TORONTO

STAFF REPORT
ACTION REQUIRED

Monetization of the Toronto Hydro Promissory Note

Date:	January 19, 2010
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2010\Internal Services\Cf\Ec10006cf (AFS #11005)

SUMMARY

This report recommends the sale of the Toronto Hydro Promissory Note ("Note") to the City's debt issuance syndicate who will place the Note with investors and provide the City with the net proceeds of the sale. This action results from Council's approval on December 8, 2009 of a debt restructuring strategy as part of the adopted 2010-2019 Capital Budget and Plan.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. Council approve the sale of the Toronto Hydro Promissory Note to the City's debt issuance syndicate managers, RBC Dominion, CIBC Capital Markets and Scotia Capital who will place the Note(s) with investors.

2. The Deputy City Manager and Chief Financial Officer be authorized to negotiate the terms for the sale of the Toronto Hydro Promissory Note with the City's debt issuance syndicate managers (the "Sales Agreement"), including the pricing of the Note and commission payable based upon current interest rates and capital market conditions prevailing at the time of the sale, and to enter into the Sales Agreement on behalf of the City.

3. The Deputy City Manager and Chief Financial Officer be authorized to assign the Toronto Hydro Promissory Note and to sign any necessary documents to give effect to the assignment, on behalf of the Holder.

4. The City obtain a fairness opinion from a qualified third-party financial expert stating that the City has received a fair and equitable market price for the Note with the fee being deducted from the gross proceeds of the monetization.

5. The Deputy City Manager and Chief Financial Officer be authorized to transfer funds from the Strategic Infrastructure Partnership Reserve Fund (XR1714) during 2010 to the Interest Income – Hydro Note Account in the Non-Program budget from the proceeds of the sale of the Note, equal to the difference between the interest payments payable from the Note and $29,946,055.67 that has been included in the 2010 preliminary operating budget.

6. Council approve the withdrawal of $600 million from the Strategic Infrastructure Partnership Reserve Fund during 2010 and the deposit of the $600 million into the City Sinking Fund to be used to prepay the Sinking Fund debentures identified in Appendix A.

7. Council request the Sinking Fund Committee to retire or pay down the balances remaining in the outstanding debentures as listed in Appendix A using the proceeds received from the Note monetization.

8. Council approve the repeal of the borrowing by-laws identified in Appendix A at such time as the following conditions have been met:

   a. Recommendation 6 has been implemented; and
   b. the City's external auditor has audited the sinking fund balance and has in writing confirmed to the DCM/CFO that the balance, including any estimated revenue, is or will be sufficient to entirely repay all or part of the sinking fund debt for which the Sinking Fund was established as identified in Appendix A of this report on the date or dates the principal on such debt becomes due.

9. The City Solicitor be authorized to introduce bills to Council to give effect to Recommendation 8 at such time as the conditions set out in Recommendation 6 have been met.

Financial Impact

When the Note is sold, the City will receive proceeds of approximately $531 million, made up of $490 million from the principal portion of the Note and an estimated premium of $41.3 million based upon current interest rates and capital market conditions and assuming that the transaction closes at the end of February, 2010. The actual proceeds and premium will be determined at the time that the Note is placed with investors, based upon the prevailing capital market rates. The funds will be placed in the Strategic Infrastructure Partnership Reserve Fund.

Funds totalling $600 million will be transferred from the Reserve Fund to the City's Sinking Funds, from the proceeds of the sale of the Note, along with prior principal payments on the Note of $490 million received from Toronto Hydro in 2007 and 2009. The balance of the funds in the Reserve Fund have been or will be applied to capital projects as approved as part of the annual capital budget and plan, such as environmental projects and past Waterfront capital expenditures.

The City is scheduled to receive $29.9 million in interest payments from the Promissory Note in 2010. The recommendations in this report will ensure that this amount is protected in the Operating Budget, regardless of the actual timing of the sale of the Note as up to $29.9 million of the premium generated from the Note monetization will be used to offset the amount of interest income that will not be received after the Note is sold. The premium is, in effect, a gain on the sale of the investment in the Note, so it is appropriate to recognize a portion of the gain as income in the operating budget.

DECISION HISTORY

At its meeting held on December 8, 2009, City Council adopted report EX 38.1, "2010 Capital Budget and 2011 – 2019 Capital Plan" that contained the following recommendation XI. 1,

> "The Toronto Hydro promissory Note be monetized by the City no later than December 31, 2010 with the proceeds credited to the Strategic Infrastructure Partnership Reserve Fund (XR1714), and the Deputy City Manager and Chief Financial Officer report to the Executive Committee on the recommended process for monetization."

BACKGROUND

A $980,230,955.00 promissory Note was issued to the City initially by Toronto Hydro-Electric System Limited when the corporate debt/equity ratio and capital structure was established in 1999. The Note was later replaced in 2003 with a Note issued by the Toronto Hydro Corporation. The 2006 Amended and Restated Note currently yields 6.11% per annum and expires in 2013 in accordance with changes approved by City Council at its meetings on June 27, 28 and 29, 2006.

The Note specifies repayment in four equal instalments of $245,057,738.75 occurring on December 31, 2007, December 31, 2009, December 31, 2011, and on May 6, 2013. The first two payments have been received and funds placed in reserve funds as approved by Council.

The monetization during 2010 of the payments of $245,057,738.75 that are each payable on December 31, 2011 and on May 6, 2013 has been authorized by Council during the approval of the 2010 Capital Budget and 2011 - 2019 Capital Plan.

COMMENTS

Two options were identified in the above report that recommended the monetization of the Note. The first option required Toronto Hydro to redeem the Note earlier than its stated maturity date and provide the City with a payout that reflects its market price, based upon current interest rates. Since the Note yields 6.11% per annum and current market interest rates for the remaining terms of the two tranches are in the range of 0.8% to 1.50%, it is estimated that the payment would include a premium of an estimated $41.3 million if sold at the end of February, 2010, which represents the future value of the difference between the Note's book yield and current interest rates. The actual premium will be determined at the time the Note is placed with investors.

Toronto Hydro has indicated that it may be unable to recover this premium from customer energy usage rates and would also have to accelerate its debt program and issue debt to raise $531 million, consisting of the proceeds of the Note and the premium in the capital markets, which is contrary to their long-term financing and business plan.

The second option requires the City to enter into an agreement with the managers of its debt issuance syndicate who has indicated that they will purchase the Note from the City at an agreed market price, divide the Note into more manageable sizes and place the securities with investors. The Note would be syndicated by the management group and the proceeds, including the premium, would be remitted to the City.

This arrangement requires the Deputy City Manager and Chief Financial Officer to enter into an agreement for the sale of the Note with the managers of the City's debt issuance syndicate. Particulars such as the pricing of the Note and the net proceeds available to the City after commission would be negotiated with the syndicate managers.

After the agreement is executed, the City will receive its funds and it will be the responsibility of the debt syndicate to sell and distribute the Note(s). The City will contract with a third-party financial expert such as a Chartered Accounting firm to obtain a "fairness opinion" stating that the City has received a fair and equitable market price for the sale of the Note. The firm will have expertise in the Canadian fixed-income capital markets such that the City will be able to rely on their opinion that the deal was fair to all of the involved parties. Their fees, estimated to be in the range of $20,000, will be paid from the proceeds of the monetization.

It is anticipated that the proposed sale transaction will be finalized no later than December 31, 2010.

In order to comply with the terms of the Note, the City (the Holder of the Note) must deliver a notice along with the Note to the Issuer (Toronto Hydro), in order for a replacement note or notes to be issued to the assignee. This report seeks authority for the Deputy City Manager and Chief Financial Officer to sign any necessary documents to give effect to any such assignment on behalf of the City.

This proposed transaction will not affect Toronto Hydro's financing or business plans since the Corporation will still be responsible for the payment of the interest to the new Noteholder(s) instead of the City and will refund the principal when the two tranches mature.

Even if Toronto Hydro were able to redeem the Note before maturity, the second option would still be the preferred method of monetization since it provides the City with the opportunity to take advantage of the current low short-term interest rate environment and receive a more competitive price for the Note, based upon prevailing capital market conditions.

The City is scheduled to receive $29.9 million in interest payments from the Promissory Note in 2010 and this amount will be included in the Operating Budget. City staff will arrange the sale of the Note in accordance with conditions of the capital markets during 2010. To the extent that the amount received from Toronto Hydro is reduced from this amount due to monetization before December 31, 2010, it is recommended that the Deputy City Manager and Chief Financial Officer be authorized to transfer funds to the Interest Income – Hydro Note account in the Non-Program budget from the Strategic Infrastructure Partnership Reserve Fund, equal to the difference in interest payments relating to the Note from Toronto Hydro and $29,946,055.67. This action will ensure that there is no operating budget impact resulting from the actual timing of the sale of the Note.

Due to the current low interest rate environment, the sale of the Note will generate a capital gain since it is yielding a higher interest rate than if the Note had been issued in the current market. The premium captures some of the future interest payable on the Note and it is appropriate to recognize a portion of this gain as operating revenue.

As an example, were the Note to be sold at the end of February, then the interest payments to the City from Toronto Hydro for the Note would equate to approximately $5 million on a pro-rata basis. The remaining $24.9 million in the operating budget would be transferred to the operating budget from the Reserve Fund from the estimated $41.3 million in premium received on the Note at today's interest rates. The balance of $16.4 million from the premium would remain in the Reserve Fund.

The City has identified several debenture bylaws that are the best candidates to be either retired or paid down with the proceeds from the Note Monetization, based upon maturity dates, interest rates and remaining balances as shown on Appendix A. If approved, Council will recommend that the Sinking Fund Committee take the necessary actions to direct the funds to these debentures to either retire or reduce their outstanding balances.

Under subsection 248.1(4) of the *City of Toronto Act, 2006*, the City can repeal a borrowing by-law "to the extent that the balance of the fund as audited by the city auditor, including any estimated revenue is or will be sufficient to entirely repay the principal of the debt for which the fund was established on the date or dates the principal becomes due". Repeal of the respective by-laws will mean that principal payments for the related debt will no longer have to be made from annual operating budgets as required by the Act.

As such, this report also recommends that Council approve the repeal of the borrowing by-laws identified in Appendix A at such time as the following conditions have been met:

a. funds in the amount of $600 million have been transferred from the Strategic Partnership Infrastructure Reserve Fund to the City Sinking Fund to prepay the debentures listed in Appendix A, and
b. the City's external auditor has audited the sinking fund balance and has in writing confirmed to the Deputy City Manager and Chief Financial Officer that the balance, including any estimated revenue, is or will be sufficient to entirely repay the principal of the debt identified in Appendix A to this report on the date or dates the principal on such debt becomes due.

Although Appendix "A" lists debenture bylaws that total approximately $595 million and the report recommends a transfer of $600 million to the Sinking Fund, the additional $5 million will be used to provide the Sinking Fund with flexibility in retiring the debentures if there are additional funds that are required as Appendix "A" is based upon 2009 sinking fund earnings that have not yet been audited. In any event, any additional funds will be used to further reduce the City's outstanding debt.

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SIGNATURE

Cam Weldon
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ATTACHMENT

Appendix A- Debenture Issues to be retired or paid-down with Monetization Funds

Appendix A

Debentures Issues to be Retired or Paid-Down with Monetization Funds

Sinking Fund Tranches to be Paid Up									
Month	**Day**	**Year**	**By-Law No.**	**Amount Borrowed ($millions)**	**Coupon Rate (%)**	**SF Earning Rate (%)**	**No. of Payments Remaining**	**Annual Contributions $**	**PV of Future Contributions $**
5	21	2004	354-04	128	5.30	4.00	5	10,661,241	49,360,428
7	28	2006	605-06	300	4.85	4.00	7	24,987,283	155,974,042
9	25	2003	767-03	120	5.13	5.00	4	9,540,549	35,521,830
9	27	1996	114-96	75	8.00	6.00	7	2,038,842	12,064,488
10	2	2009	886-09	400	4.50	4.00	10	33,316,378	281,034,694
10	28	2005	861-05	50	4.38	4.00	6	4,164,547	22,704,372
10	29	2004	880-04	100	4.50	4.00	5	8,329,094	38,562,835
TOTAL								93,037,934	595,222,689