TORONTO

STAFF REPORT
ACTION REQUIRED
with Confidential Attachment

Monetization Potential of City Assets

Date:	October 18, 2011
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reason for Confidential Information:	Security of the Property – attachment includes information regarding an agreement subject to confidentiality obligations.
Reference Number:	P:\2011\Internal Services\Cf\Ec11033cf (AFS #12906)

SUMMARY

The City owns interests in a considerable number of marketable assets, including real estate and government business enterprises. Monetization of these assets has the potential to offset some of the spending and debt pressures in the City's capital budget.

This report provides:

- an overview of the City's fiscal challenge
- an overview of the City's major assets and their potential for monetization
- specific recommendations regarding proposals to monetize identified assets
- proposed use of the resulting proceeds.

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer Recommends that:

1. The City, as shareholder, jointly with BPC Penco, direct the Board of Enwave Energy Corporation ("Enwave") to undertake all necessary actions to solicit proposals for a joint sale of 100% of the shareholders' interest in Enwave on behalf of both shareholders through a competitive auction, in such a way as to obtain the maximum proceeds for the shareholders.

2. The Deputy City Manager and Chief Financial Officer (the DCM/CFO) execute amendments to the Enwave Shareholder's Agreement, as described in the Confidential Attachment, on terms and conditions satisfactory to the DCM/CFO and in a form satisfactory to the City Solicitor, to facilitate the sale of the shareholders' interest in Enwave free from the restrictions on sale contained therein.

3. The Deputy City Manager and Chief Financial Officer be directed to report back directly to Council on the sale process in regard to Enwave and the recommendations from the Enwave Board in that regard, and make recommendations in regard to execution of a sale.

4. The City, as sole Shareholder, direct the Board of Toronto Hydro Corporation to prepare for an initial public offering of shares to effect a reduction of the City's ownership stake in the corporation up to a maximum of 10%, for the purposes of issuing a one-time disbursement to the City of the entire net proceeds of the issuance**,** and seek approval from the shareholder before execution.

5. The City further direct the Board of Toronto Hydro Corporation to design the public share offering so as to allocate the maximum portion of shares to Toronto residents that would not adversely affect the proceeds of sale.

6. The net proceeds of disposition of Toronto Hydro Corporation and/or Enwave shares be allocated to the Capital Financing Reserve Fund (XR 1011) and used to offset future debt issuance.

7. The appropriate City officials be authorized and directed to take the necessary action to give effect to these recommendations; and that leave be granted for the introduction of any necessary bills in Council to give effect thereto.

Implementation Points

Any monetization resulting from the above recommendations would require the Deputy City Manager & Chief Financial Officer to report back to Council prior to disposition.

Financial Impact

The actions recommended above and contemplated in this report (e.g. monetization activities regarding Enwave, Toronto Hydro, and real property dispositions by Toronto Parking Authority, Real Estate Division and Build Toronto) are expected to result in cash proceeds over the remaining term of Council that would offset City debt requirements by approximately $600 million. At current interest rates for ten year debentures, the associated operating budget benefit, less revenues currently being derived from these assets, would be approximately $65 million annually over ten years, with the associated reduction in potential revenues from those assets of approximately $10 million annually persisting thereafter.

The initiation of a sale process for Enwave and 10% of Toronto Hydro Corporation by their respective Boards would result in various transaction costs as well as financial and legal advisor costs paid by each company to prepare for a sale which would not materially impact cash disbursements to shareholders whether or not the sales occur. If a sale of either Enwave or Toronto Hydro Corporation occurs, additional success fees are expected to be payable to financial advisors, and be netted from the proceeds of sale paid to shareholders. These costs have been accounted for in the $600 million net proceeds estimate.

In addition the City may require independent financial and legal advice in regard to the sale processes, at a cost not to exceed $400,000 to be funded from within the City's operating budget.

These actions would have the effect of reducing overall debt requirements, and the potential to prevent debt levels from rising, and therefore help to maintain the City's debt service ratios below the 15% threshold.

Allocation of Proceeds

Application of the proceeds of monetization to fund operating expenditures in the year of sale does nothing to sustain service in subsequent years, while cash flows previously generated by the investment (such as dividends) are no longer available. Consequently, the proceeds of monetization should generally be reinvested in a long term sustainable purpose, such as:

1. The purchase of needed capital infrastructure to provide long term service benefits.
2. The avoidance of additional debt – with the associated long term expenditure reduction benefit to the operating budget.
3. The acquisition of an investment that generates higher returns – to generate long term revenue for the operating budget.

The City's capital plan presents a funding challenge for the City, resulting in increasing reliance on debt financing and curtailed capital expenditures, despite increases to capital from current contributions. Debt service charges are approaching the City's 15% debt service ratio limit, and so continue to crowd out operating expenditures.

Therefore, this report recommends that the proceeds of disposition be allocated to the Capital Financing Reserve Fund and used to offset future debt requirements.

DECISION HISTORY

On numerous occasions staff have made recommendations to increase the generation of funds through asset monetization. Monetization can also, in some instances, be consistent with the Mayor's Platform of reducing the size and cost of government. In 2010, Council considered "Potential Monetization of City Assets" (listed below) and concluded at that time only that "as Toronto Hydro is a necessary instrument to achieve Toronto's environmental, economic development and financial objectives, it is not in the public interest to sell all or any part of it."

Council at its meeting of September 27, 2011 passed a motion exempting the Toronto Parking Authority from monetization.

Recent reports dealing with monetization strategies include the following:

Long Term Fiscal Plan
http://www.toronto.ca/budget2011/pdf/ltfp_update_feb_10_2011.pdf

Potential Monetization of City Assets
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2010.EX45.40

Debt Restructuring Report
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2010.EX40.10
http://www.toronto.ca/legdocs/mmis/2009/bu/bgrd/backgroundfile-25415.pdf

Toronto Prosperity Initiative
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.ED5.2

Toronto Parking Authority Exempt from Monetization
http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2011.EX10.1

COMMENTS

1. Fiscal Challenge

As documented in the City's Long Term Financial Plan and via the annual budget process, the City has a number of financial challenges due to a structural gap between normal revenue growth and expected expenditure growth of in excess of $140 million each year. The persistent structural gap has lead to budgeting challenges such as the opening 2012 budget expenditure pressure of $774 million, the forecasted growth in net debt to support the capital budget, from $2.6 billion in 2011 to $4.3 billion by 2014, the $2.3 billion funding shortfall for the 10 year TTC capital plan, and a resulting lack of capacity to provide for major new initiatives.

In order to address the structural gap, the City has pursued a variety of revenue and expenditure control strategies in the past with some success, including:

- budgetary constraint targets
- periodic program reviews
- reform of cost sharing of Provincial programs
- gas tax revenue sharing with the Provincial and Federal governments
- City property tax and rate structure reforms to encourage and retain investment

- new City taxes under the new City of Toronto Act
- fee structure reviews

The strategy for the 2012 operating budget is based on a core service review, service efficiency reviews, and a review of user fees. A fourth key initiative, relating to the capital budget, is the review and possible monetization of City assets for debt reduction. City-held assets are subject to similar considerations as program expenditures: Are they core assets - is continued ownership required in order to provide core City services? The core service review dealt with these issues. It is also appropriate to question whether continued ownership is the most efficient option – is City ownership obtaining expected returns? Could a higher return be obtained or more service provided if the assets were sold and the proceeds reinvested elsewhere?

2. Models for Choosing Monetization Targets

Private Sector Models

In the private sector, physical assets (e.g. factories) and investment assets (e.g. subsidiaries) are constantly assessed to determine if they are providing positive returns to shareholders and whether that return is high enough (i.e. above the "hurdle" rate) as compared to other alternatives. If they are not, they are considered to be underperforming and the private sector would consider selling these assets and re-investing the proceeds in one of the following ways:

- Re-invest in other physical assets (e.g. new factories) that are more cost efficient.
- Purchase other investments (e.g. other companies) that meet or exceed the hurdle rate of return.

If there are no immediate investment long-term opportunities on the horizon, the proceeds could be parked in an investment fund or the proceeds could be used to pay down debt.

The choice between investing and debt reduction would depend on existing rates of return and interest rates and on the outlook for future returns and interest rates. For example, if the company has long-term low interest debt and the expectation is that rates will rise, the company may choose not to pay the debt down and invest the funds in marketable securities until an appropriate long term investment becomes available.

A company could also consider declaring a special dividend as a result of the sale proceeds and flow the funds to shareholders. This would usually only be considered if it could not find better uses for the proceeds either through re-investment or debt reduction. Once that money is distributed to shareholders, it is gone and no longer available to grow the company.

Municipal Options

The City also has physical and investment assets. The City should also be assessing the state of these assets on a regular basis to determine if they are providing a positive return. With respect to physical assets, the question is whether or not the asset is providing the expected service level for an efficient cost.

For investments, the City should be assessing the return in the same way as the private sector: Are the returns at or above our hurdle rate? The City's hurdle rate in most cases should be at least its average interest on debt (currently around 4%). For example, the Toronto Parking Authority's current hurdle rate of return for investing in new parking lots is 5%.

If the decision is made that the asset is underperforming and should be sold, the City has to make the same decisions as the private sector would around what to do with the proceeds:

- Should it invest the proceeds in new or improved physical assets that provide service at a higher level or at less cost?
- Should it invest the proceeds in a different investment vehicle that will earn new or higher returns?
- Should the funds be "parked" in the form of short term investments or temporary debt reduction?

The City could also use the proceeds to declare the equivalent of a "special dividend" to the taxpayers by using the proceeds to delay a property tax increase in the operating budget. But just like the special dividend to shareholders, this money can only be used once and will not be available for future investments, or to generate future returns.

Measuring Asset Performance vs. Sale Proceeds

Measuring asset performance has to take into account cash proceeds but also value creation. Dividends or other cash disbursements alone are not the measure of returns on ownership – equity appreciation is also important as it implies increased future revenue capacity, and future value in a sale.

The market looks to this performance, and will pay for future expected returns. The decision to monetize should therefore take into account a comparison of the proceeds of monetization with the present value the City would obtain or expect to obtain from retaining ownership. An attractive bid is most likely to occur when the marketplace assumes that less cost or higher revenues can be derived from the asset compared with continued City ownership.

Balance Sheet Considerations

An overriding consideration on asset sales is the strength of one's balance sheet. Both the public and private sector must ensure that their balance sheets are attractive enough to lenders to secure the lowest financing cost available. Lenders look for liquidity (e.g. financial assets are easier to sell than capital assets) and set their interest rates on perceived risk of default. In order to maintain the required liquidity needed to attain reasonable interest rates it may be necessary to sell capital assets even if they are returning a reasonable rate of return. Thus is particularly relevant to the City's existing situation as rising capital expenditures will require significant additional debt.

3. Potential Areas for Monetization

Enwave Energy Corporation (Enwave)

The City currently owns a 43% stake in Enwave, effectively sharing control with the other shareholder, BPC Penco Corporation, an OMERS subsidiary. In 1999 the City participated in the restructuring of Enwave into a for-profit share-capital corporation in partnership with OMERS, in order to put the company on a sound commercial footing, reverse years of under-performing returns, and facilitate the funding and construction of the deep lake water cooling project. These strategic aims have all been achieved. In 2010, Enwave's net income was $11.2 million, representing a return of 4.9% of total equity, or 5.6% of shareholder contributions.

Enwave's return on equity is now in excess of the City's rate of return from city investments, or the avoided cost on City debt. Furthermore, Enwave recently became more tax efficient and has initiated cash distributions to its shareholders in the form of interest payments on debt to the shareholders. Enwave's business returns are expected to continue to improve over the next few years as recent cooling contracts and investments in boiler efficiency begin to generate revenues. In the long run, Enwave cooling should become increasingly profitable as electricity prices continue to rise faster than inflation.

However, the City's policy objectives and value creation opportunities through owning Enwave appear to have been exhausted, and as a result, the City should consider monetizing its investment and reinvesting in other City priorities. It is expected that a private buyer might see considerable value in Enwave's record of steady financial improvement, healthy cash generation, and strategic brand position. Interested bidders could include pension or other investment funds, and energy or utility companies from around the world. The proceeds of sale could compare favourably to modest cash distributions and prospects for future growth under City ownership.

Under the current shareholder agreement the terms of sale include provisions protecting the rights of the remaining shareholder, which could have the effect of dampening market interest in bidding. Additionally, the market is expected to be more receptive to the whole company rather than a portion. Accordingly, staff have initiated discussions with the other shareholder regarding temporarily suspending the related terms of the agreement in favour of a joint sale process, as described in Confidential Attachment 1, for Council's consideration.

Recommended Strategy:

It is recommended that the City as shareholder, jointly with BPC Penco Corporation, direct the Board of Enwave Energy Corporation to undertake all necessary actions to solicit proposals for a joint sale of 100% of the shareholders' debt and equity interests in Enwave on behalf of both shareholders. It is further recommended that the Deputy City Manager and Chief Financial Officer be directed to report back to Council on the sale process in regard to Enwave and the recommendations from the Enwave Board in that regard, and make recommendations in regard to execution of a sale. The City may retain independent legal and financial advisors to review whether the results are sufficiently attractive to proceed. A final recommendation would be submitted for Council's consideration likely in the first or second quarter of 2012.

Toronto Hydro Corporation (THC)

The City is the sole shareholder of THC, a company primarily in the business of owning and operating the monopoly distribution of electricity in Toronto, regulated by the Ontario Energy Board (the "OEB"). In many ways THC is a similar business to that of natural gas distribution, operated in Toronto by Enbridge Gas Company, a publicly traded gas distributor with operations in many regions of Canada and pipeline interests across North America that is also regulated by the OEB.

The City has obtained considerable financial returns from its ownership position in THC, particularly from business initiatives such as the short-lived retail business, the competitive tender of the water heater business and more recently THC's telecom assets, and from the ongoing primary business of electricity distribution and billing.

The outlook for THC, as for many Ontario local distribution companies in older urban centres, is for growth through capital reinvestment in asset renewal. THC recently submitted their 2012 rate application which calls for a 50% increase in its rateable assets over the next three years. This in turn would increase its net income and dividend expectations proportionally pending OEB approval and/or changes to the application. Although the short term outlook is highly dependent on the outcome of the current rate application, the City can expect a general trend of growth in assets and income, 50% of which are currently paid out via dividends, and the balance retained for reinvestment. That reinvestment benefits the City in the long term in that it adds to the value of the City's ownership in THC. The related revenue stream also contributes to the City's positive credit rating.

Sale of Toronto Hydro has been considered and rejected by Council in the past. However, it should be emphasized that there are few negative implications from a 10% sale. Electricity distribution rates would not be affected – they are and would continue to be regulated by the OEB – not the shareholders. The City would retain controlling interest, with a slightly reduced dividend stream, but with use of the sale proceeds to reinvest in other productive City assets.

Monetization through an initial public offering ("IPO") provides the opportunity for shares to be widely held by a large number of investors, many of whom could be Toronto residents. The City may even direct Toronto Hydro to consider allocating a portion of the initial offering to Toronto residents, although care must be taken to avoid adversely affecting the sale price. IPOs typically have higher transaction costs than private auction sales, but similar if not superior results in appropriate circumstances.

A major impediment to monetization are the potential taxes under the Provincial Electricity Act. These include departure tax on a sale of 10% or greater to a non-municipal government entity, and the potential for transfer tax on the sale to an entity other than Ontario municipal distribution companies or Hydro One. These taxes have the potential to be prohibitive, and staff would not recommend a monetization proceed if they apply. However, if a sale is limited to 10%, staff expect these taxes would either not apply, or be completely offset by credits held by Toronto Hydro Corporation.

The City has previously obtained outside legal advice with respect to the 2010 monetization report and those conclusions are generally repeated in this report. If Council directs this initiative to proceed, outside legal counsel will be retained and any further issues related to the proposed transaction will be addressed at that time.

The potential downside of a 10% or less sale would include new governance complexities – primarily reporting, confidentiality and transfer pricing (inter-company business) obligations to the other shareholders, including the periodic holding of shareholder meetings (other than a meeting of City Council which serves for the current meetings of the shareholder). However, most of these procedures are already in place as THC issues debt in the public markets and is subject to the *Business Corporations Act* (*Ontario*) and the *Securities Act (Ontario).*

Recommended Strategy:

The City can monetize 10% of its holdings in Toronto Hydro Corporation via an initial public offering (IPO) without significant downside. Shares would be widely held by a large number of investors, including a portion of City residents. The proceeds would be available to reduce the City's debt issuance.

The valuation of an initial public offering may be highly dependent on the outcome of the rate application currently before the OEB, and not likely to be resolved before the spring of 2012. Therefore, it is recommended that the City direct the Board of Toronto Hydro Corporation to prepare for an initial public offering of 10% of the company, most likely after the completion of its 2012 rate application process, and seek final approval from the City to execute the offering some time in 2012. Furthermore, it is recommended that the City direct the THC Board to conduct the IPO so as to allocate the maximum portion of shares to Toronto residents that would not adversely affect the proceeds of sale.

Toronto Parking Authority

The TPA provides the most significant cash returns to the City among the three City owned business enterprises. Council at its meeting of September 27, 2011 passed a motion exempting the Toronto Parking Authority (the TPA) from privatization initiatives. Staff will continue to work with the TPA to identify options to emphasize revenue generation within its mandate.

City Real Estate

Real Estate Services is engaged in asset review and monetization on an ongoing basis. In partnership with Build Toronto, the Division is key to unlocking value from the City's real estate.

The current assessed value of the City's real estate holdings, excluding holdings of government business enterprises such as TCHC and Toronto Hydro, is $15.8 billion. This figure is a useful estimation, but not an accurate reflection of the monetized potential value of the lands for two main reasons. First, any assessed value may vary significantly from what the City might achieve through a sale. For example, some small properties are not large enough to be commercially attractive, but may have been assessed at the same rate as adjacent properties, overstating their value. In other cases, the assessed value may not reflect the value of the land if developed to its highest and best use. The second reason assessed value does not reflect monetization potential of the properties is that these properties are generally not surplus to the City needs, or are encumbered for some other purpose.

Below is a table showing the four broad categories of properties the City owns, followed by a description of the prospects for future monetization.

Summary of Assessed Value of City Real Estate Holdings ($ Billions)*

	Assessed Values	# of Properties
Assets related to provision of City Services		
Parks	5.4	1,163
Primary Service Properties	5.0	842
Secondary Service Properties	1.2	273
Subtotal	**11.6**	**2,278**
Vacant Lands	2.6	2,358
Commercial	1.2	132
Institutional	0.3	30
Subtotal	**4.1**	**2,520**
Total	**15.8**	**4,798**

*Values represent MPAC Assessed Values - does not reflect appraised or current market value

Assets related to provision of City Services ($11.6 billion): The total current assessed value of land assets used to provide City services is $11.6 billion. The largest holding is municipal parkland and open space, at $5.4 billion. Parkland is generally fully engaged in service provision. There are also policy and legislative restrictions on the disposal of any surplus park lands. To date parkland or green space has generally not been made available for sale, although to a minor degree is being evaluated for additional or complimentary uses.

The second largest type of holding, worth $5.0 billion in aggregate, is comprised of primary service program facilities, such as police, fire and ambulance stations, community and recreation centres, works yards, treatment plants, municipal offices, libraries, etc.

The remainder of the City facilities, assessed at $1.2 billion, include secondary municipal services, such as fairgrounds, golf courses, museums and municipal parking lots. Many of these asset holdings contribute to tourism, culture, and recreation for residents and visitors to the City of Toronto.

The City's Core Service Review and Service Efficiency Reviews may help identify opportunities among these asset groups to reduce facility requirements and increase potential targets for monetization. In some cases it may be determined that the facilities are underperforming assets and the City funds tied up in them could be put to more productive use elsewhere. Any change in ownership would have to address how the service aspects of the asset, if any, would continue to be met vs. the expected proceeds from monetization. For some assets, like the Toronto Zoo, divestiture may not generate any return, but it would relieve the City of future capital obligations and in turn decrease the need for additional debt.

Vacant properties ($2.6 billion): The City has acquired over 2,000 properties that are currently vacant, the majority of these zoned residential. Most are too small to be of development value, and adjacent owners have little incentive to purchase them from the City and incur higher taxes as a result. Typically they are assessed at the same rate as adjacent property (per hectare), and so the value figures are considered inflated. Nevertheless, the systematic review of these parcels by the Real Estate Audit Committee workgroup is underway and is expected to identify further surplus properties.

Commercial Properties ($1.2 billion): The City owns 132 properties that serve other municipal interests, such as clubhouses, sports complexes, and assets that support service delivery, such as industrial storage for equipment and supplies.

Institutional Properties ($251 million): The City owns 30 properties in which other government entities are conducting operations or have an interest. While almost half are school lands, each of these properties has unique circumstances that led to City ownership while used by other governments. In most cases, rents or cost sharing arrangements apply, so the City is extracting value from the investment, and by maintaining ownership, has a voice in the future use of the property should the need for its current use change. Nevertheless, the Real Estate Audit Committee will be reviewing these properties as part of their work plan.

As a general principle, all City assets are owned and/or acquired to serve a current or future municipal need. In the event that an immediate municipal use cannot be established, properties are leased-out and generate rents from third-party tenants (under a lease agreement). As circumstances change, the City's interest in the property may change, providing an opportunity to renegotiate lease agreements to derive higher value for both the City and the occupant, or divest the City's interest through surplus declaration. Periodically, the City's Real Estate Services Division brings these matters to Council for consideration.

The City has increased its efforts in recent years to identify and release properties for sale at their full potential value. The Real Estate Audit Committee is a staff working group that is systematically reviewing all properties held by the City to determine where opportunities exist for intensified development and/or sale. The review typically results in a report twice per year recommending properties for transfer to Build Toronto. In a May 2011 report, 8 new properties were identified for transfer, and another report is anticipated in the fall. So far, 32 properties with an estimated value at transfer of about $230 million have been approved for transfer to Build Toronto.

Currently, the Chief Corporate Officer has the Delegated Authority to declare City property surplus if the property is not required by any City Division (or ABC) and if the ward Councillor is in agreement. If the ward Councillor does not agree, the request can be "bumped up" to Committee and Council. In the event of competing priorities and interests, the ward Councillor has the ability to make alternate recommendations to Committee and Council for approval. This process expedites real estate activities but maintains ward and Council oversight.

Staff have been working to identify areas where the process can be improved or streamlined, and expect to bring forward further strategies to Government Management Committee in the first quarter of 2012.

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SIGNATURE

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Deputy City Manager and Chief Financial Officer

ATTACHMENT:

Attachment 1 – Confidential Information