REPORT TO THE LEGISLATURE
on
Diesel Fuel Price Hedging, 2013-15 Biennium

WASHINGTON STATE DEPARTMENT OF TRANSPORTATION

FERRIES DIVISION

November 2015

Washington State Ferries

Executive Summary

In 2011, the Washington State Legislature authorized the Washington State Department of Transportation (WSDOT) to enter into a distributor-controlled fuel hedging program. The first distributor-controlled hedges[1] were executed in fiscal year 2012. In 2012, the Legislature expanded the authorization to include other methods of hedging approved by the fuel hedging committee. The first financial hedges[2] were executed in fiscal year 2015.

During the 2013-15 biennium, the fuel hedging program accomplished its goals of decreased volatility of fuel costs and improved likelihood that costs not exceed the fuel budget. For the 2013-15 biennium, hedges were executed only in fiscal year 2015 and, as noted above, represented the first financial hedges executed by the department. The amount hedged for the fiscal year totaled 9.6 million gallons – or 53 percent of budgeted gallons – at an average price of four cents per-gallon below budget. For the 2015-17 biennium, hedges are in place for both fiscal years at prices substantially below the 2015 enacted fuel budget. The price forecasts for fuel continue to decline based on global factors, including supply and demand fundamentals, speculation, foreign political instability, and other economic variables. As opportunities arise, the department will execute hedges only at or below the adopted budgeted price for fuel.

Fuel Hedging in 2013-15

During the 2013-15 biennium, WSDOT ferries division continued a hedging program for the purpose of stabilizing fuel expense. The statutory authority to conduct hedging is provided in RCW 47.60.830.

The Secretary of Transportation's Executive Order 1078 (Attachment A) provides specific direction for implementing a hedging program. The Executive Order established a Fuel Hedging Committee to provide guidance; provides for the use of a hedging consultant to advise on the timing, quantities, and tenure of hedge contracts; sets maximum hedging limits; and outlines other operating parameters. The Fuel Hedging Committee consists of the Assistant Secretary for Financial Administration, the Assistant Secretary for the Washington State Ferries (WSF), and a transportation Budget Assistant to the Governor from the Office of Financial Management. The committee meets to receive periodic updates on the status of the market, hedges in place, and future hedging plans, or when a need arises to make a policy decision or to set parameters for the program. The committee is staffed by the Director of Finance and Administration at WSF.

The hedging policy sets forth parameters within which hedges will be executed in terms of maximum quantities and length of contracts. The policy states that the purpose of the hedging program is to seek to decrease the volatility of fuel cost and increase the likelihood that actual net fuel cost will remain below the budgeted cost, not to save money. The Executive Order establishing the policy was changed in August 2014 to authorize hedge contracts at the discretion of the Assistant Secretary for Ferries, provided that the quantities and length of contract were within limits of the "standard recommendation," which can change by action of the Committee. The limits established by the standard recommendation as of June 30, 2015 were:

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[1] Distributor-controlled hedges make use of price contracts with fuel distributors for quantities of fuel to be delivered at fixed times.

[2] With financial hedges, the department enters into futures contracts directly, allowing the purchase of fuel at a specific price at a set date in the future. For both distributor-controlled and financial hedges, WSF retains the services of a Fuel Hedging Program Advisor by way of a consultant contract.

- Up to the first twelve months, on a rolling basis, a maximum of 85 percent of the forecasted consumption may be hedged. In addition, hedges will not exceed the forecasted monthly consumption level for any specific month.
- Between the thirteenth and twenty-fourth months, on a rolling basis, the volume of fuel hedged will not exceed 70 percent.
- Individual hedging transactions in excess of 20 percent of total projected fuel consumption will not be permitted unless otherwise approved by the committee.
- The maximum maturity of any contracts entered into under the standard recommendation is twenty-four months. Contract terms may cross biennial lines.
- Transactions that cause the projected total hedged cost to exceed budget will not be permitted unless otherwise approved by the committee.

A slight adjustment to the standard recommendation was made in August 2015, allowing for a hedge maximum of up to 80 percent between the thirteenth and twenty-fourth months for the remainder of the calendar year. However, this modification applies to fiscal year 2016, rather than the 2013-15 biennium, and will be included in the FY 2016 annual report. (The Executive Order in Attachment A is the version in effect as of June 30, 2015.)

There were no hedges put in place for fiscal year 2014. For fiscal year 2015, hedges were executed using financial contracts whereby WSF agrees to pay a fixed dollar amount for a notional volume of fuel and, in return, receives a variable dollar amount based on a fluctuating index that is highly correlated with the price WSF pays to its fuel supplier. By hedging in this manner, the price for hedging fuel is lower than the price for an identical hedge with the supplier. WSF takes some price risk because the index is not perfectly correlated with the price.

For fiscal year 2015, hedged fuel totaled 9.6 million gallons, or 53 percent of budgeted gallons, at an average price of $3.07 per gallon. Currently, there are hedges in place for fiscal year 2016 for 14.7 million gallons, or approximately 80 percent of projected consumption, at an average price of $2.46 per gallon. There are hedges in place for fiscal year 2017 for 12.1 million gallons, or approximately 66 percent of projected consumption at an average price of $2.10 per gallon. Figures 1 and 2 show fiscal years 2015, 2016, and 2017 hedged gallons compared to total budgeted consumption.

Figure 1

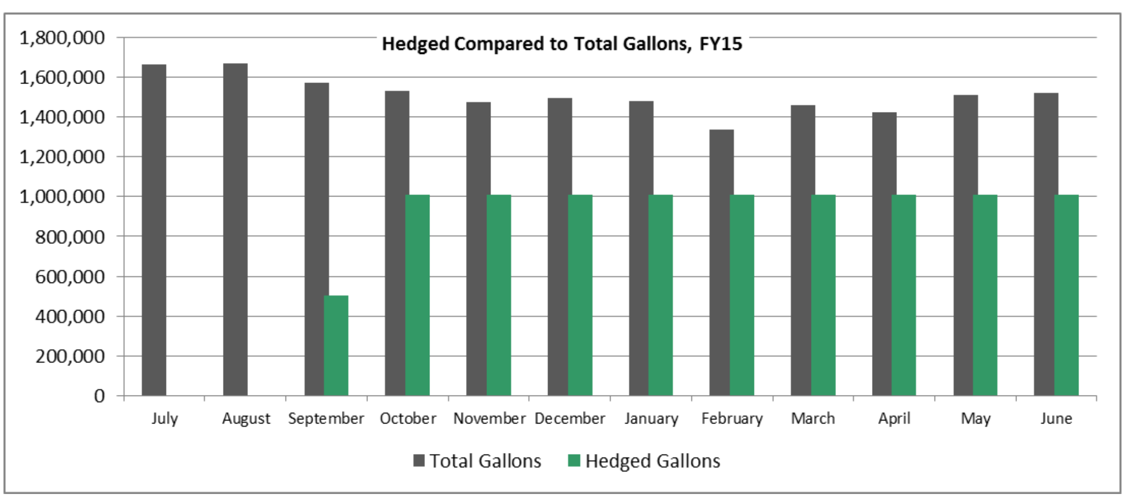
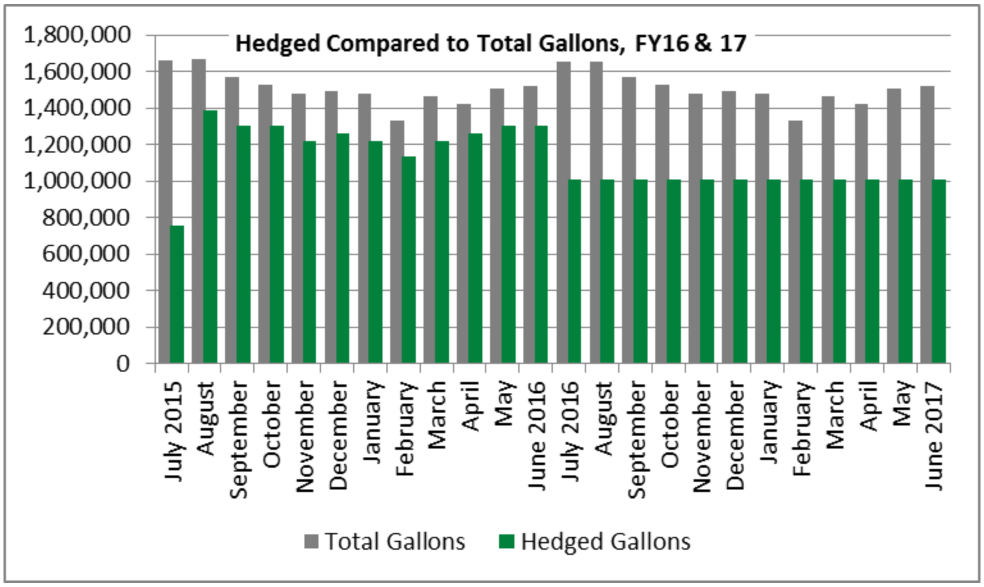


Figure 2



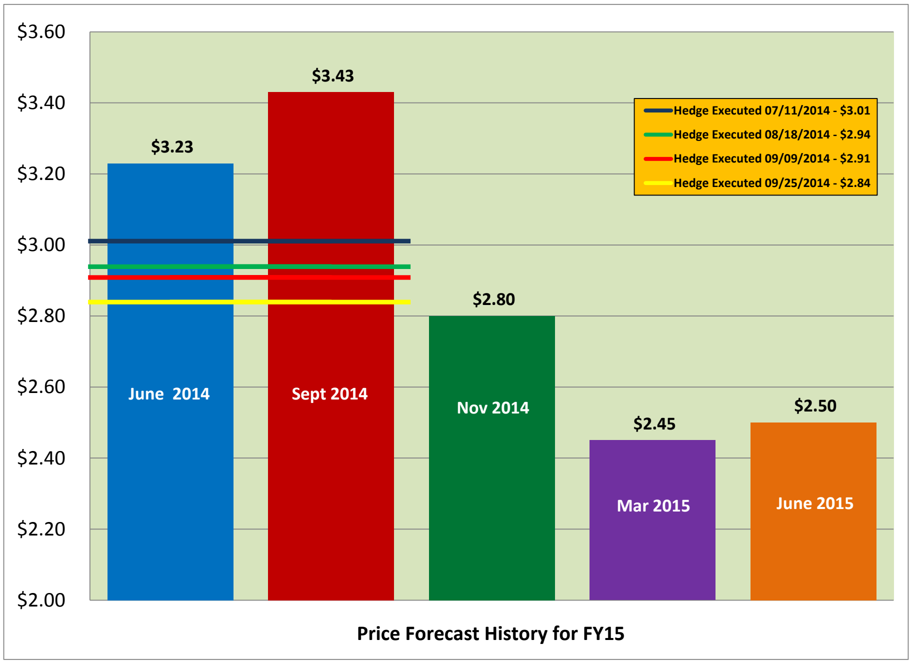
Hedging had the effect of reducing the expected price for hedged gallons in fiscal year 2015 by an average of four cents compared to the budget, and by 16 cents compared to the price forecast at the time the hedges were executed. For fiscal year 2016, compared to the forecasts at the time hedges were put in, the hedged prices were an average of 36 cents lower. However, forecasts were lowered for the hedge period after the hedges were executed, and the revised forecasts that were used for the 2013-15 and the 2015-17 budgets are lower than the price of the hedges. For fiscal year 2017, the average hedge price is $2.10 per gallon, which is 21 cents below the adopted budget and 72 cents below the June forecast. Figure 3 on the following page shows the hedge prices compared to the price forecasts at the time the hedges were put in place.

Hedges vs. Forecasts

In Figure 3, the 2014 price forecasts in June, September, and November and the price forecast of March 2015 are represented by the large bars. The horizontal lines are the prices at which hedges were executed. All the hedges were below forecast at the time they were executed.

At the time the last hedge for fiscal year 2015 was executed, the price forecast was $3.43 per gallon; the hedged price was $2.84 per gallon. The forecast subsequently dropped to $2.80 and then to $2.45 per gallon. So, during a biennium where forecast-to-forecast price adjustments were declining sharply, hedges were locked in below forecast – which achieved the price and budget stability desired. However, subsequent forecasts continued to decline.

Figure 3

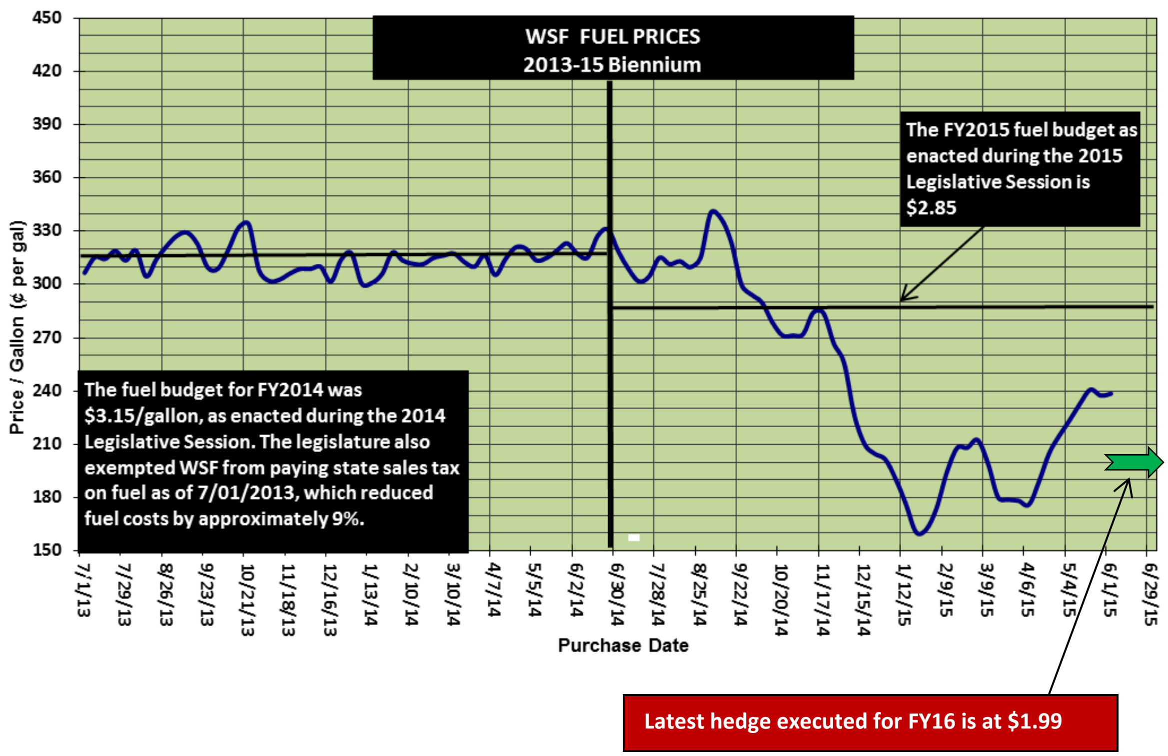


As opportunities arise, the department will be executing hedges at or below the adopted budgeted price for 2015-17.

Price History, 2013-15 Biennium

After remaining relatively stable in fiscal year 2014, volatility of prices reappeared and trended steeply lower. Prices for the biennium through June 1, 2015, are shown in Figure 4.

Figure 4



Prices decreased over fiscal year 2015 to relatively low levels because of an imbalance in global supply and demand where, over the last nine months of the fiscal year, the global petroleum market was oversupplied by 1.5 to 2.0 million barrels per-day, compared to global consumption of roughly 92 million barrels per-day. In addition to OPEC not reducing their output, the global oversupply was due to strong growth in domestic crude oil production, which increased from 5.5 million barrels per-day to 9.5 million barrels per-day over the prior four years. These factors caused petroleum inventory levels to grow to record high levels, which put downward pressure on price. In response to this new low-priced environment, domestic crude oil producers reduced the number of operating oil rigs in the U.S. from 1,600 to 650 between October 2014 and the end of 2013-15. This development has and will continue to reduce the rate of growth of domestic crude oil production, and may outright reduce production since some marginal operations became unprofitable. In addition to basic supply and demand fundamentals, there are many other factors that affect price, such as speculation, foreign political instability, the strength of the domestic and foreign economies, and the strength of the U.S. dollar.

Attachment A

Washington State Department of Transportation

Secretary's Executive Order Number: E 1078.03

Signature on file

Lynn Peterson
Secretary of Transportation

August 20, 2014

Date

Fuel Hedging Program

I. Introduction

A. Purpose

This Secretary's Executive Order informs employees how to administer fuel hedging in the Ferries Division.

B. Background

In 2011 the Washington State Legislature authorized the Washington State Department of Transportation (WSDOT) to enter into a distributor-controlled fuel hedging program for the biennium of 2011-13. In 2012 the Legislature expanded this authorization to include other methods of hedging approved by the fuel hedging committee. The department is required to consult with the Department of Enterprise Services' Master Contracts and Consulting Program on strategies to reduce the overall cost of fuel and mitigate the impact of market fluctuations and pressure on short-term and long-term fuel costs to the Ferries Division.

C. Definitions

Forward Pricing Period – The term of any fuel hedging contract.

Fuel Hedging – A contractual tool used to reduce exposure to volatile and potentially rising fuel costs. Fuel hedging results in price stability, not necessarily budget savings.

Fuel Hedging Program – The fuel price risk management program.

Hedge Ratio – The ratio of hedged fuel compared to total fuel purchases projected for a certain period of time.

Maximum Maturity – The maximum length of time that a fuel price contract may be extended.

D. Supersession

This Secretary's Executive Order supersedes and replaces the prior version with the same title dated October 3, 2013. All references to the superseded E 1078.01 now reference E 1078.02.

E. What Has Changed

- In I.D., references to the prior version title and date are updated.
- In III.A., language has been added authorizing the Assistant Secretary for Ferries Division or designee to enter into hedge contracts that meet the standard recommendation criteria without prior consultation with the Fuel Hedging Oversight Committee.
- In III.E., reference to Appendix A is added.
- Item III.I.1.c. has been added to provide direction to Ferries Division staff and the Program Advisor.
- Item III.J. has been added to define the purpose of the standard recommendation of the Fuel Hedging Oversight Committee and includes reference to Appendix A.
- Appendix A has been added.

II. Secretary's Executive Order

The Assistant Secretary for the Ferries Division or designee is directed to establish and maintain a fuel hedging program with the primary purpose of managing price risk on fuel used by the Ferries Division. The fuel hedging program will be carried out by the Ferries Division, executing the appropriate transactions at the appropriate times and prices to create the desired effect within policy constraints.

The objectives of the fuel hedging program are to:

- Decrease the volatility of fuel cost.
- Increase the likelihood that actual net fuel cost will remain below the budgeted cost.

Immediate cost savings is secondary to managing overall price risk.

Specific fuel hedging program strategies may include:

- Entering into financial contracts with hedge providers for specific quantities of fuel at specific times, using a specific index.
- Using price contracts with fuel distributors for quantities to be delivered at fixed times.
- Mitigating transaction timing risk by making numerous small volume transactions as opposed to large transactions at a single point in time.
- Continually monitoring the market and assessing program effectiveness.
- Addressing market opportunities and market risks based upon budget goals.

III. Policy

A. Program Administered by Ferries Division

The Assistant Secretary for the Ferries Division is responsible for administration of the fuel hedging program. The Assistant Secretary or designee may enter into hedge contracts that meet the Oversight Committee's standard recommendation criteria. The Assistant Secretary or designee may enter into hedge contracts that exceed the standard recommendation criteria with approval of the Fuel Hedging Oversight Committee.

B. Fuel Hedging Oversight Committee

The Fuel Hedging Oversight Committee shall meet at least quarterly, and includes the Assistant Secretary for the Ferries Division, the Chief Financial Officer, and a representative from the Office of Financial Management (OFM). The committee provides recommendations to the Assistant Secretary for the Ferries Division regarding hedge contracts. The committee reviews reports from Ferries Division staff and directs Ferries Division staff to provide information on program operations.

Ferries Division staff coordinates times, locations, and agendas for the committee. The committee reviews performance reports and policy and strategy recommendations from Ferries Division staff. The committee directs Ferries Division staff to provide additional information on program operations.

C. Fuel Hedging Program Advisor (Consultant)

The Fuel Hedging Program Advisor is selected by the department through a competitive process and will:

- Provide contracted services for a time period established by the department.
- Recommend an execution strategy.
- Generate monthly reports on the program's status and results.
- Monitor the program and energy markets.

The costs associated with the program advisor consultant position will be budgeted and accounted for separately from fuel purchases, but will be considered as part of Ferries Division's fuel budget.

D. Qualified Independent Representative

The Assistant Secretary for the Ferries Division or designee will designate one or more persons or entities that represent or otherwise demonstrate that they meet the requirements of a qualified independent representative as set forth in Title 17 Code of Federal Regulations (CFR) §23.450(b)(1) adopted by the Commodity Futures Trading Commission (CFTC) under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Ferries Division staff will review at the time of each fuel hedge transaction whether the persons or entities continue to represent or otherwise demonstrate that they meet these requirements. These requirements may be satisfied through representations or other evidence that the qualified independent representative (which may be the Fuel Hedging Advisor to the extent the Fuel Hedging Program Advisor provides these representations or other evidence):

- Has undertaken a duty to act in the best interests of the Ferries Division.
- Has sufficient knowledge and capability to independently evaluate Fuel Hedging.
- Has appropriate risk management and valuation policies and procedures under which the representative evaluates risks with regard to the relevant trade or trading strategy involving Fuel Hedging and the fair pricing and appropriateness of Fuel Hedging transactions.

- Has conflict of interest policies and procedures reasonably designed to manage and mitigate material conflicts of interest.
- Provides appropriate and timely disclosures to the Ferries Division, including disclosure of all material conflicts of interest that could reasonably affect the judgment or decision-making of the representative with respect to its obligations to the Ferries Division.
- Is independent of counterparties to Fuel Hedging transactions, and agrees to comply with restrictions on political contributions (if and when imposed by the CFTC).

E. Maximum Hedge Ratio

Ferries Division fuel consumption is highly predictable and without significant variability over time within a given service, schedule, and fleet. Given this predictability, the maximum hedge ratio will be:

- Up to the first twelve months, on a rolling basis, a maximum of 95 percent of the forecasted consumption may be hedged. In addition, hedges will not exceed the forecasted monthly consumption level for any specific month.
- Between the thirteenth and twenty-fourth months, on a rolling basis, the volume of fuel hedged will not exceed 80 percent.
- The Oversight Committee may set lower limits, including in consideration of potential service reductions. Current limits are set forth in Appendix A.

F. Biodiesel Hedging

Hedge ratios may be adjusted if Ferries Division's planned percentage of biodiesel changes significantly from a level of five percent, or if the price correlation between diesel and biodiesel diverges more than five percent from its historical average.

G. Maximum Maturity

To allow the establishment of cost certainty in current and future budget periods, the maximum maturity of any contracts entered into in conjunction with the program is twenty-four months. Contract terms may cross biennial lines.

H. Physical Fuel Supply

The physical supply of fuel will continue according to the current process of Ferries Division under the Department of Enterprise Services contract. The physical supply price is based on the Oil Price Information Service (OPIS) index for ultra-low sulfur diesel for Tacoma and Anacortes, with taxes and other costs determined by the supply contract.

I. Reporting Responsibilities

1. Ferries Division staff, along with the Program Advisor, will:

    a. Generate for the Assistant Secretary for the Ferries Division semiannual updates on the status and results of the Program. These updates will include:

    - The cost of fuel as delivered by the fuel supplier compared to prices that would have been available on the spot market.
    - Year to date and biennium to date performance of fuel expenses relative to the budget (including hedged purchases).
    - Any recommendations for changes in policy or strategy. These will also be reported by the Assistant Secretary for the Ferries Division to the Deputy Secretary for concurrence.

    b. Compile yearly reports required per Revised Code of Washington (RCW) 35.58.262. The reports will be distributed to the oversight committee prior to submittal to the state legislature.

    c. Generate for the Fuel Hedging Oversight Committee quarterly updates on the status and results of the Program. These updates will include:

    - Details of hedge contracts entered into to include the transaction amount, gallons hedged, transaction price per gallon, variance between transaction price per gallon and budgeted price per gallon, and variance between transaction amount and budgeted amount.
    - Comparison of projected fuel usage and actual fuel usage in gallons.
    - Current energy market conditions.

2. Accounting and Financial Services Division staff will:

    a. Review the accounting and financial reporting for derivative instruments for compliance with Governmental Accounting Standards Board (GASB) standards.

    b. Make appropriate entries to record deferred inflows and outflows of resources related to financial contracts.

    c. Prepare notes to the Comprehensive Annual Financial Report (CAFR) for financial hedging contracts as required by GASB 53.

J. Standard Recommendation

The Oversight Committee shall adopt a standard recommendation that authorizes the Assistant Secretary or designee to enter into hedge contracts without further approval of or consultation with the Oversight Committee. The parameters of the standard recommendation will be reviewed at least annually and incorporated in Appendix A to this policy.

IV. Contact for More Information

For more information on the Fuel Hedging Program, please contact the Deputy Chief for Administration and Finance of the Ferries Division at 206-515-3403.

V. References

- 17 CFR §23.450(b)(1) *Requirements for swap dealers and major swap participants acting as counterparties to Special Entities*
- RCW 47.60.830 *Ferry system operation — Fuel purchasing strategies — Report*
- RCW 35.58.262 *Transportation function — Fuel purchasing strategies — Reports*

VI. Appendix

A. Standard Recommendation adopted April 3, 2014

VII. Review and Update Requirements

When changes are necessary to update this document, inform the Chief Financial Officer. The Chief Financial Officer periodically reviews this document and proposes updates to the Secretary of Transportation for approval.

Americans with Disabilities Act (ADA) Information

This material can be made available in an alternate format by emailing the WSDOT Diversity/ADA Compliance Team at wsdotada@wsdot.wa.gov or by calling toll free, 855-362-4ADA (4232). Persons who are deaf or hard of hearing may make a request by calling the Washington State Relay at 711.

Appendix A: Standard Recommendation adopted April 3, 2014

- Up to the first twelve months, on a rolling basis, a maximum of 85 percent of the forecasted consumption may be hedged. In addition, hedges will not exceed the forecasted monthly consumption level for any specific month.
- Between the thirteenth and twenty-fourth months, on a rolling basis, the volume of fuel hedged will not exceed 70 percent.
- Individual hedging transactions in excess of 20 percent of total projected fuel consumption will not be permitted unless otherwise approved by the committee.
- The maximum maturity of any contracts entered into under the standard recommendation is twenty-four months. Contract terms may cross biennial lines.
- Transactions that cause the projected total hedged cost to exceed budget will not be permitted unless otherwise approved by the committee.
- The Committee will be notified immediately upon completion of any transactions executed under this standard recommendation.
- The Oversight Committee may set lower limits, including in consideration of potential service reductions.