FOR THE RECORD

February 27, 2020

CITY OF NELSON NATURAL GAS ASSETS

There has been some questions raised about the City's agreement with FortisBC on the gas distribution system within the City of Nelson. The City of Nelson as well as a number of other municipalities entered into an agreement with one of FortisBC's predecessor's, Terasen Gas in a Lease in Lease Out agreement. The information on this agreement was shared with the public in 2003 and the borrowing was approved by our residents that allowed the City to enter into this agreement. (link)

The agreement included a 35 capital lease with the opportunity for FortisBC to opt out after Year 17 by paying the City out for the value of the remainder of the lease. Under the agreement, it is FortisBC's decision to exercise the option. Also under the agreement FortisBC continues to operate the natural gas distribution system, The City of Nelson is in effect the silent owner of the assets only.

Under either option FortisBC will continue to operate the natural gas distribution system and there is a requirement to serve customers through the Utilities Commission Act. Although Council is working towards reducing our reliance on fossil fuels, Council has no authority to restrict customers who choose to use natural gas.

TERASEN GAS FRANCHISE AGREEMENT

Distribution System Purchase
Option Proposal
June, 2003

Introduction

City Council approved in principle the renewal of the City's Franchise Agreement with Terasen Gas Inc. (formerly BC Gas). Formal, renewal, if granted, will result in the elimination of the City's "buy-out" clause in exchange for the City owning a term financial interest in the gas distribution system within the City and Terasen Gas operating it. This will create a net lease payment in the first year of approximately $250,000 and total lease payment estimated to be approximately $1.5 million over the life of the agreement. Formal renewal is subject to the approval of City residents, the BC Utilities Commission (BCUC) and the Inspector of Municipalities.

This Background Paper explains to City residents how the renewal of the Franchise Agreement would be managed to establish this revenue stream.

The Franchise Agreement

In 1956 the City of Nelson entered into a Franchise Agreement with Terasen Gas (known at the time as Inland Natural Gas). The Agreement provided Terasen Gas with the exclusive right to establish a natural gas distribution system within the City. Access to road rights-of-way was extended through the Agreement in order to allow for the construction of system infrastructure. In exchange for these privileges, Terasen Gas was required to pay an annual franchise fee to the City at an amount equal to 3% of natural gas sales within the municipality.

Since 1956, the Franchise Agreement has been renewed once and extended several times under its original terms and conditions. The Agreement remains in effect today, but must be either renewed or allowed to expire on September 30, 2003.

The Buy-out Clause

Section 16 of the current Agreement is of particular interest to the City. This section, known as the "buy-out" clause, allows the City to purchase the natural gas distribution system in the event that the parties cannot agree on terms for renewing the franchise. For Terasen Gas, the buy-out clause represents a source of uncertainty that the corporation would like to see removed. For the City, the buy-out clause represents an important contractual right.

When the need to consider renewing the Agreement first arose, the City and its team of advisors met to discuss the implications of, and opportunities related to the buy-out clause. The City took the view that the clause, as a contractual right, is a City asset with a particular, if undefined, monetary value to municipal taxpayers. The City considered itself duty bound to find some way to realize the value of this asset before agreeing to any franchise renewal.

The City identified seven options to consider. The list of options included:

- exercising the buy-out clause (i.e., buying the distribution system);
- renewing the Agreement without the clause;
- renewing the Agreement with the clause;
- allowing the Agreement to simply lapse;
- negotiating a one-time payment from Terasen Gas in exchange for removing the buy-out clause;
- initiating the buy-out clause then litigating a settlement; and
- developing a "lease-in, lease-out" transaction to capture the value of the buy-out clause without actually taking full ownership of the system.

In considering these options, the City was concerned with three criteria: feasibility, risk and reward. Put differently, the City was intent on identifying the specific option that:

- would be feasible to undertake;
- would expose taxpayers to little or no risk; and
- would provide significant financial reward to the community.

The "lease-in, lease-out" transaction emerged as the option that best met these terms.

The Transaction

The key features of the proposed transaction are a prepaid capital lease and an operating lease. Although the details of the transaction are relatively complicated the principles that generate the surplus for the City are the very same that make owning Nelson Hydro such an attractive investment for the City. These advantages include the City's strong borrowing capacity, access to preferred interest rates and non-taxable status. The major difference is that under the proposed Terasen Gas Franchise Agreement, Terasen Gas will operate the gas distribution system on behalf of the City and take on the risk associated with operating the system.

This revenue stream in its simplest terms is generated by the difference in the lower interest rates that the City can borrow at compared to the return allowed on the gas distribution system that is permitted by the BCUC . The natural gas customer is not negatively affected since he would be charged the permitted rate of return regardless of who owns the gas distribution system. In fact under this proposal the natural gas customer is better off as part of the savings are passed on to the customer.

Capital Lease/Debt:

As the first step in the proposed transaction, the City would enter into a 35-year capital lease with BC Gas for the natural gas distribution system within the municipality's boundary. The value of the City's rights in the lease has been set at $8.0 million. At the beginning of the transaction, the City would pre-pay 95%, or $7.6 million, of this value to Terasen Gas as rent due under the lease; the remaining 5% would be paid to Terasen gas over the life of the lease.

The City would borrow the $8.0 million required for the complete transaction to cover the costs incurred in obtaining the financing, and developing the transaction and making the required pre-payment. The total $8.0 million sum, would be obtained through the Municipal Finance Authority (MFA). The MFA's triple-A credit rating - higher than that of any provincial government - guarantees that the interest rates on the City's loan would be very competitive.

Operating Lease/Revenue

After establishing the capital lease, the City would lease back the operation of the distribution system to Terasen Gas under a 17-year operating lease. Through this lease, the operation of the system, and the risks inherent in such operation, would be transferred back to Terasen Gas.

The terms of the operating lease would require Terasen Gas to make annual payments to the City over the 17-year period. Each payment would be based on the total annual revenue generated by the Transaction, which would be calculated using the formula:

BCUC allowable rate of return on capital assets	x	unamortized value of City's Rights	+	annual amortization	=	Total Annual Revenue

As negotiated, the bulk of the total revenue would be paid each year to the City. Terasen Gas would receive 5% of the gross revenue, as well as 15% of the annual net revenue. Net revenue would be determined by subtracting the City's annual MFA debt payment from total revenue.

The formula refers to the unamortized value of the City's rights in the lease - this value, as noted earlier, has been set at $8.0 million for year one. Each year during the term of the lease, the value would be reduced by an average of 3%. As the unamortized value decreased each year, so would both the total revenue generated by the transaction, and the annual revenue payment to the City.

The BCUC allowable rate of return, also referred to in the formula, is an important source of benefit to the City. The rate determines, in essence, the amount of revenue that regulated utility companies, such as Terasen Gas, are allowed to earn each year on their capital assets. The BCUC sets its rate to reflect the federal and provincial corporate taxes that private companies are required to pay. Because the City of Nelson, through its capital lease, would be holding the bulk of the capital assets, the City's allowable revenue from those assets would be determined using the BCUC rate.

Unlike private utility corporations, however, the City of Nelson does not pay corporate income taxes. The City, therefore, would keep the taxes that would otherwise be paid on the transaction's revenues.

It should be noted that the proposed transaction, with respect to income taxes, affords the City the same benefit it would receive if it exercised its buy-out option and took ownership of the distribution system.

Cash Flow

A concern raised by some residents when the Terasen Gas Franchise Agreement was originally presented to the public was that residents would have to wait 17 years before seeing a return. Under the original proposal a "Legacy Fund" of approximately $3.16 million would be created after year 17. Some residents suggested that the City should take a smaller payment up front as opposed to waiting 17 years to get our money. Council has worked with our consultant and Terasen Gas in order to restructure the deal to generate surpluses from year one as opposed to creating the "Legacy Fund".

The investment, as now structured, would create surpluses from year one of the agreement. The surpluses being generated at the front end versus the tail end of the agreement have been achieved by restructuring the borrowing to more closely match the payments received from Terasen Gas. The most significant change is that the approximately 50% of the borrowing will be paid off after the receipt of the termination payment ($3.9 million) from Terasen Gas in year 17. If Council invested these funds as they were received it would generate a similar legacy fund amount as was envisioned under the original proposal. Instead of creating a legacy fund for future taxpayers, Council's intent is to invest these funds into new capital projects such as the new Museum Archives Art Gallery (MAAG) and relocation of City Hall as proposed by the Facility Planning Committee.

In the event that Terasen Gas chooses not to make the termination payment in year 17, a new operating lease would be negotiated for an additional 18 years to coincide with the 35 year term of the capital lease. Under this scenario, the annual revenue payments from Terasen Gas to the City would continue. The accumulated value of these payments would be greater than the outstanding borrowings at that time and would be utilized to repay the outstanding debt.

Borrowing Capacity

Another concern raised by residents was the impact that this transaction would have on the City's borrowing capacity. The immediate concern was impact that the borrowing for this project would have on the City's ability to borrow for the new proposed arena, Museum Archive Art Gallery (MAAG) and aquatic center upgrade. This concern has been addressed by the City targeting reserves to the MAAG and City Hall relocation and the Regional District agreeing, subject to a successful referendum result, to be the borrowing party for these projects.

The City has also reviewed its borrowing needs over the next 10 years and even with this project the City is well within the present statutory borrowing capacity limits. The lending agency for most BC municipalities is the Municipal Finance Authority (MFA) and through the new community charter the MFA is in the process of changing the way it looks at borrowing limits to move from a strictly assessment based model to revenue based model. Under this model such things as the revenues generated by Nelson Hydro would be taken into consideration when assessing the City's borrowing capacity. Under this new model the City's borrowing limit would increase from $31.7 million to approximately $70.0 million.

A key factor that a resident needs to consider is the impact of City borrowing on property taxes. The City has a current statutory gross borrowing limit of $31.7 million and its current borrowings are $15.2 million. Only 11.2% of this borrowing is serviced by property taxes the balance of the debt is serviced by other revenue sources including, electrical, sewer & water rates, the Province of BC (Tenth Street Campus) and the regional district (Lakeside Playing Fields). The borrowing for the "lease-in lease-out" option is fully paid for by the lease payments received from Terasen Gas under the proposed agreement.

Risk Management

The proposed transaction requires the City to borrow $8.0 million. For the City of Nelson - indeed for almost any city - this amount is quite significant but very manageable within the City's financial capability. The City has borrowed at such a level for Nelson Hydro and Tenth Street Campus projects.

The City has exercised extensive due diligence in reviewing the proposed transaction. A tremendous amount of time and effort have been devoted to identifying and addressing all potential risks associated with the opportunity.

Throughout its review of potential risks, the City's primary objective has been simple: to ensure that the City could meet 100% of the transaction's debt obligations without impacting City taxpayers. To provide this assurance, the City negotiated a "make whole" provision in the agreement. This security provision guarantees that the City would not be any worse off in 17 years than it is today, should financial variables used to project the net benefit change significantly over the life of the agreement.

Other security instruments, in addition to the "make whole" provision, have been included in the transaction to protect City taxpayers from various potential risks. Several forms of risk have been identified and addressed, including those related to:

- unpaid lease revenues;
- changes in regulatory, management or industry circumstances; and
- reduced financial capabilities of Terasen Gas.

It should be stated that while the City has taken all necessary steps to identify and mitigate potential risks, the City is not able to foresee or eliminate every risk in a transaction of this magnitude and duration. When the transaction's potential risks are matched against its expected benefits, however, the City is confident that the proposed course of action is prudent and responsible.

Third Party Review

The foregoing transaction was reviewed on behalf of the City of Kelowna by corporate law firm of Owen Bird. The City of Kelowna retained the legal counsel to anticipate and address all questions of risk to City taxpayers. It is critical that the security provisions identified above are both adequate and enforceable. In Owen Bird's opinion, the provisions meet these tests.

The transaction was also reviewed by the accounting firm of Deloitte & Touche LLP. The firm's written report supports the view that the transaction represents an appropriate and effective means of optimizing the value of the City's buy-out clause.

The City of Nelson worked with the City of Kelowna and the transactions proposed are identical with the exception of the:

1. Borrowing—in the case of the City of Kelowna the borrowing was for $50 million compared to the City of Nelson at $8.0 million, and
2. timing of the debt payment, Kelowna opted for the Legacy Fund (i.e.: the return at the end of the agreement) and the City of Nelson is proposing to match the debt repayment more closely with the lease revenues (the return at the front end of the agreement).

The City of Nelson will be paying the City of Kelowna for expenses related to legal and accounting advice if the Nelson residents approve the transaction by a counter-petition process.

Conclusion

The City recommends the "lease-in lease-out" transaction to residents. The proposed transaction uses the City's natural advantages to capture the value of the buy-out clause without incurring the risks inherent in purchasing the distribution system. The City and its advisors, in cooperation with the City of Kelowna as the lead municipal government, have spent considerable energy and resources developing the transaction.

The revenue stream generated from this transaction will be utilized to help fund much needed capital projects in the City and will allow the City to proceed with these projects without overburdening City residents with additional property taxes.

Residents have asked the City to identify other sources of revenues to decrease the tax burden on the taxpayer. The "lease-in lease-out" is an opportunity to achieve this goal.

Contact Information

If you have questions about this proposal and require further information, please e-mail: cfo@city.nelson.bc.ca or call Mr. Kevin Cormack, C.A. @ 352-8203.