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HALIFAX
REGIONAL MUNICIPALITY

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June 22, 2004
Halifax Regional Council

TO: Mayor Kelly and Members of Halifax Regional Council

SUBMITTED BY:

George McLellan, Chief Administrative Officer

Dan English, Deputy Chief Administrative Officer

DATE: June 22, 2004

SUBJECT: **Halifax Harbour Solutions Permanent Long Term Debt Financing**

ORIGIN

In Camera report and recommendation approved at the May 25, 2004 Regional Council meeting. The necessity to put in place permanent financing for the Harbour Solutions Project.

RECOMMENDATION

IT IS RECOMMENDED THAT

1) The Mayor and Municipal Clerk be authorized to sign the attached Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate confirmation, not to exceed 6.5%, to enable the Halifax Regional Municipality to immediately issue a debenture in the amount of $110,000,000 to the Nova Scotia Municipal Finance Corporation.

2) Issue costs for this debenture to be paid from the Environmental Protection Levy.

BACKGROUND

At the May 25, 2004 meeting of Regional Council, resolutions were approved for the immediate placement of long term financing for the Halifax Harbour Solutions Project in the amount of $110,000,000 with staff to return to Council with a recommendation for the financing package and lender on June 15.

A subsequent Information Report to June 8 Regional Council requested that this matter to be deferred to the June 22 meeting.

Staff was authorized to conclude negotiations with the Nova Scotia Municipal Finance Corporation (MFC) for the provision of the financing on an unhedged basis and also negotiate with Stonebridge Financial Corporation for financing on a hedged tranche basis. These parties were recommended as a result of an Expression of Interest (EOI) process initiated by staff.

Staff has also been in negotiations with the Federation of Canadian Municipalities with respect to the HRM application for a $20,000,000 loan from the Green Municipal Investment Fund.

DISCUSSION

Permanent Long Term Debt Financing Required

Staff is pleased to confirm that the amount of permanent long term debt financing required for the Harbour Solutions Project is $130,000,000. A summary of how this amount was arrived at follows:

Harbour Solutions Project
Financial Summary

		(all figures millions)
Amount to be financed		
Total net project costs from inception to end of construction		$ 332.7
Less: Amounts already paid		
Total cash expenses to date	$ 25.9	
Less: holdbacks payable	0.9	$ 25.0
Amount to be financed		$ 307.7

Source of funding

Government of Canada: original CSIF funding (before Watershed Protection Program)	$ 30.0
Nova Scotia cash contribution during construction period	10.0*
Environmental Protection Levy Collections during construction period	52.2
Potential short term debt to be repaid from Environmental Protection Levy	2.5
Long term debt	130.0
Environmental Protection Reserve	83.0
* Balance of $20 million commitment will be applied to service long term debt.	$ 307.7

Long term debt

N.S. Municipal Finance Corporation	$ 110.0
Federation of Canadian Municipalities: Green Municipal Investment Fund	20.0
	$ 130.0

Negotiation and Selection Process

Staff has conducted negotiations with all of the parties approved at the September 23, 2003 meeting of Regional Council identified through the Expression of Interest (EOI) process, including the Nova Scotia Municipal Finance Corporation (MFC). Based on quantitative analysis of the proposals, the three proposals offering the lowest cost plus MFC were selected for more detailed negotiations. In addition the other three proponents were offered the opportunity to make new submissions. The staff report to the May 25, 2004 In Camera Council reduced the number of proponents under consideration to two.

Since any debt structure chosen must be approved by the Minister of Service Nova Scotia and Municipal Relations, staff has met frequently with provincial staff from a number of departments to seek direction as well as keep provincial staff updated on the various structures proposed and the structure preferred by HRM staff.

Initially the financing model for the Halifax Harbour Solutions Project projected a series of cash flows which culminated in the necessity to borrow at various times. The optimum timing for borrowing was as follows:

September 30, 2005	$40 Million
May 31, 2006	$40 Million
October 31, 2007	$30 Million

Respondents to the EOI were challenged to come up with Financing proposals that would be demonstrably superior to what would be available to HRM through the MFC. Given that bonds issued by the MFC carry the guarantee of the Province of Nova Scotia, this was indeed a formidable task. Certain respondents chose to withdraw during the review process and staff wish to thank them for their candor. Others offered unique and creative solutions that were not a good "fit", in staff's opinion, for HRM in terms of cost, risk and / or legal impediments. These were discussed in the confidential report to the May 25, 2004 In Camera Regional Council.

Due to the complex nature of the financing proposals received, staff have used the services of specialists at KPMG to conduct certain procedures on the financial models prepared by staff as well as assist in the negotiations. The law firm of Cox Hanson also provided assistance to staff.

Staff's concentration during the EOI process was not to speculate on where interest rates would go in the future. Instead, staff has concentrated on ensuring that the Environmental Protection Levy (EPL) rate set for this Project would not be negatively impacted by Project Financing Costs. Throughout the process staff have been guided by the principle of providing financing with a predictable cost and impact on the EPL rate at a minimum of risk.

While a variety of terms for the borrowing were available, staff are recommending a term of 20 years with interest rates locked in for the entire period over the term of the financing. Sufficient funds are available from the current Environmental Protections Levy component of the Pollution Control Charge to service debt of this term. By paying off the debt in this relatively short period of time, funds will be freed up in the future to better respond to any changes in Regulations, enhance treatment facilities, take on new projects, etc. In addition, an equal principal payment structure favored by staff would result in a decreasing demand on the Environmental Protection Levy during the term of the borrowing.

Overview of Financing Approaches Considered

There are basically three potential options when it comes to the financing of this Project, each with its advantages and disadvantages:

1) Borrow only when funds are required in the future. The principal disadvantage is that the cost of these funds cannot be known now as it will depend on borrowing rates in the future. This will expose the Environmental Protection Levy rate to financing cost risk.

2) Use hedging products to lock in the cost of borrowing at today's interest rates while actually receiving the funds at pre-arranged dates in the future. The principal financial disadvantage here is the cost of the hedge product.

3) Funds can be borrowed now at current rates and invested until required in the future. The principal disadvantage is that funds received in advance would be invested at lower rates than would be paid on the borrowed funds. In addition, this will subject the financing model to earlier than anticipated permanent debt payment financing costs thereby reducing the amount of capital cost funded by the monthly collections through the EPL.

In assessing Option 1 versus Option 2 the critical factor is whether, on average, market interest rates available to HRM in the future will result in a financing cost greater than the cost of the hedge. This cannot be determined until after all of the financing costs are put in place and with hindsight. Option 2, in effect, includes an insurance policy that provides for the cost of borrowing and the impact on the EPL rates to be known now.

Option 3 imposes a cost in the form of the difference between what is paid in interest on the funds borrowed in advance versus what can be earned on these funds through investment (referred to as "negative carry").

Hedged Tranche Structure Evaluation

Staff has been advised by Provincial Staff that neither the Province nor the Municipal Finance Corporation have in place the necessary legislation to put in place a hedge for interest rates for the borrowing requested by HRM. Rather, the position taken is that a Municipality, in this case the HRM, requires new legislation. HRM staff maintains their opinion that the facility for hedging should be provided for within the MFC and be transparent to the Municipality.

Although the HRM has received special legislation for Financing this Project, in the absence of a specific provision for hedging, the legal advisor for the HRM has questioned whether HRM has the legal capacity to engage in hedging transactions directly.

It should be noted that Stonebridge Financial Corporation has offered an innovative hedged tranche solution whereby HRM would not be a direct party to the hedge. Unfortunately the cost of the underlying debenture through this private placement combined with the hedge cost is greater than the cost of the "Borrowing Up Front Structure" offered by MFC. Using the proponents submissions as at March 10, 2004, the cost difference in these two approaches is approximately $9.7 million on a net present value basis. Staff has no reason to believe that the relative cost difference between these two approaches would have substantially changed. The hedged tranche solution would eliminate any risk of the Project Financing possibly being in a deficit position for short periods of time.

Borrow up-front Structure Evaluation

As a result of apparent restrictive legislation, the only option remaining for the HRM through the MFC is to borrow the full amount of $110,000,000 up front. Although, largely, this achieves the objective of staff to fix the financing costs for this project, it will subject the financing model to earlier than anticipated permanent long term debt financing costs thereby reducing the amount of capital cost funded by the monthly collections through the EPL. Based upon current projections, there will be periods where the Project Financing will be in a deficit position in the short term. To mitigate this, staff is recommending going to the short term money market through the issuance of Banker's Acceptances. This would provide the bridge financing now necessary due to the inability to put in place a hedge and draw down funds on the dates and amounts listed above. The bridge financing may not be necessary should projected cash flows change.

As previously discussed, borrowing in advance of the cash requirements of the Project will result in a cost in the form of the difference between the interest that will be paid on the funds borrowed versus the interest that may be earned on the funds borrowed in advance (referred to as "negative carry").
Based on current estimated interest rates for borrowing as well as interest rates that may be available for the investment of funds, staff estimates the "negative carry" cost to be approximately $3,500,000. Actual costs will only be known once funds are borrowed and all the resulting investments mature.

While the above figure for "negative carry" is certainly considerable the impact of potential future changes in interest rates is also consequential. Based on a 20-year amortization of the $110,000,000 borrowing, a 1% increase in interest rates will result in an increase of $11,550,000 in interest payments over the term of the borrowing. While it is not the position of staff to speculate on the future course of interest rates, the Graph attached of long term Government of Canada Bond Yields indicates the relative level of today's interest rate environment compared to past levels. This is indicative of current borrowing rates relative to recent history.

As previously stated in this report, based on proponents responses as at March 10, 2004, the difference, on a net present value basis, of the hedged tranche versus the borrow up front structure is approximately $9.7 million. As such the staff recommended option provides the best overall cost and predictability for the overall financing.

Conclusion

Staff has determined that borrowing immediately through the MFC with the resultant "negative carry" is the more cost effective method of meeting the goal of providing financing with a predictable cost and impact on the Environmental Protection Levy (EPL) rate at a minimum of risk versus borrowing through Stonebridge Financial Corporation on a hedged tranche basis. While informally advised the Province has approved our borrowing, we are awaiting formal notification.

Throughout staff's discussions with staff of the Provincial Departments of Finance and Service Nova Scotia and Municipal Relations, consideration has been given to possibly lending funds to the Province of Nova Scotia. Provincial staff has now expressed a desire to borrow those funds raised through the issue of bonds through the MFC that would not be required for Project expenditures in the near term. Initial discussions are that the interest that would be paid on funds borrowed by the Province of Nova Scotia would be at market rates given the credit rating of the Province of Nova Scotia and MFC. Any investment would be in accordance with the HRM Investment Policy. Any additional investments requested by the Province of Nova Scotia above the current limits set out in the HRM Investment Policy would require specific approval by Council and would require Investment Policy changes.

HRM staff will conduct discussions on this with staff of the Province of Nova Scotia and report back to Regional Council on the details of this arrangement including a formal agreement.

Approval of the staff recommendation authorizing the Mayor and Municipal Clerk to sign the attached Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate will commit Council to the borrowing subject to an interest rate ceiling of 6.5% which is the same interest rate used in the recent Spring Debenture issue.

BUDGET IMPLICATIONS

The cost to put in place and repay the amounts borrowed will be covered by the current Environmental Protection Levy component of the Pollution Control Charge.

FINANCIAL MANAGEMENT POLICIES/BUSINESS PLAN

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

ALTERNATIVES

1) Council could direct staff to only borrow when funds are required for project payments in the future at the then prevailing interest rates. Staff does not recommend this alternative as it would expose the Project Financing and the resulting Environmental Protection Levy rates to future borrowing cost risks.

ATTACHMENTS

1. Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate
2. Appendix A - Estimated Cost in "Today's Dollars" and Imputed Interest Rates of the two fina
3. Graph of Historical Government of Canada Long Term Bond Yields

Additional copies of this report, and information on its status, can be obtained by contacting the Office of the Municipal Clerk at 490-4210, or Fax 490-4208.

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Resolution for Pre-Approval of Debenture Issuance Subject to Interest Rate.

WHEREAS Section 91 of the *Municipal Government Act* provides that a municipality is authorized to borrow money, subject to the approval of the Minister of Service Nova Scotia and Municipal Relations;

AND WHEREAS the resolution of council to borrow was approved by the Minister of Service Nova Scotia and Municipal Relations as follows:

Resolution Number	Purpose	Ministerial Approval Date
03/04-02	Harbour Solutions - Wastewater Facilities and Stormwater Systems	October 30, 2003

AND WHEREAS clause 91(1)(b) of the *Municipal Government Act* authorizes the council to determine the amount and term of , and the rate of interest, on each debenture, when the interest on a debenture is to be paid, and where the principal and interest on a debenture are to be paid;

AND WHEREAS clause 91(2) of the *Municipal Government Act* states, that in accordance with the *Municipal Finance Corporation Act,* the Mayor and Clerk or the person designated by the Council, by policy, shall sell and deliver the debentures on behalf of the municipality at the price, in the sums and in the manner deemed proper;

BE IT THEREFORE RESOLVED

THAT under the authority of Section 91 of the *Municipal Government Act,* the Halifax Regional Municipality borrow by the issue and sale of debentures a sum or sums not exceeding $110,000,000 for a period not to exceed 20 years, subject to the approval of the Minister of Service Nova Scotia and Municipal Relations;

THAT the sum be borrowed by the issue and sale of debentures of the Halifax Regional Municipality in the amount that the Mayor and Clerk or the person designated by the Council deems proper, provided the average interest rate of the debenture does not exceed the rate of 6.5%;

THAT the debenture be arranged with the Nova Scotia Municipal Finance Corporation with interest to be paid semi annually and principal payments made annually;

THAT this resolution remains in force for a period not exceeding twelve months from the passing of this resolution.

THIS IS TO CERTIFY that the foregoing is a true copy of a resolution duly passed at a meeting of the Municipal Council of the Halifax Regional Municipality held on the day of , 2003

GIVEN under the hands of the Mayor and Municipal Clerk and under the Corporate Seal of the Halifax Regional Municipality, this ________ day of _______________, 2003.

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Mayor

____

Municipal Clerk

Appendix A

Summary of Financing Proposals in "Today's Dollars" and Imputed Interest Rates

Proponent	**Hedged Solution with Tranche Structure -** Estimated Cost in "Today's Dollars" *	**Hedged Solution with Tranche Structure -** Imputed Interest Rate*	**Borrow All Funds Required in Advance -** Estimated Cost in "Today's Dollars" *	**Borrow All Funds Required in Advance -** Imputed Interest Rate*
Nova Scotia Municipal Finance Corporation	N/A	N/A	$119,782,000	4.30%
Stonebridge Financial Corporation (Hedged Solution)	$129,538,000	6.26%	$126,676,000	4.93%

* The above figures have been calculated using proponent's submissions as at March 10, 2004. Therefore the actual costs will only be known when the borrowing has been placed and the legal agreements are in place and fully executed.

30 Year Government of Canada Bond Yields
January 3, 1990 to June 9, 2004