STAFF REPORT
ACTION REQUIRED
With Confidential Attachment

Asset Optimization Review - Toronto Hydro Corporation and Toronto Parking Authority

<table>
<thead>
<tr>
<th>Date:</th>
<th>November 17, 2016</th>
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<td>To:</td>
<td>Executive Committee</td>
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| From:         | City Manager  
               Deputy City Manager & Chief Financial Officer |
| Wards:        | All Wards |
| Reason for Confidential Information: | Security of the property of the City and a matter in respect of which City Council or another body may hold a closed meeting under another Act. |
| Reference Number: | P:\2016\Internal Services\Cf\Ec16026Cf (AFS #23953) |

SUMMARY

As part of the work on the City's updated long-term financial direction, the City is assessing its overall approach to enhancing both revenue and expenses. City finances are often complex and seemingly abstract, but they are fundamental for achieving Council's collective vision for a growing, diverse and dynamic community, with unique challenges such as congestion, poverty related issues, and social housing burdens that are different from those faced by other municipalities.

The City Manager and the Deputy City Manager & Chief Financial Officer have undertaken an asset optimization study in relation to the City's investments in Toronto Hydro Corporation ("THC") and Toronto Parking Authority ("TPA"), as directed by Council in June 2016. In order to carry out this work, City staff retained the services of Deloitte LLP.

The results of the Deloitte study are outlined in this report. In regard to THC, the analysis considered the relative benefit in present value financial terms of four main capital restructuring options, each designed to increase dividends or monetize equity.
The conclusion is that if the City is most concerned with maximizing present value and preserving dividend flow, then the best course of action is a direct City investment of approximately million to restore and enhance THC's capacity to pay dividends.

In the event that the revenue options study fails to identify a revenue strategy to begin to address the City's unfunded capital program, then a monetization of the City's equity in THC could be considered at a later time. Necessary steps are identified to explore monetization options, including action on a mitigation strategy for the significant transaction tax exposure.

With respect to the City's investment in Toronto Parking Authority (TPA), it is recommended that the City retain its ownership under an enhanced net income scenario, and that the potential for increasing TPA's payout rate to the City be considered as part of the 2017 budget process. It is also recommended that TPA's plans for capital expansion continue to be screened through the City-Wide Real Estate Review process.

**RECOMMENDATIONS**

The City Manager, and the Deputy City Manager & Chief Financial Officer recommend that:

1. a. City Council provide support for the credit rating and balance sheet strength of Toronto Hydro Corporation in order to restore and enhance dividend capacity by making an equity contribution of approximately $250 million, the details to be subject of a DCM & CFO report to Executive Committee in Q1 2017; and,

   b. The City Manager initiate a governance review to ensure that the Corporation and its Board have the appropriate orientation to optimize fiscal results.

2. City Council direct the Deputy City Manager & Chief Financial Officer to report to the Budget Committee as part of the 2017 budget process, on the potential for increasing the Toronto Parking Authority's income share rate to the City.

3. City Council direct the President of the Toronto Parking Authority in consultation with the Deputy City Manager & Chief Financial Officer and the Board of Directors of Toronto Parking Authority to report to Executive Committee in 2017 on potential measures to support increasing TPA income including consideration of the TPA's rate setting process, with a view to a City-wide strategy for increasing the alignment of future parking rates with market prices.

4. City Council authorize and direct the appropriate City officials 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 to Council's decision.
DECISION HISTORY

At its meeting on May 5 and 6, 2015 (Item EX5.5), City Council considered a report entitled "Consolidated City-Wide Real Estate Framework", and directed the City Manager to retain a third-party consultant, combined with an independent advisory panel to undertake a City-wide real estate review for the purposes of carrying out an objective evaluation of all City-owned real estate operations:


Subsequently, at its meeting of July 12, 2016 (EX16.4), City Council further directed that:

"City Council adopt in principle the directions to move to a centralized real estate operating model as broadly described in Appendix A of this report and authorize the City Manager to:
   a. recruit and appoint a transition team; and
   b. develop a transition strategy and implementation plan, in collaboration with affected City agencies and corporations", which includes Toronto Parking Authority, "including a recommended governance model incorporating a core city building mandate that considers public policy objectives such as affordable housing, public realm, public transit and economic development and report further to Executive Committee in Q2, 2017".

This report further directed that:

"City Council request that the City's affected City agencies and corporations", which includes Toronto Parking Authority "during the development of the real estate transition strategy and implementation plan, co-operate and coordinate with the transition team, when undertaking any real estate transaction or development work of significance (whether in dollar value, City building potential, size of site, or otherwise). "

http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2016.EX16.4

At its meeting of June 7- 9, 2016 (EX 15.1), City Council considered a report on the City's Long Term Financial Direction, and requested the City Manager and the Deputy City Manager & Chief Financial Officer to undertake an asset optimization study, including consideration of how possible proceeds could be used to address the City's capital deficit through the City Building Fund and report in the fall of 2016.

http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2016.EX15.1
The underlying report indicated that City-owned assets should be reviewed in terms of the potential to increase returns within given ownership, governance and operational structure(s) and the value of partial/full sale in order to fund key city-building initiatives. Assets identified for review included Toronto Hydro Corporation, and Toronto Parking Authority.

http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2012.EX15.4

Financial Implications:

**Toronto Hydro Corporation (THC)**

The City budgeted THC dividend payments from THC of $67.5 million and expects to receive $63.35 by year end based on 2015 net income. THC currently has a high debt-to-equity ratio of almost 65% which is well in excess of the deemed OEB ratio of 60%. On November 15, 2016 the City Manager received formal notice from the Toronto Hydro Board chairman that 2017 future dividends will be reduced to $25 million beginning in 2017 in order to preserve capital and reduce debt, unless these issues are addressed by the shareholder through other means.

In order to achieve the desired THC debt reduction and to preserve the City's dividend stream, the Deloitte analysis indicates that the City could provide an equity injection in the order of $250 million either via a direct investment or by allocating a portion of equity sale proceeds to THC. Either recapitalization option would facilitate a return to the normal dividend stream to 50% of net income and possibly lead to a future increase in the dividend payout rate commensurate with the corporation's risk profile and comparable business entities.

Deloitte concludes that the City's best option based on a present value (PV) analysis is to address the THC capital shortfall through a direct equity investment of approximately $250 million. The City's dividend expectations would increase immediately by at least $35 million, while foregone investment fund returns would be only about $5 million for a net gain to the City of $30 million in the first year.

Deloitte indicates that the 9.8% rate of return on such an investment will exceed the Ontario Energy Boards (OEB's) regulated rate of return (currently just under 9%). This rate of return is well above the current expected long term returns in the investment fund, and even above the expected returns once the City's new investment regulations are fully in effect in 2018.

Alternatively, the City could access the necessary capital by directing THC to conduct a partial sale (10% or less). A sale would entail significant transaction costs and governance changes, with a potential marginally increased value to the City, but only if future dividends are discounted at the OEB rate. However, if the City's future dividends are valued at the City's cost of capital (avoided cost of debt), retention remains a significantly higher value option.
Deloitte also modelled the sale of 49% and 100% of the company, by either a public share offering or a private market sale (auction) to a 'strategic' buyer. In each case, the treatment of future City dividend revenues is crucial. A sale of any amount only makes sense if the City values future dividends at a highly discounted rate. When these future dividends are discounted at the most recently approved OEB rate of return of 8.78%, a private market sale of 49% is expected to increase the present value for the City by about 12%. At this discount rate, value is diminished due to higher Provincial taxes, but still favourable, with a 100% sale.

Any sale of the company involves significant transaction costs, and a sale of greater than 10% triggers Provincial transaction taxes. The tax exposure for a hypothetical sale at current market prices (based on Hydro One trading multiples) would trigger departure taxes of over $200 million, and transfer taxes if the portion and value sold exceeds certain thresholds, as illustrated in the table below. Other transaction costs (legal, financial and trading commissions) can approach 5% (including THC and City costs) of the total proceeds:

<table>
<thead>
<tr>
<th>Transaction Taxes for Hypothetical Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOR ILLUSTRATIVE PURPOSES ONLY</td>
</tr>
<tr>
<td>($ millions)</td>
</tr>
<tr>
<td>Portion Sold</td>
</tr>
<tr>
<td>10%  49%  100%</td>
</tr>
<tr>
<td>Net Sale Proceeds *</td>
</tr>
<tr>
<td>250  1,125  2,500</td>
</tr>
<tr>
<td>Departure Tax</td>
</tr>
<tr>
<td>0  -240  -240</td>
</tr>
<tr>
<td>Transfer Tax</td>
</tr>
<tr>
<td>0  0  -440</td>
</tr>
<tr>
<td>Net Sale Proceeds after Taxes</td>
</tr>
<tr>
<td>250  885  1,820</td>
</tr>
<tr>
<td>As a % of Net Sale Proceeds</td>
</tr>
<tr>
<td>100%  79%  74%</td>
</tr>
<tr>
<td>Less: Contribution to THC</td>
</tr>
<tr>
<td>250  250  250**</td>
</tr>
<tr>
<td>Net Proceeds to the City</td>
</tr>
<tr>
<td>0  635  1,570</td>
</tr>
</tbody>
</table>

*after transactions costs, before taxes
**would normally reduce gross proceeds

A sale would be expected to be accompanied by an increase in the dividend payout rate, mitigating to some extent the loss of dividend revenue shared with the buyer.

**Toronto Parking Authority (TPA)**

TPA currently has a net income sharing agreement with the City, in which it currently remits 75% of net income (surplus to operating requirements). In 2016 the City will receive an estimated $47 million in the form of income sharing dividends from TPA.
Deloitte looked at four main scenarios: remaining with the status quo, enhancing revenue payments to the City, phased sale of certain TPA assets, and partial operating concession options.

Deloitte concluded that it would be most appropriate for the City to consider an enhanced income option for TPA, reviewing TPA's current plans for capital expansion, sale of certain TPA off-street assets, and increasing the net income payout rate to the City. If the City were to increase its TPA net income sharing percentage from 75% to 85%, the City would receive an estimated additional amount of $6.3 million in 2017.

The City has already taken steps through the budget process to renew and renegotiate the City - TPA Income Sharing Agreement, and will be reporting back to Council through the 2017 budget process.

BACKGROUND

The June 2016 report to Council on the City's long term financial direction discusses both the short term budgetary challenges of the City and the longer term fiscal sustainability issues such as its large unfunded capital expenditure demands, and sets out a plan for resolving these issues.

City Divisions and Agencies have identified needs or advanced planning for major capital projects for which funding has not yet been identified. The cumulative value of all unfunded capital projects, or the capital "overhang," is now estimated to be as high as $33 billion over the next 20 years. Unfunded capital projects include transit, transit expansion, housing, and other state of good repair needs.

An important part of the solution involves optimizing and allocating current and future revenue sources. There are a number of separate initiatives being pursued as part of a Long Term Financial Plan (LTFP), including expenditure control measures, capital funding strategies, asset optimization strategies and highway tolling. The latter two are the subjects of reports on this agenda.

As part of a June LTFP June report, City Council requested the City Manager, and Deputy City Manager & Chief Financial Officer to undertake an asset optimization study, including consideration of how possible proceeds could be used to address the city's capital deficit and report in the fall of 2016.

In order to carry out the Council direction, City staff retained the services of Deloitte LLP through an RFP process, to undertake an analysis of the City's investments in Toronto Hydro Corporation and Toronto Parking Authority, and to recommend viable options for the City's consideration. This analysis forms part of the overall work in addressing a long-term financial plan for the City, and has included reviewing potential options for operational changes, revenue sharing, as well as changes in ownership or control.

At the same time, Toronto Hydro Corporation is facing its own challenges raising the capital necessary to address its aging electricity distribution infrastructure, to service the
needs of a growing City, and to begin to adapt to a future low-carbon economy. On November 15, 2016 Toronto Hydro advised the City that it intends to reduce dividend payments to $25 million annually in order to preserve capital and limit debt increases for its capital expenditure program, until such time as the City identifies its preferred option for addressing THC's capital shortfall.

**Toronto Hydro Corporation**

In June 1999, City Council approved the incorporation of Toronto Hydro (under the *Ontario Business Corporations Act*) which had previously existed as a commission of the City. Toronto Hydro Corporation (THC) is primarily in the business of owning and operating the monopoly electricity distribution system in Toronto, under the regulation of the Ontario Energy Board (the "OEB").

The OEB has regulatory oversight of electricity matters in Ontario. The *OEB Act* sets out their authority to issue distribution licenses to utilities such as THC. The OEB prescribes license requirements and conditions such as accounting records, regulatory accounting principles, separation of accounts for distribution and other activities, and requirements for rate-setting and other legal filings. The OEB's authority and responsibilities also include:

- Approving and fixing rates for the transmission and distribution of electricity
- Approving the amounts paid to non-contracted generators
- Providing rate protection for rural or remote electricity customers
- Ensuring that electricity distribution companies fulfil their obligations to connect and service customers

THC is a holding company which wholly owns two incorporated subsidiaries:

- Toronto Hydro Electricity Systems Limited (THESL) that distributes electricity to customers in the City of Toronto
- Toronto Hydro Energy Services Inc. (THESI) that provides street lighting services to the City of Toronto

THESL operates under a Custom Incentive Rate (CIR) rate setting method whereby rates are set for a minimum five-year period based on a cost of service basis for the first year with subsequent annual adjustments as determined uniquely for THESL by the OEB. The OEB recently approved a five-year CIR application for the period 2015-2019.

The City, as sole shareholder, adopted a Shareholder Direction relating to THC, setting out certain corporate governance principles and shareholder objectives. As with all corporations that are governed by the *Ontario Business Corporations Act*, the THC Board must "act honestly and in good faith with a view to the best interests of the corporation". Under the Shareholder Direction, the THC Board is responsible for supervising the management of the business and affairs of the corporation, including approving any dividend payment.
The Toronto Hydro Corporation Board has 11 directors including a board appointed chair. Three of the directors are Councillors, including one who is appointed as the Mayor's designate.

The terms of the current chair (David Williams) and a non-Council director (Derek Cowbourne) end on December 10, 2016. The City's Corporations Nomination Panel has recommended that David McFadden be the new Chair.

The current dividend policy that is included in the Shareholder Direction (subject to restrictions imposed by law and by the Shareholder Direction) with respect to the declaration of annual aggregate dividends is as follows:

- 50% of the prior fiscal year’s annual consolidated net income, with a minimum annual amount of $25 million;
- payment to the City in equal instalments of $6.25 million on the last day of each fiscal quarter of the year (March 31, June 30, September 30 and December 31);
- the balance of the annual dividend, if any, payable within ten (10) days from the date of approval by the Board of THC's annual audited consolidated Financial Statements.

THESL earns a rate of return on eligible invested capital as approved by the Ontario Energy Board. The most recent OEB rate decision covers the period from 2015 through 2019 and allows for a deemed return on equity of 9.3%, sustained capital reinvestment and commensurate earnings growth (approx. 10% per year). More recent OEB rate decisions have allowed lower rates, in keeping with market changes.

The City has received dividends from THC since 2003. Initially earnings and related dividends were predominately from business activities in unregulated business initiatives such as the short-lived retail business, the competitive tender of the water heater business, the sale of THC's telecom assets (2008). Since 2009 dividends have been almost exclusively from the ongoing regulated electricity distribution business, and have been growing steadily as a result of increased investment in capital asset renewal. The table below provides a summary of the $622 million in dividends received from THC since they began issuing dividends in 2003:
Toronto Parking Authority

Toronto Parking Authority (TPA) is a public corporation owned by the City of Toronto, was established on January 1, 1998, by the City of Toronto Act (1977), and is governed by the Toronto Municipal Code, Chapter 179, "Parking Authority". TPA's mandate is to provide safe, attractive, self-sustaining, conveniently located and competitively priced off-street and on-street parking as an integral component of Toronto's transportation system. TPA also manages the City's Bike Share Program, with a fleet of approximately 2,000 bikes and 200 stations. TPA controls over 22,000 off-street parking spaces in over 200 facilities, 19,300 on-street spaces, and manages 15,000 parking spaces operating for third parties, mainly for the Toronto Transit Commission.

TPA revenues fully fund its operations and also contribute significant amounts to the City's general revenues. From 1998 (amalgamation) to 2015, the TPA returned earnings to the City of approximately $793.5 million, and with an estimated $46.8 million for 2016. In addition, TPA pays municipal taxes and rents to other Agencies and Divisions. The graph below sets out returned earning dividend payments to the City.
City Council appoints an 8 member Board for TPA, including the Board's Chair. The Board includes 2 members of City Council, 5 public members (4-year term), and the City's General Manager of Transportation Services, as a non-voting member. A vice-chair is elected by the Board.

The Board meets monthly, or at the Chair's request, and is responsible for supervising the TPA's business and affairs, including overseeing the implementation of corporate strategy by management and the investment of capital reserves.

The City's Financial Planning Division is currently negotiating a renewal of the City's Income Sharing Agreement with TPA, and will be reporting through the budget process.

**COMMENTS**

**Use of Funds/Contribution to Long Terms Financial Plan resolution**

The decision to sell all or a portion of a City business is an important financial and policy question. From a financial perspective, the City can compare expected outcomes based on the present value of the revenue streams from various options. The 'PV' provides an indication of the relative capital expenditure capacity enabled by each option. Selection of the highest PV option is important as the City attempts to address its $33 billion unfunded capital expenditure requirement.

City assets can be viewed in terms of their potential to increase returns as measured by present value, enabling increased capital expenditure. For revenue generating assets such as THC and TPA, increased returns can fund higher debt service costs. Or, if sold, the net
proceeds can fund capital expenditures directly. The comparison of which approach enables more capital expenditure is the essence of the present value analysis.

Currently THC dividends and TPA revenues are operating budget revenue for the City. A monetization would reduce dividends/annual payments and create operating budget pressure, but generate sales proceeds to offset unfunded capital requirements. Operating revenue can be considered in terms of the amount of capital expenditure debt service it could support. In this way the PV analysis compares all options on an equivalent basis.

Monetization decisions are usually final – they are generally not reversible in practical terms. And assets like THC and TPA are unique and therefore irreplaceable. In addition, they may provide important policy levers for City objectives.

This is certainly the case for the TPA. The TPA provides a service that is already available from the private sector. Its role is therefore based on how it is different from the private sector operators. Parking rate and location decisions are integrated with City objectives like traffic flow (on-street parking rules), planning for business activities in residential areas (off-street lots vs. permit parking management), and redevelopment proposals (surplus lots). This policy integration works best when the governance framework is flexible enough to deal with changing City and TPA priorities.

Toronto Hydro, on the other hand, is a monopoly power distributor, regulated by the Ontario Energy Board. Rates, services standards and even governance and administration issues are the purview of the OEB if there is the potential for ratepayers to be affected. The City has influence only at the margin, and typically pays for discretionary service requests, abiding by the affiliates relationship code which restricts cross corporate subsidies.

**City Optimization and Evaluation process**

City staff, with the assistance of Deloitte LLP, have undertaken an optimization analysis of the City's investments in Toronto Hydro Corporation, and Toronto Parking Authority. The summary report prepared by Deloitte is provided as Confidential Appendix 1 to this report. A discussion of the options being considered is provided in this report.

**Toronto Hydro Corporation**

**Direction to Deloitte**

Deloitte was retained to review asset optimization, analyzing and comparing potential options for the City's investment in THC including retention, sale, partial sale, lease, or strategic partnership. The analysis was to include both quantitative and qualitative elements. They were also directed to review recent comparable transactions, structures, and decisions in other jurisdictions.
Deloitte was also requested to review and verify THC's assertions that they required a source of equity capital to manage debt levels and provide flexibility for investment opportunities. After THC announced that dividends would be curtailed, Deloitte was further requested to comment on whether this action appeared to be warranted based on the current financial situation.

**Process**

Deloitte reviewed THC financial models based on the current five year OEB approved rate decision (2015-2019) and THC's 20 year expenditure and revenue forecast. It used this confidential information to conduct analysis of various dividend and equity generation options.

The centrepiece of the analysis is the present value comparison of the cash flows to the City. Toronto Hydro is a dynamic company which expects to grow significantly due to plan investments in regulated distribution assets. While it is dealing with capital funding constraints in the short run, the long run forecast, subject to periodic Ontario Energy Board review and approval, is for continued investment in capital expenditure, and related growth in net income and dividends. In addition, based on the risk profile of the company, in the medium to long term the dividend payout rate may be able to be increased by up to as much as 75% to be on par with industry comparables.

The valuation of future dividend expectations is therefore a complex business. Deloitte modelled THC's assumptions, and set dividends so that conservative credit metrics would be obtained. Future dividends were then discounted to reflect the time value of money, and the uncertainty of the forecasts being realized. A crucial assumption in these calculations is the how future income flows are discounted for uncertainty. When the present values are calculated using the City's cost of capital — essentially assuming full realization of future revenues, retention of ownership is by far the preferred option. When these future incomes are discounted at a risk adjusted rate as indicated by the OEB's regulated rate of return (most recently 8.78%) the present value distinctions between various options becomes much less clear, but favour a partial sale.

In addition to incomes forecasted by THC, the company has prospects for growth due to climate change, and Provincial plans to deal with it through greater electrification. Although the City's policies are consistent with significant investment requirements and adaptation expenditures to deal with climate change, it is not certain which companies will be most engaged in the solution and which will benefit most. Toronto Hydro has the potential to grow significantly to address further electrification, but neither THC nor Deloitte has quantified the prospective income value.

**Findings**

Deloitte found that THC claims of an equity capital shortfall were well founded, driven by the demands of its $2.5 billion capital expenditure program. Deloitte agreed that without an equity contribution, there is a risk of a credit rating downgrade as the debt-to-
capitalization ratio continues to be almost 65% rather than the deemed OEB rate of 60%. A credit rating downgrade to BBB would result in a significant increase in debt financing costs. Deloitte found that a capital contribution of approximately $250 million would restore the company's equity to debt ratio to a more appropriate level, enabling or enhancing dividend capacity.

Secondly, the City's legal advisors found that the Board of Toronto Hydro was within its rights and duties to announce that it intends to reduce annual dividend payouts to $25 million until its equity issues are resolved. Deloitte determined that this course of action is fiscally appropriate. It appears that this curtailment would need to last about four years to achieve the appropriate rebalancing of equity to debt.

Finally, Deloitte was asked to advise the City on the most appropriate way to address the THC equity situation. Deloitte considered the following factors to reach its conclusions:

- **Financial**
  
  1. Council Position: Retain while Shareholder’s income stream is comparable to financial benefit from divestiture (per Shareholder Direction)
  2. Income and transfer tax impacts of sale, key thresholds, potential for exemptions
  3. Appropriate share for retention/divestiture
  4. Competitive process vs. negotiated sale to strategic buyer
  5. Impact of existing/pending provincial and/or federal legislation (i.e. Green Energy Act)

- **Strategic**

  1. OEB relationship and respect for municipal shareholders
  2. Street light service provider – future contract negotiations

- **Governance**

  1. Determine governance implications, new shareholder rights related to sale
  2. Maintain control vs. establish commercial arm's length service relationship

**Options Analysis**

In addition to the status quo, Deloitte considered four main options available to the City with regard to the addressing THC’s equity requirements and the City's own capital funding optimization needs. Each was ranked in terms of its present value generation to the City.

**Option 1 - Status Quo**

In this baseline scenario, the dividend payments to the City are maintained at 50% of net income. THC's debt levels gradually return to targeted levels by 2028. As a result there
is the risk of a credit downgrade in the next few years as well as potential regulatory risk at the next rate rebasing in 2019.

This scenario was eliminated in practical terms when the Board indicated that it would be limiting dividend payments to the $25 million level for the foreseeable future.

**Option 2 – Adjusted Dividend Option**

This scenario models the dividend curtailment for four years. By preserving capital, this scenario is similar to a direct equity contribution, but with less certainty for the bond market and regulator.

This scenario was eliminated due to the City's position that a $35 million budget impact was not an acceptable outcome.

**Option 3 – Direct Equity Investment Option**

In this scenario the City makes an equity contribution of approximately $250 million to maintain THC's credit capacity and enable the company to react to emerging business opportunities.

THC has indicated to the City that its dividend curtailment and the resulting $35 million 2017 City budget pressure could be avoided if the City is able to make a direct equity contribution of approximately $250 million. Staff have confirmed that the City is authorized to make such an investment under the rules of the Electricity Act, which would be funded "off budget" from its investment portfolio. THC's forecasted debt requirement would be reduced commensurately, its credit metrics improved immediately, and adherence to the 50% of net income direction restored.

For the City, the advantage of this scenario is that dividends are restored or enhanced, enabling a positive return on the incremental investment. Also, mandatory governance changes and transaction costs associated with funding the capital contribution through a partial sale are avoided. But fundamentally, the Deloitte analysis shows that under most evaluative assumptions, if the City retains all future THC dividend revenues it maximizes present value, and participation in the future growth of THC.

**Option 4 - Initial Public Offering**

As an alternative to a City equity contribution, up to 10% of the company could be sold without triggering transaction taxes, and the proceeds reinvested in the company to meet its capital/equity requirements.

Deloitte considered a minority public share offering of 10% or less. A transaction of this magnitude would not generate high value, and not optimize share price, unless it were structured as the first of a series of sales, i.e. a significant IPO sale as described below. Accordingly, any IPO would require major changes to the shareholder direction to reflect
minority shareholder rights and optimize share value at issuance. The governance changes would reduce the City's ability to influence issues such as senior management and Board member compensation, which have been important issues for Council in the past. They could also put the City in a position where further erosion of its ownership stake and control could occur if the Corporation sought to raise capital through a subsequent share issuance. The street lighting agreement with the City would need to be restructured to reflect distributed ownership. This option has no advantage over direct City investment in terms of raising funds for City needs, and introduces significant governance complications.

Deloitte also modelled a larger sale – 49% of the company, and a complete sale of 100% of the company, via public share offering. This approach does not by itself generate business synergies or strategic benefits that might accrue from a sale to a private entity. In addition, the Provincial tax regime makes the cost quite high, especially for a 100% sale. But most importantly, as with all sale options, the present value of foregone dividends to the City is simply not replicated by the sale proceeds, unless the forecasted dividends do not materialize to a larger degree due to business and regulatory risk, as illustrated when a high (OEB return) discount factor is used to calculate future value.

Relative to strategic buyer/auction (below), an IPO can have some advantages, because new ownership is widely held so that there are no other dominant shareholders. In addition, market timing risk can be managed by partial sales spread over time, based on the City's assessment of trading price and market conditions. However, IPOs typically have higher transaction costs than private sales.

The PV of any large sale would be significantly enhanced if the Province agreed to offset the applicable transaction taxes. Nevertheless, it would still be considered less attractive from a PV basis than a direct investment in the context of the City's cost of funds.

**Option 5 - Private Market Sale Option**

The City could also raise the capital to address THC's requirements, plus generate immediate proceeds for reinvestment in other capital priorities, through a private sale of equity shares. Deloitte's analysis considered a private sale, to a single entity, of 10%, 49% and 100%.

A private sale is thought to be the most effective in terms of generating the highest sale proceeds, through the realization of synergies and strategic benefits. Otherwise it shares many of the attributes of an IPO sale.

Governance changes would be required to reflect the arrangement between the City and the new co-owner, unless 100% of the company were to be sold.
Transaction Taxes

Provincial taxes on a sale have been considered a major impediment to selling more than 10% of the company. The comparative analysis prepared by Deloitte takes these issues into consideration. Nevertheless a basic understanding of the applicable taxes is important, particularly to support a City request to the Province to take steps to mitigate these taxes.

Interplay between key transaction taxes and the portion of the company tendered for sale is illustrated below. Taxes can be avoided by a sale of 10% or less, and minimized in percentage terms by selling a larger stake (the optimal sale for tax purposes appears to be about 50%), or in absolute terms by obtaining tax relief or mitigation from the Province.

### Transaction Consequences from Hypothetical THC Sale

**FOR ILLUSTRATIVE PURPOSES ONLY**

($ millions)

<table>
<thead>
<tr>
<th>Portion Sold</th>
<th>10%</th>
<th>33%</th>
<th>49%</th>
<th>67%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Proceeds (net of transaction costs)</td>
<td>250</td>
<td>833</td>
<td>1,250</td>
<td>1,667</td>
<td>2,500</td>
</tr>
<tr>
<td>Departure Tax</td>
<td>0</td>
<td>-240</td>
<td>-240</td>
<td>-240</td>
<td>-240</td>
</tr>
<tr>
<td>Transfer Tax</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-77</td>
<td>-440</td>
</tr>
<tr>
<td>Net Proceeds</td>
<td>250</td>
<td>593</td>
<td>1,010</td>
<td>1,350</td>
<td>1,820</td>
</tr>
<tr>
<td>Less: Contribution to THC</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>Net Proceeds to the City</td>
<td>0</td>
<td>343</td>
<td>760</td>
<td>1,100</td>
<td>1,570</td>
</tr>
<tr>
<td>Percentage of Gross Proceeds Retained by City &amp; THC</td>
<td>100%</td>
<td>71%</td>
<td>81%</td>
<td>81%</td>
<td>73%</td>
</tr>
</tbody>
</table>

Dividends

Dividend expectations are at times more important to the City than present value, due to the direct operating budget implications of changes in dividend revenues.

As the City ownership share decreases through a common share equity sale, so too would the City's share of dividends, creating a new operating budget pressure. However, a coincident increase in the dividend payout ratio (as a percentage of future net income) could mitigate some of the dividend loss depending on the portion sold and the payout rate increase.

Below is a summary of the various dividends depending on the % ownership of THC by the City as well as various dividend payout rates, all else being equal:
In the table above, which is for illustrative purposes only, a sale of a one third share of the company (with net proceeds of about $750 million after tax and $250 million retained by THC) could result in a dividend stream similar to the current forecast if the payout rate were increased to 75%.

It should be noted that although comparable firms may pay dividends corresponding to a higher share of net income, important circumstances such as business risk and capital requirements vary.

**Strategic Buyer vs. IPO**

As discussed in the options analysis, private auctions, especially those involving a controlling interest, are expected to result in the highest value for the City if future dividends are discounted at the relatively high rate of 8.78%. The value from a strategic private sale would be generated from the expectation of synergies, and possibly valuing potential future gains from merger and acquisition activity or growth from climate change response initiatives. Due to the likely rebasing requirement, the retention of synergies is limited.

Private auctions also have lower transaction costs. They require contractual arrangements between shareholders that may constrain liquidity, but if no future sales are contemplated for an extended period, this arrangement can work well. The City had this type of arrangement for its former ownership of Enwave Energy Corporation. There is evidence that an auction would attract significant market interest from energy companies and major pensions.

A sale of shares through an initial public offering (listing shares on the stock exchange) is expected to generate somewhat lesser value, but facilitate a sale by tranche over time similar to the Province's sale of Hydro One, thereby spreading out the market timing risk (sale proceeds/prices are constantly changing in response to market factors). Also, the City could have more flexibility over its retained shares (i.e. timing and amount of future sales).
If the City were to pursue either type of equity sale, a new governance framework including a new Board structure would be required. Furthermore, rules governing dividend policy, future sales, and equity contributions would be necessary to optimize the sale value and reflect the rights of the other shareholders. The changes would be expected to free the company from compliance with City specific guidelines and interventions in areas such as senior management and board compensation, stock options, procurement, and oversight by City accountability officers. In short, the City would have less control over the administration of the company, including its activities to raise additional capital and potentially further dilute the City's ownership position.

Also, for either sale option, changes would be required to the street lighting service agreement between to the City and THC to ensure that the City's rights are protected when dealing with third party owners.

A strategic sale or an IPO would be subject to OEB approval pursuant to its authority under the Ontario Energy Board Act to approve MAAD applications (Mergers, Acquisitions, Amalgamations and Divestitures). Competition Act approval would also likely be required. Furthermore, there would be third party consents, approvals and notices with lenders, landlords, suppliers and unions as possible categories of third party discretionary approvals.

**Timing Conditions Favouring a Sale**

Deloitte found that market conditions are favourable (i.e. likely to result in a relatively high share price), at present due to:

- Market – low interest rates and high demand for equity rates of return
- Attractive regulated return on equity (9.3% - 2015 rate decision)
- 5 year rate approval 2015 – 2019 with fixed return expectations
- Market activity of comparables – Powerstream merger, Hydro One IPO, indicating potential for future value creation through further sale/merger, synergies. This position is supported by the interest indicated by potential buyers.
- Provincial tax window (reduced transfer tax and certain gains taxes until 2019).

Any monetization process would require between six to eight months to complete. Staff suggest that the THC board is best positioned to manage a sale process. The Board is currently comprised of experienced private sector business leaders, as well as three City Councillors.

**Conclusion**

THC is well positioned for internal growth through capital asset renewal expenditures. Its income growth forecast is enviable, particularly in today's economy.
Deloitte concluded that the City's best option in terms of maximizing present value is most likely to retain ownership of 100% of Toronto Hydro and make the necessary equity contributions to restore dividend capacity and flow. This would allow the restoration of the dividend payout ratio to 50% and potential increases of upwards of 75% in future years. Simply accepting a dividend reduction until equity is rebalanced would have also been reasonable, but the City's budgetary reliance on dividends made this option unacceptable.

The dividends enabled by an equity contribution provide a favourable return on investment relative to the City's other current and future investment options. The equity contribution also protects against erosion of earnings through credit downgrade or regulatory risk. In the long run, the rebalancing of debt to equity is expected to provide returns at the regulated rate of return, currently about 9%.

An equity sale can generate high values based on synergies, but since these cost efficiencies are largely returned to the ratepayers over time, bid prices would be largely limited to the expected dividend value over time. The City is expected to value future dividends more highly than private sector buyers due to its lower cost of capital and threshold investment rates.

It is never possible to know for certain what price a unique asset such as Toronto Hydro would attract, without going to the market. For example, a bidder might place a high value on the growth prospects from the company's role in adjusting to climate change. If the City sold the business, and the company did not profit from climate change as anticipated, the City would be ahead as the seller, and the buyer would take a loss.

Deloitte and City staff think this situation is unlikely to occur. Business investors seek to avoid risks. Prices would be expected to reflect a healthy discount for risky future income. Accordingly, the City is thought to be in the best position to retain ownership and realize future revenue gains associated with uncertain prospects.

There are circumstances which could lead the City to consider a sale. The first relates to the company itself. Toronto Hydro is a non-core function of the City by most criteria. It is regulated by the OEB, and so City ownership is not an imperative for service or policy reasons. Many former government owned corporations have continued and thrived post divesture, and Toronto Hydro could follow in this tradition.

If the City were to find that it is unable to find the means to properly capitalize the company, now or in the future, it could result in diminishing value of the company. Government control of a business corporation is not always the optimal arrangement for the value of an asset. In this case the City would likely be better off by selling to a shareholder better able to optimize the business.

More importantly, in the event that a revenue strategy to deal with the City's unfunded capital program is not identified as part of the 2018 budget process, Council may wish to re-consider a sale of a share of Toronto Hydro.
If the City were unable to fund its own capital requirements in the short term it could require access to the proceeds of sale of an otherwise valuable asset. This is not the City's current situation, because the City has recourse to debt, and a tax base to service that debt. Consequently, it should be in a position to afford to choose the highest present value option. However, if debt markets were to become closed to the City, or if the City were unable or unwilling to use its tax base to service the debt required to meet its capital expenditure requirements, and the social, rather than financial rate of return on alternative investments in public infrastructure were considered a higher priority, then an equity sale could be an option worth considering.

If such a decision is reached, Council would need to direct the City Manager and Deputy City Manager & Chief Financial Officer to identify the preferred approach for a sale, and to enter into discussions with the Province of Ontario regarding potential Provincial actions to mitigate or offset the potential transaction taxes. Authorizations would be required to retain appropriate financial and legal advisors to prepare the City for and if approved, monitor the sale on behalf of the City, and to instruct Toronto Hydro regarding its role in the process.

**Toronto Parking Authority**

**Direction to Deloitte**

Council directed staff to include a review of TPA in the City's asset optimization study at its meeting of June 7-9, 2016. The scope of work undertaken by Deloitte in relation to TPA included a quantitative and qualitative analysis and comparison of potential options for the City's investment in TPA. These options included maintaining the status quo, sale, revenue optimization, and sale or lease options. The work included a cash flow analysis, review of internal parameters such as City policies, and a comparative review of parking authorities in other jurisdictions.

**Process**

For the purposes of carrying out this work, Deloitte requested and reviewed materials provided from TPA, and met with TPA staff, as well as City staff from Finance, Planning, Economic Development, and the TTC.

Deloitte undertook a strategic options analysis, identifying options for further review. A qualitative review was undertaken to identify key considerations for TPA from the City's perspective. For example, under the current TPA structure, the City has the ability to plan and allow for the maintenance, repair, and reconstruction of roads and underlying utilities. The City also has the ability to change the rules associated with the road allowance to allow for bike lanes, to reconfigure dedicated transit, and to prevent parking on certain roads during rush hour. As well, the City is able to undertake road closures for planned events such as street festivals and marathons.
Deloitte developed the following four options for consideration in relation to the City's investment in TPA. For each option, Deloitte undertook a discounted cash flow analysis, quantifying the overall value of anticipated cash flow distributions to the City on a present value basis.

1. Status Quo
   - TPA continues to operate in its current state.

2. Enhanced Net Income
   - TPA continues to operate in its current state
   - Changes are made to enhance net income, and to allow for a higher payout ratio to the City
   - City retains ownership of TPA and through TPA, indirect control over on-street, and off-street parking
   - All parking rates reflect market rates
   - Parking operations continue to be automated
   - More efficient and disciplined financial management of TPA

3. Enhanced Income and Partial Concession Option
   - TPA operates as above with an enhanced income option
   - Concession agreement for operation of all off-street parking lots for a 10 year period. A concession agreement typically takes the form of a private sector investor making an upfront payment to the City, in exchange for the right to operate TPA assets, including receiving the associated future revenue stream
   - Revenue sharing ratios with performance-based incentive thresholds
   - Parking rate increases are negotiated with City of Toronto
   - Operating and maintenance standards set

4. Enhanced Income and Phased Disposition of Certain TPA Assets option
   - TPA operates as above with an enhanced income option
   - Real estate valuation/review off-street asset locations, and sell assets where highest and best use is not as a parking lot, with cash back to City

Findings

Deloitte concluded that there were certain elements of the status quo that could generate additional value for the City if modified. In general, sale or transfer of long term rights for the business in its entirety or by major segment were not considered to increase value. Continued City control of and intervention in issues such as use of roadways, and support for community based parking were likely to continue and not be compatible with a long term operating agreement with a third party.

As a result of undertaking its work, Deloitte's proposals for increasing value to the City are as follows:
1. Retain ownership of TPA under an enhanced net income scenario as described in option 2 above. Core elements include increasing revenues, in part by reviewing the parking rate setting process with a view to ensuring consistency with the "market". Where feasible, TPA should also continue to pursue operating efficiencies through such options as automation and mobile pay.

2. Review TPA's future plans for capital expansion where they are not part of its State of Good Repair, nor already committed as part of existing arrangements.

   It is important to note that City staff are currently undertaking a City-Wide Real Estate review in accordance with Council direction of July 2016, which includes a review of TPA assets. TPA has been requested, and is co-operating and coordinating with City staff in this context.

3. Sale of certain TPA assets, which will be identified as part of the City-Wide Real Estate Review mentioned above.

4. Consider the potential for increasing TPA's income sharing payout rate to the City. Deloitte proposed that this could be facilitated in part by the use of debt financing of TPAs capital program, but City staff have considered and rejected this option.

   It should be noted that the City's Financial Planning Division is undertaking a parallel process for renewing and renegotiating the existing Income Sharing Agreement between the City and TPA. The current agreement expired on December 31, 2015, and staff will be reporting back on the terms of the renewal as part of the 2017 budget process.

**Concession/Lease options**

A long term concessions is not recommended for on-street parking due to the interconnectivity of TPA managed on-street parking within the overall City, including transportation services, TTC, and planning and economic development considerations. A concession contract would not generate value and allow the City the continued flexibility to manage its roads without running afoul of its obligations to a concessionaire.

With respect to off-street parking lots, Deloitte concluded a concession for all lots would not be feasible. Net income generation is highly concentrated at a small number of highly profitable lots. Existing TPA labour arrangements were also considered to be a potential impediment, as a significant number of TPA employees are involved in off-street parking operations.

A limited concession could be considered, but would be expected to generate little value. Only 44% of TPA revenues are generated by off-street parking- mostly at a few marquee lots- so the value potential was not considered to be significant. In addition, existing joint ventures or other legal arrangements with third parties further limit the potential. Finally,
the main avenue for increased operating value is by implementing automation and mobile pay, and TPA has already taken steps in that direction.

**Sale Options**

The sale of TPA to a third party has the same disadvantages as a long term concession. However, Deloitte reviewed the list of individual parking assets and determined that a targeted approach to identifying specific lots for disposition could have the potential to significantly increase value, giving consideration to their highest and best use. As mentioned above, a review of TPA assets is already underway as part of the ongoing City-Wide Real Estate Review.

**Toronto Region Board of Trade Report on TPA**

A September 2016 Toronto Region Board of Trade report identified TPA as the largest supplier of city-owned parking services in North America.

Many of the suggestions in the Board of Trade report are consistent with and validated by the work done by Deloitte, including restructuring income sharing arrangements, curtailing capital expansion plans, and accelerating land sales.

The report also emphasized the urgency of funding transit expansion, and suggested that all of TPA surplus cash be directed to fund transit expansion.

**Conclusion**

The Toronto Parking Authority is an unusually large municipal parking operation. It manages a large portfolio of on-street and off-street parking in a reasonably competitive manner, generating considerable returns for the City.

The operations of the TPA and the City are highly co-mingled, particularly through shared use of road rights of way, but also through the requirement for community based off-street parking, and the land development opportunities afforded by these lots.

The fluid relationship between the TPA and the City means that divesture of the operation through a sale or long term concession is impractical. It could not generate values better than those through retained ownership unless the City were willing to cede significant loss of control over its related operations and important policy levers.

Deloitte did find opportunities to increase value, while retaining control of the Authority, through income enhancement options that include reviewing the parking rate setting process with a view to ensuring consistency with the "market", as well as by increasing the payout rate to the City. Deloitte also concluded that given the ongoing City-Wide Real Estate Review, and the City's attempts to optimize decisions regarding surplus lands controlled by the City and its agencies, the TPA's uncommitted capital expansion plans
should be paused until a corporate resolution to the issue is identified. Deloitte estimated that significant land values could be realized through this process.

Through these measures Deloitte estimated that both annual operating income and income from specific asset sales could be increased for the City.

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**SIGNATURE**

Peter Wallace  
City Manager

Roberto Rossini  
Deputy City Manager & Chief Financial Officer

**ATTACHMENT**

Appendix 1: Deloitte Confidential Report