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Policies and Procedures

No. 59

SUBJECT:

Board Approval: 11/10/2016

Natural Gas and Energy Commodity Hedge Policy

PURPOSE

The purpose of this policy (the “Policy”) is to establish guidelines for the execution and management of the Metropolitan Transit System’s (“MTS”) use of hedging instruments and related transactions in connection with the purchase of natural gas and electrical energy for MTS’s transit operations.

Specific objectives of the Policy are as follows:

1. Achieve a high degree of budget certainty in the purchase of natural gas and energy commodities.
2. Maintain a high degree of fuel and energy supply reliability.
3. Ensure no adverse operational impacts.
4. Ensure no adverse impacts on MTS’s credit rating.
5. Ensure that all hedging instruments are acquired through competitive bidding with credit-worthy counterparties.

This policy confirms the commitment of MTS management to adhere to sound financial and risk management practices. The Policy shall govern the execution and management of all hedging instruments and activities carried out in connection with natural gas and energy purchases for MTS’s transit operations.

59.1 AUTHORIZATIONS AND APPROVALS

The Chief Executive Officer and Chief Financial Officer are the designated administrators of the Policy (“Hedge Administrators”) and are authorized to execute hedges in accordance with this Policy without further approval of the Board.



59.2 CONDITIONS FOR THE USE OF HEDGING PRODUCTS

59.2.1 General Usage

Financial commodity swaps may be used to lock in a fixed price for natural gas and energy commodities in accordance with the conditions and restrictions set forth below. Should MTS elect to purchase gas or electricity from a qualified energy services provider (“ESP”), MTS may accomplish its commodity hedging objectives by converting the price of an ESP-provided energy supply from a variable market price to a fixed price so long as the competitive bidding and other provisions of this Policy are met.

59.2.2 Maximum Transaction Volume

The maximum aggregate transaction volume for all financial commodity swaps entered into for any budget year shall be equal to the volume of natural gas or energy forecast to be used in connection with the transit fleet during that year. If, at any time prior to or during the fiscal year being hedged, the projected volumes change by more than 10% below or above the amount hedged, additional hedges may be entered into, or termination of existing hedges may be executed in order to account for the change in projected volume.

59.2.3 Hedge Frequency

The number of hedge transactions for any fiscal year shall be no greater than four as determined by the Hedge Administrators except as may be required in response to a change in the volume of fuel or energy projected as provided in Section 59.1 above.

59.2.4 Hedge Timing

Hedging instruments shall be entered into no sooner than 30 months in advance of the first business day of the fiscal year being hedged. All hedges for any fiscal year will be in place in advance of the annual budget submission to the Board of Directors for that fiscal year.

59.2.5 Hedge Termination

The Hedge Administrators may terminate any and all hedges in whole or in part in response to changes in the projected volume of fuel or energy in any fiscal year as provided in Section 59.1 above or if required due to any action by the California Public Utilities Commission or the San Diego Gas and Electric Company, which impacts the effectiveness of the hedge. Under no circumstance will hedges be terminated for the sole purpose of generating a profit.

59.2.6 Hedge Term

All hedging instruments will be limited in term to 24 months.

59.2.7 Prohibited Commodity Swap Features

The MTS will not use commodity swaps that: (i) involve any purpose other than hedging natural gas or energy commodity prices as set forth in this Policy; (ii) lack adequate liquidity to terminate without incurring a significant bid/ask spread; (iii) provide insufficient price transparency to allow reasonable valuation; or (iv) are used as investments.

59.3 HEDGE INSTRUMENT FEATURES

59.3.1 Hedge Agreement

The International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement shall be used as the basis for the documentation of commodity swaps. The swap agreement between the MTS and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as MTS, in consultation with its legal counsel, and/or hedge advisor deems necessary or desirable.

If MTS takes part in SDG&E’s CAT Program for natural gas purchases, or becomes a Direct Access customer for electric energy purchases, the hedging objectives of this policy may be met by execution of an appropriate amendment to the relevant Purchase and Sale Agreement entered into with a qualified ESP.

59.3.2 Commodity Swap Counterparty Credit Criteria

Qualified commodity swap counterparties will be those having, at the time of execution, a general credit rating not lower than “A3” or “A-” by at least two of the nationally recognized rating agencies, unless such party provides a guaranty from a parent or other guarantor rated “A3” or “A-”. The nationally recognized rating agencies are Moody’s Investors Services, Inc., Standard and Poor’s, and Fitch Ratings.

59.3.3 Collateral Requirements

Threshold collateral amounts shall generally be established in accordance with the guidelines set forth below.

Counterparty Credit Rating	Threshold
Aa3/AA- or better	Unlimited
A3/A- to A1/A+	\$25 million
Baa1/BBB+	\$15 million
Baa2/BBB	\$10 million
Baa3/BBB-	\$2.5 million

Collateral shall be deposited with a third-party custodian or as mutually agreed upon between MTS and the counterparty. A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty. Once collateral has been posted, the market value of the collateral shall be determined at

least weekly.

59.3.4 Security and Source of Repayment

Commodity swaps will be payable from any lawfully available funds of MTS. Whenever possible, language will be included in the swap agreement specifying that with respect to farebox revenues, swap obligations of the MTS are payable on a basis subordinate to the payment of MTS taxable pension obligation bonds, certificates of participation, or any other obligation secured on a parity therewith.

59.4 SELECTING AND PROCURING COMMODITY SWAPS

59.4.1 Counterparty Selection

Commodity swap counterparties will be selected by the Hedge Administrators consistent with the credit and performance criteria set forth in this Policy.

59.4.2 Competitive Bidding

All hedge instruments will be procured through a competitive bidding process that will provide the lowest commodity price. The nature and timing of the bidding process will be determined by the Hedge Administrators.

59.5 SALE OF ENERGY CREDITS

59.5.1 Energy Credit Sales on Open Market

MTS's use of energy sometimes results in the generation of energy credits such as California Air Resources Board (CARB) Low Carbon Fuel Standard (LCFS) credits, federal Renewable Fuel Standards credits and other existing or future credit programs. The disposition and sale of such credits is often the subject of a formal contract for the purchase of energy commodities (e.g., electric, diesel, gas). However, from time to time, MTS may be in possession of credits that are not the subject of an existing agreement. The market for energy credits fluctuates substantially on a day-to-day, month-to-month and year-to-year basis.

In order to capture the best price in a fluctuating market, the CEO has the authority and discretion to sell unallocated energy credits on the open market.

59.6 MONITORING, REPORTING, AND DISCLOSURE

59.6.1 Quarterly Reporting

The hedge program will be monitored to ensure consistency with this Policy. Annual and quarterly reports will be provided to the MTS Board of Directors in written form which shall include, but not be limited to, the following:

- (a) A description of all outstanding commodity swaps, including terms, rates paid and received, and current termination value.
- (b) Current counterparty credit ratings.
- (c) Collateral required and posted by MTS and each commodity swap counterparty, if any.
- (d) Any material event involving outstanding swap agreements, including a default by a commodity swap counterparty, counterparty downgrade, or termination.
- (e) Updated projection of the volume of fuel or energy expected to be required for operational purposes and compared to the volume hedged.
- (f) Description of any regulatory changes, including changes in the energy-pricing methodology of the California Independent Systems Operator (CAISO) or changes to San Diego Gas and Electric's hedging practices, which may impact the hedge program.

59.6.2 Disclosure and Financial Reporting

Steps will be taken to ensure that there is full and complete disclosure of all commodity swaps to the Board. With respect to its financial statements, MTS adheres to the guidelines for the financial reporting of commodity swaps as set forth by the Government Accounting Standards Board.

59.6.3 Disclosure of Energy Credit Sales

Any sale of energy credits by the CEO under the authority granted in Section 59.5 shall be reported as part of the monthly Operations Budget Status Report at the next applicable Board of Directors meeting.

REVISED: 11/10/1016
ADOPTED: 2/18/2010