%
Substantially Complete	75 to 99	2, 3, 4	3	50%
Complete	100	5, 6	2	33%
<b>Total</b>			<b>6</b>	<b>100%</b>

### Conclusion

Finance department is now providing greater oversight as it pertains to natural gas forward agreements. Finance management has met with the Chair of the OCEPG twice during 2013. In addition to the Senior Project Manager Engineering (Chair of OCEPG); the Officer, Senior Investment, Treasury Unit; and, the Manager, Strategic Sourcing and Supply Chain Management, Supply Branch now also attend the OCEPG Steering Committee’s meetings as additional City representatives.

At the time we conducted the follow-up audit in December 2013, Public Works expected the draft Energy Management and Investment Strategy report and Corporate Utility Procurement policy to be tabled at Environment Committee in April 2014. We noted that the drafts we reviewed did not fully follow the approach outlined during the April 2013 meeting between Deputy City Treasurer, Corporate Finance; Manager, Treasury; Chief Procurement Officer; and, Senior Project Manager Engineering (Chair of OCEPG). However as these were still in draft form, we recognize there may be further changes to both documents before they are submitted.

We found that Council is informed of the level of financial implication (savings) resulting from favourable hedging positions but that they are not provided the same information (losses) from unfavourable positions. Recent losses resulting from the drop in natural gas prices should be fully disclosed to Council. For the period November 2009 to November 2012, the City had a natural gas total cost loss of \$2.6 million.

The December 31, 2012 *Notes to the City's Consolidated Financial Statements* (i.e., notes 13(h)) provided a listing of natural gas forward commitments totalling \$10.7 million for 2013 to 2017.

### **Acknowledgement**

We wish to express our appreciation for the cooperation and assistance afforded the audit team by management.