
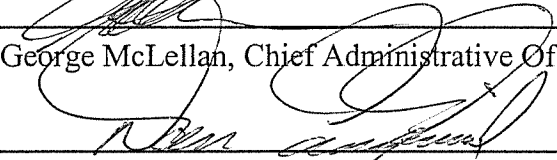


Halifax Regional Council
June 28, 2005

TO: Mayor Kelly and Members of Halifax Regional Council

SUBMITTED BY:


George McLellan, Chief Administrative Officer


Dan English, Acting Chief Administrative Officer

DATE: June 21, 2005

SUBJECT: Alderney Gate Acquisition - Financing

ORIGIN

This report originates with the Regional Council March 22, 2005 motion authorizing the Mayor and Municipal Clerk to exercise the Option to Purchase 40 Alderney Drive, Dartmouth, under the terms of the Ground Lease dated September 14, 1988 between City of Dartmouth and City Centre Limited, and to enter into an Agreement with Sun Life Assurance Company of Canada, subject to the terms and conditions set out in the March 22, 2005 Council Report.

Staff committed to return to Council subsequent to the purchase price being finalized, with recommendations on long-term financing of the acquisition and required budget increases.

RECOMMENDATIONS

It is recommended that Council:

1. Approve an increase to the 2005-06 Capital Budget through the creation of a Capital Project - Alderney Gate Acquisition, with funding to be provided from debt, as per the Budget Implications section of this Report.
2. Not release this Report until the transaction has closed.

BACKGROUND

Alderney Gate was built in 1988 / 1990 through a development arrangement that included a long-term municipal accommodation commitment of approximately 65,000 square feet under lease for 65 years, until 2055. The land on which the building sits is owned by HRM and the building complex is currently owned by Sun Life Assurance Company of Canada.

The Ground Lease between City of Dartmouth and City Centre Limited provided an option to purchase the building at May 2, 2005 or at May 2, 2020. Based on the March 22, 2005 Council approval, HRM served notice of its intent to exercise the May 2005 option to purchase. Under the terms and conditions of the Ground Lease, the purchase price is determined by the average of three appraisals following exercise of the option to purchase.

DISCUSSION

Purchase Price

The appraisal firms were engaged by HRM and Sun Life in accordance with the terms of the Ground Lease, and the valuation results are as follows:

Appraiser	Client	Appraisal as of May 2005
The Altus Group	HRM	\$22,500,000
Turner Drake and Partners Ltd	Sun Life	\$24,285,000
Ingram Varner	HRM / Sun Life	\$22,100,000
Spread	\$2,185,000	
Purchase Price (Average of 3 Appraisals)		\$22,961,667

As part of the Municipality's due diligence, a building inspection, and structural and environmental assessments were completed. The report findings were provided to HRM, Sun Life and each appraiser, and have been noted in each of the appraisal reports as limiting conditions.

Overall the building is in sound condition and appears to have been well maintained.

The key terms and conditions of the purchase agreement are as follows:

Purchase Terms and Conditions	
Property Address	40 Alderney Drive, Dartmouth
Vendor	Sun Life Assurance Company of Canada
Purchaser	Halifax Regional Municipality
Appraisal	\$22,962,000 <i>(average of the 3 appraisals, as required under the original Ground Lease)</i>
Purchase Price	\$22,962,000 <i>(excluding HST)</i>
Closing Date	August 2, 2005
Deposit	N/A
Additional Items	N/A

Financing Approach

Staff have considered a number of options with regard to the terms and structures available through the Nova Scotia Municipal Finance Corporation (NSMFC) for the financing of this purchase, as well as the timing of the required debenture issue.

A 20-year amortization is recommended, with an initial 15-year term and a balloon payment to be financed for the remaining 5 years. While it is not staff's position to speculate on the future course of interest rates, the rates currently available compare favourably with financing rates available in the past. Therefore locking in the rates available in the current market for as long a period as possible is recommended. A straight 20-year term was not available.

Staff have had discussions with NSMFC regarding the feasibility of a special bond issue to coincide with the closing date for the purchase of this building. The terms and conditions of the Ground Lease governing this acquisition, however, resulted in timelines that are too restrictive to make a special debenture issue possible. As well, the incremental cost to the NSMFC of a special debenture issue, estimated at \$15,000, would have to be paid by HRM.

BUDGET IMPLICATIONS

Cost Differential / Savings

Based on the final purchase price (average of the three appraisals), the following table reflects updated projected savings to HRM upon acquisition of the building:

Projected Costs & Savings ¹	Estimates to Council March 2005 ²	Revised Projections June 2005 ³
Projected net cost of leasing through 2055 (Scenario 1: Status Quo)	\$156,523,200	\$156,523,200
Projected net ownership costs through 2055 (Scenario 2: Purchase)	\$86,880,400	\$91,303,100
Projected net ownership costs through 2055 (Scenario 3: Purchase)	\$101,466,300	n/a
Projected Net Savings over 50 Years	\$55,056,900 to \$69,642,800	\$65,220,100
Net Present Value of Projected Savings	\$7,501,200 to \$14,996,800	\$13,505,000

Debt Financing

Issuance of the required \$24,189,000 debenture (to cover the purchase price of \$22,962,000 plus net HST at 3.429%, debenture issue costs, appraisal, legal and professional fees, etc) will be included with the regular NSMFC Fall debenture issue, anticipated for mid-October. This portion of the debenture issue will be based on a 20-year amortization with an initial 15-year term and a balloon payment to be financed for the remaining 5 years.

Interest rates used for analysis for years 1 to 10 are based on actual rates from the HRM May 2005 debenture issue and for years 11 to 20 are estimated at 6%. It should be noted that debenture rates may fluctuate, from now until the Fall 2005 debenture issue.

HRM will be required to provide bridge financing from operating cash flows to cover the period from the date of purchase to the date of settlement of the Fall debenture issue. As a result, it is anticipated that HRM investment income for 2005-06 will be reduced by approximately \$126,000, assuming a mid-October debenture issue. This reduction will be offset during 2005-06 through savings accruing to HRM from the acquisition of Alderney Gate and the related cessation of lease payments.

¹ Projected costs and savings for the June 2005 analysis are based on the final purchase price; see Appendix A - Annual Financial Comparison, and Appendix B - Assumptions.

² Financial analysis presented to Council in March 2005 reflected a range of estimates as the final purchase price could not be determined until after HRM exercised its option to purchase. Scenario 2 was based on an estimated purchase price of \$22,000,000 and Scenario 3 at \$27,500,000 (25% higher than Scenario 2).

³ Current financial analysis reflects final purchase price based on the required three appraisals.

HRM Debt Policy

In 1999 Regional Council approved the Multi-Year Financial Strategy (attached) to address rapidly increasing debt, an operating deficit and the absence of financial policies guiding debt and capital spending. One of the products of the Multi-Year Financial Strategy was a debt policy. This policy supports the financial objective of ensuring long-term fiscal sustainability. Quoting from the debt policy, *"As the debt has increased over the last three years, the proportion of operating revenues which are devoted to debt service has also increased and is currently eroding the portion of revenues available to fulfill the program and service objectives of HRM."* Under this policy, debt has fallen in each of the last six years. The current policy excludes the value of capital leases, such as the existing 65-year lease (50 years remaining) for space at Alderney Gate.

This transaction will result in a net increase in HRM's long-term obligations (including capital leases) of \$9.8M (\$24.2M debenture less \$14.4M capital lease). The purpose of the HRM debt policy is not simply to decrease the debt level. The purpose is to reduce the cost of servicing our debt so that operating funds can instead be used to support programs and services required by residents rather than paying interest costs. The primary reason the option to purchase Alderney Gate was put forward to Council is that the cost of servicing the existing capital lease far exceeds the cost if the building were financed through debt.

There are two primary means of reducing debt service costs:

- 1) reduce overall debt over time
- 2) convert high cost long-term debt obligations to less expensive forms of financing.

In accordance with Clause 7 of the attached Capital Dept Policy, by limiting the amount of new debt issued each year to 80% of debt retired, HRM is effectively achieving the first goal. The Alderney Gate purchase falls into the 2nd category. An analogy to this transaction is to consider an individual who converts high cost credit card balances to bank debt at a much lower interest rate. The end result is a higher bank loan but a much lower cost.

In this case, net long-term obligations increase by \$9.8M but our net occupancy costs, including debt service costs, drop by \$13.5M. The underlying purpose of the debt policy (as referenced above) is to preserve operating funds for programs and services rather than using it to pay interest on debt. While the clear intent of the policy is the reduction of debt service costs, the strategy in the wording of the policy itself references only the debt reduction goal, reflecting the very pressing risk which existed at that time, namely rapidly increasing debt. HRM is now in a position to address the next level by lowering debt service costs through the conversion of this high cost capital lease to a lower cost debenture. Debt and reserves policies are currently under review for consideration by Council in late fall of 2005. The issues outlined above will be reflected in any revised debt policy.

Discussions have been held with Standard & Poor's (HRM's independent credit rating agency) and they concur that this transaction is preferable to leaving the existing capital lease in place.

The opportunity has been presented and accepted by Council to save the taxpayers \$13.5 million dollars. Council has the authority to approve the recommendation as it relates to the existing debt policy and for the reasons outlined staff clearly supports this. This transaction is not only consistent with the purpose of the policy, if not the strict wording, but it produces a better outcome than strict adherence to the policy would. Staff have not presented a recommendation to revise the debt policy itself at this time, as this will come forward with other revisions to the debt and reserve policies in the fall. If Council wishes to consider a revision to the policy, wording is contained in the alternative section of this report. While staff would support the alternative, it is not required at this time.

Deed Transfer Tax Claim

There is an outstanding claim related to Deed Transfer Tax related to the property. This matter is the subject of a separate report also dated June 28, 2005.

FINANCIAL MANAGEMENT POLICIES / BUSINESS PLAN

This report complies with the intent of the Municipality's Multi-Year Financial Strategy, for the purpose of debt reduction, but not the specific wording of the debt policy. This report complies with 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 amend the Debt Policy as follows:

Amend Section 1 of the Strategy section.

1. Reduce capital debt *service costs* by restricting capital spending funded by debt to an amount less than the debt retirement, *or by arranging debt financing in a manner which provides the lowest available debt service cost.*

Add section 10 to the Policy section.

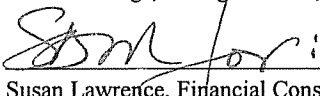
10. Notwithstanding section 7, new and existing long-term obligations will be structured in such a manner as to provide the lowest available overall debt service costs.


ATTACHMENTS

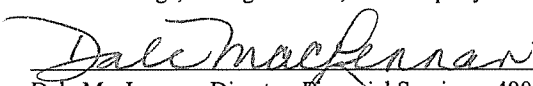
- A. Annual Financial Comparison
- B. Assumptions for Financial Analysis
- C. HRM Debt Policy

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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APPENDIX "A" - ANNUAL FINANCIAL COMPARISON

Purchase Price (excl HST):
Annual Inflation:
NPV Discount Rate:
Financing Method:
Debenture Principal:
Debenture Amortization:
Financing Term:

Scenario 1	
Status Quo	
	n/a
	2.0%
	5.0%
	n/a
	n/a
	n/a
	n/a

Scenario 2	
Purchase in 2005	
	22,962,000
	2.0%
	5.0%
	Serial Debenture
	24,189,000
	20 years
	15 years + 5 years

Year	HRM Fiscal Y/E	Scenario 1 Total Cost	Scenario 2 Total Cost	Net Savings (Cost)
1	Mar-06	1,667,200	894,000	773,200
2	Mar-07	2,515,100	2,673,300	(158,200)
3	Mar-08	2,533,200	2,677,600	(144,400)
4	Mar-09	2,546,000	2,697,600	(151,600)
5	Mar-10	2,560,000	2,695,400	(135,400)
6	Mar-11	2,593,800	2,685,500	(91,700)
7	Mar-12	2,618,500	2,666,000	(47,500)
8	Mar-13	2,633,000	2,706,400	(73,400)
9	Mar-14	2,653,100	2,679,400	(26,300)
10	Mar-15	2,674,200	2,648,000	26,200
11	Mar-16	2,696,900	2,616,700	80,200
12	Mar-17	2,720,000	2,751,700	(31,700)
13	Mar-18	2,744,000	2,695,800	48,200
14	Mar-19	2,768,200	2,639,800	128,400
15	Mar-20	2,792,700	2,584,200	208,500
16	Mar-21	2,817,800	2,529,100	288,700
17	Mar-22	2,843,500	2,474,100	369,400
18	Mar-23	2,869,500	2,419,700	449,800
19	Mar-24	2,896,000	2,365,400	530,600
20	Mar-25	2,922,800	2,311,400	611,400
21	Mar-26	2,950,800	2,257,700	693,100
22	Mar-27	2,979,000	995,000	1,984,000
23	Mar-28	3,007,800	1,015,200	1,992,600
24	Mar-29	3,037,500	1,035,600	2,001,900
25	Mar-30	3,067,600	1,056,500	2,011,100
26	Mar-31	3,098,100	1,078,000	2,020,100
27	Mar-32	3,129,200	1,099,400	2,029,800
28	Mar-33	3,161,000	1,121,400	2,039,600
29	Mar-34	3,193,300	1,143,900	2,049,400
30	Mar-35	3,226,200	1,166,700	2,059,500
31	Mar-36	3,260,200	1,190,100	2,070,100
32	Mar-37	3,294,700	1,213,900	2,080,800
33	Mar-38	3,330,000	1,238,400	2,091,600
34	Mar-39	3,365,800	1,263,300	2,102,500
35	Mar-40	3,402,400	1,288,600	2,113,800
36	Mar-41	3,439,500	1,314,300	2,125,200
37	Mar-42	3,477,200	1,340,700	2,136,500
38	Mar-43	3,516,200	1,367,400	2,148,800
39	Mar-44	3,555,700	1,394,800	2,160,900
40	Mar-45	3,596,200	1,422,800	2,173,400
41	Mar-46	3,637,500	1,451,200	2,186,300
42	Mar-47	3,679,700	1,480,100	2,199,600
43	Mar-48	3,722,300	1,509,800	2,212,500
44	Mar-49	3,766,000	1,540,100	2,225,900
45	Mar-50	3,810,700	1,570,700	2,240,000
46	Mar-51	3,856,100	1,602,000	2,254,100
47	Mar-52	3,902,500	1,634,000	2,268,500
48	Mar-53	3,949,700	1,666,500	2,283,200
49	Mar-54	3,997,800	1,699,900	2,297,900
50	Mar-55	4,047,000	1,734,000	2,313,000
TOTAL NET COST TO HRM		156,523,200	91,303,100	65,220,100
NET PRESENT VALUE (NPV)		54,147,800	40,642,800	13,505,000

APPENDIX "B" - ASSUMPTIONS

Ref#	Topic	Applicable to Scenario #	Assumption
1	Analysis Period	1, 2	All cash inflows and outflows are analyzed for the period August 2005 (closing date) through to 2055 (end of original contract between City of Dartmouth and City Centre Limited).
2	Inflation	1, 2	Inflation at 2% annually has been included in both inflows and outflows, as applicable, following expiration of existing leases.
3	Net Present Value (NPV)	1, 2	For purposes of NPV calculations, all cash flows are assumed to occur regularly throughout each fiscal year. Discount rate of 5% has been used for all scenarios analyzed.
4	HST - Outgoing Lease Payments	1	Outgoing HRM lease payments from HRM to Sun Life (ie. base rent, share of operating costs and share of commercial tax) include 3.429% net HST.
5	HST - Acquisition of Alderney Gate	2	Purchase price for Alderney Gate includes 3.429% net HST, required due to provisions of Excise Tax Act (since HRM occupies more than 50% of the leasable space in the building, a full input tax credit is not available upon acquisition of a commercial building).
6	Ground Lease	1	Original "ground lease" between City of Dartmouth and City Centre Limited (Registry of Deeds book #4678, page 215) provides: - option to purchase in 2005 or 2020, as well as provision that if neither option is exercised, then HRM gains title to building in 2055 at \$0 cost. - annual payments of \$50,000 from building owner to HRM until the earlier of: exercise of option by HRM or 2055.
7	65-year HRM Lease	1	The original contract between City of Dartmouth and City Centre Limited guaranteed 65-year leases in Alderney Gate as follows: Library = 43,311 sq ft and Suite 200 (RTC and SSBU) = 21,584 sq ft. Lease rates were established in 1990, with pre-set escalations applicable to base rent until 2055. The current rates are significantly higher than market rates for comparable space in HRM.
8	Other HRM Leases	1	As of the date of acquisition, HRM occupies an additional 34,000 square feet in Alderney Gate, accommodating several business units under various lease arrangements. For purposes of analysis of Scenario 1 (Status Quo) financial impact, these leases are assumed to be renewed until 2055, escalated to reflect inflation after expiration of the current leases.
9	Non-HRM Leases	2	For comparative purposes under Scenario 2 (Purchase), it is assumed that existing non-HRM leases at Alderney Gate will continue throughout the period of analysis, under existing lease terms until expiration of those leases, and escalated to reflect annual inflation thereafter.
10	Parking Revenue	2	Monthly and hourly indoor parking revenues have been calculated based on current rates, escalated to reflect annual inflation during the period of analysis.
11	Vacancy Allowance	2	- a vacancy allowance of 10% has been deducted from estimated revenue for non-HRM leases, other than existing lease commitments. After expiration of current non-HRM leases, the vacancy allowance is calculated at 10% of the total non-HRM space in the building. - no vacancy allowance has been provided against parking revenue. This is based on the current and expected future demand for parking space in downtown Dartmouth, as well as the fact that parking revenues would increase if the parking mix were shifted to increase hourly parking and decrease monthly parking.
12	Commercial Tax	1, 2	Included in analysis, based on 2005 estimated tax assessment of \$15,079,000, as follows: - Commercial Assessment = \$4,056,300 (related tax is recoverable from tenants); - Exempt Commercial Assessment = \$11,022,700 represents portion of building leased by HRM. Current owner pays to HRM an annual "grant in lieu of tax" equal to calculation of commercial tax on the exempt assessment amount; landlord recovers this from HRM under existing leases.

Ref#	Topic	Applicable to Scenario #	Assumption
13	Deed Transfer Tax (DTT)	n/a	<ul style="list-style-type: none"> - DTT on the acquisition of Alderney Gate by HRM has not been included in the analysis; under section 5(1)(h) of the Assessment Act, HRM is not required to pay DTT when purchasing real property. - Outstanding DTT of approximately \$265,000 owed to HRM on the assignment of the Maplehurst Properties Ltd. leasehold mortgage to Mutual Life in 1996, has not been included in this analysis.
14	Business Occupancy Tax (BOT)	n/a	<ul style="list-style-type: none"> - Not included in analysis, as BOT will be received on non-HRM space regardless of whether HRM owns the building or not. Under the Assessment Act, HRM does not pay tax on space it occupies (ie. leased or owned space). - Under the Assessment Act, HRM does not pay tax on space it occupies (ie. leased or owned space).
15	Debenture	2	<ul style="list-style-type: none"> - Principal amount includes purchase price of \$23,749,400 (including net HST), debenture issue costs, and estimated closing costs (ie. appraisal, legal, etc). - Debenture repayment reflects a 20-year amortization, with an initial 15-year term, and a balloon payment to be financed for the remaining 5-year term. - For years 1 - 10, interest rate used for analysis is based on actual rates from HRM May 2005 debenture issue, as provided by Financial Services-Capital Funds Team. - For years 11-20, the interest rate has been estimated at 6%, as provided in March 2005 to Dale MacLennan, Director, Financial Services, from Jane Fraser, CEO of Municipal Finance Corporation.
16	Building Operating Costs	2	Includes all regular annual operating expenses such as repairs and maintenance, utilities, security, cleaning, property management fees, insurance on rental revenue, etc.
17	Operating Expense Contingency	2	An operating expense contingency of 10% has been added to estimates for annual building operating costs. Since HRM occupies 67% of the building at the time of acquisition and since an additional 22% of the building is leased on the basis of a "gross lease", any fluctuations in operating expenses will be borne primarily by HRM.
18	Reserve: Recapitalization and Leaseholds	2	Model includes annual contributions to a Recapitalization / Leasehold Reserve, equal to 1.5% of the 2005 purchase price of the building, escalated to reflect inflation over the period under analysis. This reserve will be used to cover costs to preserve the structural integrity of the building, maintenance items that are not recoverable from tenants, leasehold incentives to retain existing tenants or attract new tenants at the expiration of leases, etc.
19	Reserve: Insurance	2	Since HRM's standard insurance coverage provides a deductible of \$100,000, it is prudent to create a reserve to cover the risk of small claims. As recommended by Peter Ross, HRM Procurement Manager, the 05/06 reserve contribution is \$300,000 to provide an initial fund to cover any claims; for 06/07 and beyond, the Reserve will be funded at a rate of \$15,000 (plus inflation) annually.
20	Purchase Price	2	<ul style="list-style-type: none"> - Based on the original contract between City of Dartmouth and City Centre Limited, exercising HRM's option to purchase required 3 appraisals: one appraiser selected by HRM, one appraiser selected by Sun Life, and the 3rd appraiser selected by the 1st two appraisers. - The average of the 3 appraisals yielded a purchase price of \$22,962,000 (excluding net HST), or \$23,749,400 (including net HST at 3.429%).
21	Closing Costs	2	Closing costs are estimated at \$440,000, which includes debenture issuance costs, appraisals, legal, etc.
22	Bridge Financing	2	HRM will provide bridge financing from Operating cash flows covering the period from the date of purchase (August 02, 2005) to the date of settlement of the Fall debenture issue (estimated to be mid-October 2005). As a result, it is anticipated that HRM investment income will be reduced by approximately \$126,000. This reduction is offset by cash flow savings accruing to HRM from the acquisition of Alderney Gate and the related cessation of lease payments during the balance of 2005/06.

8

Capital Debt Policy

Approved by Council May 18, 1999

The Capital Debt Policy was unanimously adopted by Regional Council on May 18, 1999. The policy was developed by the Multi-Year Financial Strategy Committee, in conjunction with the Executive Management Team and the Directors and General Managers. The Capital Debt Policy is intended to provide a framework for reducing the debt of HRM in the long term financial context of the Municipality.

Purpose

One of the overall financial objectives of HRM adopted by Council in December 1998, is to ensure long term fiscal sustainability without increasing the debt burden. As the debt has increased over the last three years, the proportion of operating revenues which are devoted to debt service has also increased and is currently eroding the portion of revenues available to fulfil the program and service objectives of HRM.

The Capital Debt Policy is intended to provide a framework for reducing the debt of HRM in the long term financial context of the Municipality.

Strategies

1. Reduce capital debt by restricting capital spending funded by debt to an amount less than the debt retirement.
2. Develop a five year upper and lower limit for debt servicing.
3. Produce a five year Debt Servicing Plan.

Policy

1. Debt can only be issued in compliance with all appropriate provisions contained within the Municipal Government Act and with the CAO's recommendation and Council's approval.
2. The Director of Finance will be responsible for administering capital debt and this policy.
3. A capital Debt Servicing Plan with a five year debt projection will form an integral part of the annual budget. The Debt Servicing Plan will include an upper and lower limit.
4. The CAO will provide Council with a report annually in conjunction with the capital budget as to the total capital debt issued and approved.
5. Debt funding will be restricted to items with a life expectancy of at least 10 years. This clause will be phased in over a period of not more than five years.
6. Debt for a specific capital project will be issued for a period not longer than the expected life of the asset.
7. The dollar amount of new issued debt funded from the general tax rate will be limited to the debt being retired in the same year less a reserve for debt retirement or a notional reserve for non-amortizing debt obligations.
8. Capital Debt will be segregated in the Accounting records which shall ensure the maintenance of accurate information with respect to the purpose, issuance and retirement.
9. The capital debt policy will be reviewed annually in conjunction with the budgeting process.