TO:	**CHAIR AND MEMBERS STRATEGIC PRIORITIES AND POLICY COMMITTEE MEETING ON JULY 28, 2014**
FROM:	**MARTIN HAYWARD MANAGING DIRECTOR, CORPORATE SERVICES AND CITY TREASURER, CHIEF FINANCIAL OFFICER**
SUBJECT:	**LONDON HYDRO PROMISSORY NOTE TO THE CITY OF LONDON**

RECOMMENDATIONS

That, on the recommendation of the Managing Director, Corporate Services and City Treasurer, Chief Financial Officer, the following actions be taken with respect to the $70 million promissory note payable by London Hydro Inc. to The Corporation of the City of London:

a) the Civic Administration **BE AUTHORIZED** to call the $70 million promissory note on November 30, 2014, prior to the maturity date of October 31, 2015, subject to the mutual agreement of The Corporation of the City of London and London Hydro Inc., noting that action should be taken prior to year end to ensure that the promissory note is not reclassified as a short-term liability on London Hydro Inc. financial statements which may cause financial challenges for London Hydro Inc. because it would change liquidity ratios resulting in covenants being breached and may ultimately negatively impact London Hydro Inc.'s credit rating;

b) the Civic Administration **BE AUTHORIZED** to invest the proceeds from the payment of the $70 million promissory note into a professionally-managed investment portfolio that is in compliance with the City of London Investment Policy and Ontario Regulation 438/97 Eligible Investments and Related Financial Agreements, with the $70 million principal to be held for The Public Utility Commission of the City of London for the purposes of investigation, remediation, restoration, and any other related costs with respect to the coal tar affected lands held by The Public Utility Commission of the City of London;

c) the London Hydro Inc. **BE REQUESTED** to increase the dividend payable to The Corporation of the City of London to $5 million annually, subject to LHI Board approval, with the dividend to be used to offset the reduction of interest anticipated to be received on the $70 million reinvested funds;

d) the Civic Administration **BE DIRECTED** to apply the interest earned on the $70 million principal held by The Public Utility Commission to the City of London's general fund to mitigate the impact to the tax levy to ensure that the total annual dividend and interest earned are maintained at $7.2 million, which is in keeping with current revenue, and any additional interest earned be contributed to the Economic Development Reserve Fund;

e) the London Hydro Inc. **BE REQUESTED** to pay The Corporation of the City of London a one-time special dividend of $10 million resulting from the $70 million promissory note being called prior to the maturity date, subject to LHI Board approval;

f) the Civic Administration **BE DIRECTED** to apply the one-time special dividend, should it arise, to the Economic Development Reserve Fund to be used to support initiatives that best accelerate London's economy; and

g) the Civic Administration **BE DIRECTED** to report back to the Strategic Priorities and Policy Committee at its meeting on August, 27th, 2014 with a form of agreement between The Corporation of the City of London, London Hydro Inc. and the Public Utilities Commission of the City of London to address and implement the matters set out in clauses a), b) and d) above.

PREVIOUS REPORTS PERTINENT TO THIS MATTER

- London Hydro Inc. - Reduction of Promissory Note (August 1, 2001 – Board of Control)
- Promissory Note (January 29, 2003 – Board of Control)
- London Hydro Inc. – Promissory Note (September 30, 2009 – Board of Control)

BACKGROUND

London Hydro Inc. (LHI) is a corporation with share capital incorporated under the *Business Corporations Act*, R.S.O. 1990 c. B.16. LHI is managed by a Board of Directors appointed by The Corporation of the City of London ("the City") as the sole shareholder.

When the electricity distribution assets of the London Hydro-Electric Commission were transferred to LHI on November 1, 2000, an extendible non-interest bearing promissory note for $95 million representing approximately 55 percent of the value of the assets, was delivered to the City. The note was then assigned by way of an Undertaking to the Public Utility Commission of the City of London (PUC) which retained responsibility for coal tar remediation of the Thames River and adjacent lands.

On August 7, 2001 Council by resolution approved a reduction, concurred by the PUC, in the principal amount of the note to $70 million in order to accommodate LHI's proposed revolving line of credit for operating purposes; the contributed capital by the City as sole shareholder to LHI was correspondingly increased by $25 million.

On February 13, 2003, a resolution was passed to amend the maturity date of the note to July 1, 2008 and for the note to bear interest at 6% per annum beginning July 1, 2003 with interest paid quarterly. Interest payments may be postponed if LHI's interest ratio falls below 2:1, in which case postponed interest will be paid when the ratio is or exceeds 2:1. All other terms and conditions of the note remained the same and no principal repayments have so far been demanded or paid under the note.

The PUC has agreed to extensions of the maturity date of the note, with the latest extension being October 31, 2015. The promissory note can be called by the City prior to the maturity date with 367 days notice. It should also be noted that the City and LHI can call the promissory note at any time as long as both parties settle on a mutually agreeable date.

On June 26, 2014, the PUC resolved the following:

> *That, on the recommendation of the Chief Administrative Officer for The Public Utility Commission of the City of London, The Corporation of the City of London* ***BE ADVISED*** *that The Public Utility Commission of the City of London hereby consents to the following actions with respect to the $70 million promissory note payable by London Hydro Inc. to The Corporation of the City of London and assigned to The Public Utility Commission of the City of London:*
>
> *a) calling the $70 million promissory note on November 30, 2014, prior to the maturity date of October 31, 2015, subject to the mutual agreement of The Corporation of the City of London and London Hydro Inc.;*
>
> *b) the Civic Administration of The Corporation of the City of London investing the proceeds from the payment of the $70 million promissory note into a professionally-managed investment portfolio that is in compliance with the City of London Investment Policy and Ontario Regulation 438/97 Eligible Investments and Related Financial Agreements, with the $70 million principal to be held for The Public Utility Commission of the City of London for the purposes of investigation, remediation, restoration, and any other related costs with respect to the coal tar affected lands held by The Public Utility Commission of the City of London; and*

c) *the Civic Administration of The Corporation of the City of London applying the interest earned on the $70 million principal held by The Public Utility Commission to the City of London's general fund to mitigate the impact to the tax levy and/or the Economic Development Reserve Fund.*

Preservation of the $70 million

The Undertaking limits the PUC's use of the principal payments made to it under the note to the investigation, remediation, restoration and legal proceedings of the coal tar affected lands to which the PUC has retained ownership of and responsibility for. Civic Administration recommends that the principal amount be retained for these purposes.

Calling The Promissory Note

The Ontario Energy Board provides regulatory oversight over rates, reliability, and service quality. Ultimately, LHI no longer has the authority for setting rates or establishing service and reliability targets. According to David Arnold, Chief Financial Officer, Vice-President of Finance, Corporate Secretary of London Hydro:

> "As part of the 2013 Cost of Service Application, our regulator, the Ontario Energy Board, has reduced the interest on the Promissory Note in our rates from the current level to the market interest rates (around 4%). As a result of the reduced rates, which came into effect on May 1, 2013, it is challenging to sustain a 6% interest on the Note while maintaining current dividend levels and our infrastructure investment requirements."

In addition, once the promissory note becomes due within one year of the maturity date then it must be reclassified from a long-term liability to a short-term liability on LHI's financial statements. This reclassification may cause financial challenges for LHI because it would change liquidity ratios resulting in covenants being breached and may ultimately negatively impact LHI's credit rating.

As a result of the position of the Ontario Energy Board as it relates to the interest rate on the promissory note and the potential reclassification to a short-term liability, Civic Administration is recommending that the promissory note be called prior to the maturity date of October 31, 2015. November 30, 2014 has been established as a mutually agreed upon date with LHI.

Financial Impact

Under the current agreement with LHI, the City receives $4.2 million annually in interest revenue from the $70 million promissory note and $3.0 million annually in dividends. If the promissory note was called on November 30, 2014, then the funds would need to be reinvested into an investment vehicle that maximizes return on investment while guarding against capital losses. In order to mitigate the interest revenue loss of $4.2 million, Civic Administration is recommending that the $70 million from the called London Hydro promissory note be reinvested into a professionally managed investment portfolio that is in compliance with the City Investment Policy and Ontario Regulation 438/97 Eligible Investments and Related Financial Agreements. Assuming current market conditions and the boundaries established in the City's Investment Policy and Ontario Regulation 438/97, a reasonable rate of return on a $70 million investment would yield 3% or $2.2 million in interest revenue per year. In addition, Civic Administration is requesting that the annual dividend be increased to $5.0 million annually to compensate for the loss of interest revenue.

Civic Administration is also requesting that LHI provide the City with a one-time special dividend of $10 million as a result of the promissory note being called prior to the established term. This would be mutually beneficial for the City and LHI because the City could use the one-time funding to support initiatives that best accelerate London's economy and LHI would be in a position to secure alternative financing when interest rates are favourable.

Although the City can request that a dividend be paid, both regular and one-time, it is ultimately up to the London Hydro Board to determine the amount of dividend payable. LHI has a dividend policy, under the provision in the shareholder declaration and the Business Corporations Act, that provides for the amount of the annual dividend to be equivalent to 40% of the Company's prior year's net earnings, subject to satisfactory cash flow. Cash flow can be impacted by a number of elements, such as capital spending that can vary both in terms of volume and timing.

The financial implications are summarized in Table 1.

Table 1

Revenue Source	On-Going Funding	One-Time Funding
Existing		
• $70 million promissory note @ 6%	$4.2 million	
• Annual dividend	$3.0 million	
Total	**$7.2 million**	**$0**
If Promissory Note Called November 30, 2014		
• $70 million reinvested @ 3% [1]	$2.2 million	
• Annual dividend	$5.0 million	
• Potential special dividend		$10.0 million
Total	**$7.2 million**	**$10.0 million**
Additional Revenue	**$0.0 million**	**$10.0 million**

NOTE 1: Changes in market condition may result in changes to investment yields.

<u>Application Of Interest Revenue</u>

As noted above, when the promissory note was established in 2000 it was non-interest bearing. In 2003, the promissory note was restructured so that the promissory note would bear interest at 6% per annum and payable in quarterly instalments. Since the promissory note was restructured and began bearing interest, the interest revenue earned has been applied to the City's general fund and used to reduce the property tax requirement. As the rights to the interest payments created in 2003 were not pledged to the PUC, the interest payments are the property of the City. In order to provide clarity on the application of the interest earned on the $70 million, by way of promissory note or re-invested proceeds, it is recommended that the total annual dividend and interest earned are maintained at $7.2 million, which is in keeping with current revenue, and any additional interest earned be contributed to the Economic Development Reserve Fund.

<u>Conclusion</u>

The Ontario Energy Board's decision to reduce the allowable interest rate on the promissory note from 6% to market levels reduces the expenses that can be recovered through the energy rates, which results in financial challenges for LHI. Civic Administration is recommending that the $70 million promissory note payable by LHI be called on November 30, 2014 as mutually agreed to with LHI and the proceeds be reinvested into a professionally managed investment portfolio with the interest being applied to the operating budget to reduce the tax levy and/or increase the Economic Development Reserve Fund. Civic Administration also requests that the annual dividend be increased to $5.0 million and LHI provide the City with a one-time special dividend of $10.0 million to be used to fund economic development initiatives, noting that dividends are determined by the London Hydro Board using the provision in the shareholder declaration and the Business Corporations Act.

Prepared By:	Reviewed By:
Jason Senese **Manager of Financial Planning & Policy**	**Mike Turner** **Deputy City Treasurer**
Concurred:	**Concurred:**
Larry Palarchio **Director of Financial Planning & Policy**	**John Braam** **Managing Director Environmental & Engineering Services and City Engineer**
	Recommended By:
	Martin Hayward **Managing Director, Corporate Services and City Treasurer, Chief Financial Officer**

Cc: John Lucas, Director – Water and Wastewater
Jennifer Smout, Solicitor