Item No. 11.1

Audit & Finance Standing Committee
January 16, 2013

TO:	Chair and Members of the Audit & Finance Standing Committee
	Original Signed
SUBMITTED BY:	Councillor Barry Dalrymple, Chair, and Members of the Environment and Sustainability Standing Committee
DATE:	January 13, 2013
SUBJECT:	**East Port District Energy Project**

ORIGIN

On April 17, 2012, Regional Council requested that following HRM's meeting with stakeholders, the information on the East Port District Energy project be forwarded to the Environment and Sustainability Standing Committee for review and recommendation.

On June 7, 2012, the Environment and Sustainability Standing Committee requested that staff report on the role HRM should play in fostering district energy projects and provide information on district energy best practices from other Canadian Municipalities.

On September 6, 2012, the Environment and Sustainability Standing Committee requested a supplementary report from staff addressing issues and opportunities raised in East Port Energy's September 6, 2012 presentation, including discussion with the potential partners on this project.

On January 10, 2012, the Environment and Sustainability Standing Committee considered this matter and approved a resolution.

RECOMMENDATION

The Environment and Sustainability Standing Committee recommend that the Audit and Finance Standing Committee recommend to Regional Council that HRM recognize the unique opportunity to enable a district energy system for the municipality and identify the East Port District Energy Project as a 2013-14 capital project to be taken to the next stage of development as per the specific instructions of the Environment and Sustainability Standing Committee listed below:

Council will ask staff to analyse the proposal and develop options for Council with the objective of:

- Ensuring the project has technical merit;
- Minimizing the financial risks to the taxpayers; and
- Providing sufficient return on any investment to prevent the general tax rate from subsidizing the project.

In advancing the project, Council will undertake to:
1) Instruct staff
a. To work with East Port Energy and proposed partners (Emera and Alta Gas), and the Province of Nova Scotia to confirm the project scope and timeline, to identify equity/governance models and to draft a partnership and governance agreement that takes into account HRM's interests ;
b. Produce draft documents necessary to advance the project including a development and management agreement between the parties and other documents as are reasonably required;
c. Begin work to get enabling legislation as required for HRM investment and provincial district energy regulations in place including the ability to borrow funds for this project;
d. Report back within one month with respect to a draft partnership and governance agreement and identify project milestones for Council's consideration in 2013/14 based on the tasks outlined above.
2) Approve investing up to $300,000 in 2013-14 to enable the due diligence required to fully explore the proposed district energy project. Due to the urgency of project timing, instruct staff to propose options for immediate interim funding for the project;

In order to facilitate consideration of this motion, the Environment and Sustainability Standing Committee requests that this motion be forwarded to the Audit and Finance Standing committee meeting of January 16, 2013 for consideration and recommendation to Regional Council on January 29, 2013.

BACKGROUND

East Port Energy, a consulting firm based in HRM and a division of East Port Properties, has approached HRM with a proposal to develop a district energy project for downtown Halifax. The proposal is to construct a facility that would provide electrical power from a natural gas boiler and recycle the waste heat from the boiler to provide hot water for district energy heating. As well, the facility would use sea water for district energy cooling. The heating and cooling water would then be distributed to commercial customers in downtown Halifax.

East Port Energy has proposed that the HRM be an equity partner in the project with a 25% equity stake. Given the scale of the project, the proposed equity share would imply a $28 million to $37 million investment by HRM. The other equity partners would be Emera (50%) and Alta-Gas (25%). The Province of Nova Scotia is expected to assist in the project by providing interim financing during the construction and start-up phase of the project. The Province would also be a key partner in the development of legislative changes that may be required.

In the initial East Port proposal, the returns are estimated to be 9% to 10% for the private investors, while HRM's returns would be capped at only 4.0%, plus property tax and encroachment fee revenue. As outlined in the August 30, 2012 staff report, this return is expected to cover HRM's interest costs and direct incremental project expenses, but would not provide sufficient returns to repay the original investment. As an investment alone, the proposal would not meet the requirements of HRM's current Investment Policy.

There are also legislative and governance issues that would need to be addressed. For example, there is no precedence or legislation to outline how HRM could partner with for-profit corporations on such a system. There is also no legislation permitting HRM to borrow funds for construction of facilities primarily owned by private sector entities. With respect to governance, HRM would be a minority shareholder with the future direction of the entity almost entirely outside of its control. As such, HRM Council would be unable to direct the activities of the corporation and would be fully subject to the business decisions of the Board of Directors.

For these reasons, staff recommended in the August 30, 2012 report that HRM not invest in the project and limit its involvement to providing expedited and efficient support with respect to municipal mandated services and requirements such as easements, permits, planning, project and utility coordination, and any other regular municipal service required.

DISCUSSION

As directed by the Environment and Sustainability Standing Committee, staff re-examined the financial issues which appear to be a barrier to HRM participating as an equity partner. One of the assumptions used by East Port in their financial model was that property taxes and encroachment fees payable to HRM would average close to $1 million annually over the twenty year debt financing period. Staff has now confirmed that there would be no significant increase in property taxes attributable to this project because Section 18(2) of the Nova Scotia Power Privatization Act exempts Nova Scotia Power (a subsidiary of Emera) from taxation by a municipality, with the exception of deed transfer tax. Also, HRM would not be able to tax the distribution pipes as they would be in the street right-of-way. With respect to encroachment fees, the nominal amounts HRM is charging in new agreements are only a small fraction of what East Port assumed in their financial model.

Removing almost $1 million in annual on-going operating expenses from the financial model allows HRM's return to increase from 4.0% to 8.5% without compromising the returns required by the private investors under the "Reduced Build" scenario of the financial model. This rate of return would be adequate to cover HRM's interest costs and direct incremental project expenses, and still provide sufficient returns to repay the original investment. Therefore, a capped return of 8.5% should be required as a condition for HRM to become an equity partner in this project.

East Port's financial model assumes a list of specified potential customers will link up to the new district energy service. The failure of some of these customers to do so would significantly impact investor returns. This is a significant risk inherent in this project. Staff reviewed the list of potential customers under the "Reduced Build" scenario of the financial model with East Port to determine the likelihood of each customer linking up. The "Reduced Build" scenario is an appropriate scale for the projected client base at start up. The total project cost is estimated to be $112.7 million for the "Reduced Build" and $148.5 million for the "Full Build" scenario. The "Reduced Build" has a smaller distribution network, with 2,100 metres of piped system vs 4,100 for the "Full Build" scenario. Factors considered were new construction (i.e. Central Library, Nova Centre) and need for replacement of existing heating and cooling systems in the near future (i.e. Dalhousie University).

Sensitivity to District Energy Client Base and Tax Treatment

Revenues from the proposed project would be affected by the number and size of the client base connecting to the new district energy system. The business case is developed on a conservative estimate of eleven (11) customers connecting to the new system. A sensitivity analysis was done, using the financial model developed for the project by East Port Energy. A "worst case" analysis was done looking at the impact of signing up only three customers to the system – Dalhousie's Sexton Campus, the new Central Library and the Nova Centre – over the 25-year period. East Port Energy would only recommend that the project proceed with a minimum number of energy contracts in place. This scenario showed lower than desired returns for private investors, and a break-even result for HRM, assuming payback of equity over 20 years at a 4% interest rate. This is in contrast to the 11-customer "reduced build" scenario, which indicated an $8+ million net present value. [Note: this cash flow analysis assumes a rebate of HRM income taxes paid; should the rebate not happen, the net present value would reduce below $3 million.]

While HRM's participation in this project as an equity partner may be financially feasible with a capped return of 8.5%, there are still legislative and governance issues to consider. Considering the magnitude of the investment required this would be a very significant move into a new line of business for which HRM has little expertise. Legislative changes would also be required to permit HRM to partner with the private sector on a project such as this, and to debt finance an asset that would be majority owned by the private sector. As a minority shareholder, HRM Council would be unable to direct the activities of the corporation and would be subject to the business decisions of its Board of Directors.

To complete the work as directed by the Environment and Sustainability Standing Committee, staff will need to hire external resources as there are not sufficient resources to complete the work in the required time; neither do staff have sufficient experience nor expertise in negotiating a partnership arrangement as proposed.

BUDGET IMPLICATIONS

As outlined in this report, a capped return of 8.5% would be sufficient to cover interest costs, direct project expenses, and debt payments for the "reduced build" scenario, even with a minimal district energy client base. While HRM would experience negative cash flows due to carrying costs for the first two to five years (until construction completion), these would be recovered from projected energy sales revenues that follow. The cumulative carrying costs (of less than $2 million) in the first five years of the project will be funded in the project budget following confirmation of these amounts in the next phase of work. The financial model indicates a $25-million debenture requirement for the 11-customer "reduced build" scenario, at the end of year five, which HRM could finance over 20 years.

FINANCIAL MANAGEMENT POLICIES/BUSINESS PLAN

This report complies with the Municipality's Multi-Year Financial Strategy, the approved Operating, Project and Reserve budgets, policies and procedures regarding withdrawals from the utilization of Project and Operating reserves, as well as any relevant legislation.

COMMUNITY ENGAGEMENT

Community engagement will follow any decision by Council to proceed with the project.

ENVIRONMENTAL IMPLICATIONS

Details of the environmental implications were provided in the August 30, 2012 staff report to the Environment and Sustainability Standing Committee.

ALTERNATIVES

The Audit and Finance Standing Committee could decide not to recommend to Council that HRM not provide funding for this project. In that case, all work would need to be performed by internal staff. This would create significant risk to the project time lines and/or outcomes. As well, staff do not have sufficient expertise in negotiating such specialized arrangements.

ATTACHMENTS

N/A

A copy of this report can be obtained online at http://www.halifax.ca/boardscom/SCenv/index.html then choose the appropriate meeting date, or by contacting the Office of the Municipal Clerk at 490-4210, or Fax 490-4208.

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