TO: Business Board

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DATE: October 22, 2002 for November 11, 2002 meeting

AGENDA ITEM: 4

ITEM IDENTIFICATION:

Enabling Agreement with Ontario Power Generation for the supply of electricity to St. George, UTSC and UTM

JURISDICTIONAL INFORMATION:

The form of agreement standard to OPG is that of a derivatives trading agreement. However, University policy prohibits contracting for derivatives with a company having a credit rating less than "A". OPG has a credit rating of BBB+ (S&P). It is unlikely that any other major electricity vendor would be able to achieve the credit rating requirement of the Policy.

PREVIOUS ACTION TAKEN:

None

HIGHLIGHTS:

The Ontario electricity market was deregulated on May 1, 2002. As part of a group of 14 Ontario universities, the University of Toronto was involved in tendering for the most favourable fixed price contract for the supply of electricity. The submission from Ontario Power Generation (OPG) had the most beneficial terms.

FINANCIAL AND/OR PLANNING IMPLICATIONS:

With deregulation of electricity prices, the University intends to enter into a fixed price contract with OPG to reduce budget uncertainty. The structure of the OPG contract has proven to be problematical. Instead of a simple purchase contract to buy electricity at a specific price, the contract is structured as a spot purchase combined with a financial derivatives hedge. This is apparently the only form of contract available to commercial customers in Ontario.

The contract requires that the customer acknowledge that it is a derivatives contract and that all of the attendant risks of such contracts are understood, as required by Ontario Securities Commission regulations.

The university's derivatives policy requires that counterparties have a credit rating not lower than A. OPG's credit rating is currently BBB. Therefore an exception to the policy is required.

The credit rating limit is required because a contract is only as good as the ability of the counterparty to meet its obligations. An A limit is common even with financial institutions that have a competence and focus on these matters.

The situation with OPG is particularly problematical since not only are they the hedge counterparty, but also the major electricity producer. OPG will have limited means to hedge their own position on these contracts. This is an inherently risky situation – financial institutions typically offset their own position within reasonable limits. From history, institutions that run long dated hedges without offsets have typically become insolvent. We therefore risk the situation that that the more the hedge is in the university's favour the more we run the risk of default on the hedge contract.

Nevertheless, as previously stated the market is only offering firm priced contracts structured in this manner. We are negotiating with OPG to mitigate our concerns. In essence we have traded price risk on electricity for credit risk on OPG. The request for this exception to policy is requested assuming that we can arrive at a satisfactory solution to our concerns regarding the derivative nature of the contract.

RECOMMENDATION:

It is recommended that the Business Board approve:

THAT for the purposes of negotiating a fixed commodity price electricity supply agreement an exemption to the usual minimum credit rating requirement be granted to the Vice-President – Business Affairs.