
HALDIMAND COUNTY

Report CS-GM-02-2018 Hydro Legacy Fund Policy & By-law

For Consideration by Council in Committee on March 27, 2018



OBJECTIVE:

To present a policy and by-law to govern the use of and manage the \$72.4 million in net proceeds, plus annual investment earnings, resulting from the sale of Haldimand County Utilities Inc. to Hydro One Networks Inc.

RECOMMENDATIONS:

1. THAT Report CS-GM-02-2018 Hydro Legacy Fund Policy & By-law be received;
2. AND THAT the Hydro Divestiture Reserve Fund be renamed the “Hydro Legacy Reserve Fund”;
3. AND THAT the draft Hydro Legacy Fund Policy, included as Attachment #2 to Report CS-GM-02-2018, be approved;
4. AND THAT the draft Hydro Legacy Reserve Fund By-law, included as Attachment #3 to Report CS-GM-02-2018, be approved;
5. AND THAT, in accordance with section 3(b)(i) of the Hydro Legacy Fund Policy, an accrual of investment income, based on unrealized market yields, be credited to the Hydro Legacy Reserve Fund, starting with the 2017 fiscal year, with such interest rate established through the 2017 Investment Report to be presented at an upcoming Council in Committee meeting.

Respectfully submitted: Karen General, CPA, CGA, General Manager of Corporate Services

Approved: Karen General, CPA, CGA, Deputy Chief Administrative Officer

EXECUTIVE SUMMARY:

Since deciding to sell Haldimand County Utilities Inc. to Hydro One Networks Inc. in 2013, Council has had extensive discussions, on several occasions, regarding the management and use of the Hydro sale proceeds. This report recaps the associated decisions regarding: protection and inflation of the principal proceeds; accruing of investment earnings; principles for use of the investment income; administering the Litigation Allowance; and reporting of the activities associated with the Hydro fund to ensure public transparency.

A proposed policy and by-law have been drafted to formalize these recommended approaches, which will ensure that the Hydro sale proceeds are managed in a prudent, secure and sustainable manner for the long term benefit of the taxpayers of Haldimand County. The proposed policy highlights Council’s fiduciary responsibility to protect these funds and guarantee the perpetual “legacy” left from the profitable sale of the public’s historical investment in the local electricity distribution sector. Accountability will be transparent through annual reports disclosing all transactions that impacted the Hydro Legacy Reserve Fund in a given year.

BACKGROUND:

At the December 16, 2013 Council meeting, the following resolution was ratified:

THAT the offer from Hydro One Inc. to acquire Haldimand County Utilities Inc. be approved subject to the following conditions:

- 1. The Share Purchase Agreement, at a minimum, must reflect the commitments presented by Hydro One on December 10, 2013 regarding:*
 - Financial value*
 - Rates*
 - Reliability and customer service*
 - Employment of HCUI staff*
 - Local service centres;*
- 2. Legal review of the Share Purchase Agreement; and*
- 3. Final Council review and approval of the Share Purchase Agreement;*

AND THAT the public be assured that Council's intent is to contribute the net proceeds of the divestiture in a secure, stable, long term investment for the future benefit of Haldimand County taxpayers."

In April 2014, Council reviewed Report CS-GM-07-2014 which provided information and legal advice on options for managing the potential sale proceeds of Haldimand County Utilities Inc. (HCUI) to Hydro One Network Inc. (HONI), including: legislative restrictions on municipal investments; forming a municipal corporation; and creation of a "legacy fund". This was important background for Council members to guide their consideration of any investment opportunities, using the HCUI sale proceeds, once the divestiture transaction was concluded.

Effective June 30, 2015, the transaction to sell 100% of Haldimand County's HCUI shares to HONI was concluded for net cash proceeds of \$73.3 million. After accounting for the carrying value of shareholder's equity, the net gain on this sale was \$34 million (86.5% over value). The County incurred one-time divestiture costs of approximately \$1 million, leaving net sale proceeds of \$72.4 million (principal value to be protected), which were contributed to the Hydro Divestiture Reserve Fund. Within this principal sum is an amount of \$7 million that was negotiated as additional cash in exchange for an indemnification provision within the Share Purchase Agreement. Also of note, this sale agreement required HONI to reduce the electricity distribution rates (about 1/3 of the total hydro bill) of Haldimand customers by 1% and freeze those rates for five years. For historical reference, Report CS-GM-04-2016 provides further details on this transaction.

In April 2016, Council approved a new investment strategy for Haldimand County which allowed for a more diversified investment mix to generate higher returns over the long term (Report CS-FI-08-2016). This approach was possible given the HCUI sale which essentially doubled the County's investment portfolio to approximately \$150 million. Some of the new investments (growth/equity) will not generate annual interest income but should increase in market value over time; thus, generating a significant return on the investment when liquidated. To account for this timing difference in realizing gains, Council approved the creation of an Investment Income Stabilization Reserve. This is an important concept when looking at annual interest earnings accrued to the Hydro Divestiture Reserve Fund.

In January 2017, a workshop was held with Council entitled "Municipal Financial Management Overview". The staff presentation included information on the Hydro divestiture, including a discussion paper on proposed principles/criteria for use of the funds, name of the reserve fund, reporting requirements, etc. (Attachment #1). Those ideas were left with Council to contemplate, prior to a further meeting in April, which would be dedicated to this topic.

In the intervening time period, during review of the 2017 Tax Supported Operating Budget, Council decided to use \$300,000 per year of the Hydro divestiture investment earnings to reduce the annual tax levy.

On April 3, 2017, a Council workshop was held regarding “Management of Hydro Sale Proceeds”. The purpose of this workshop was to:

- review the methodology for accruing investment earnings to the Hydro Fund;
- discuss principles for the use of income from investing Hydro sale proceeds;
- outline potential provisions in a governing by-law; and
- suggest approaches to ensure public transparency and accountability related to the Hydro Fund.

Following discussion, the following recommendation was passed:

THAT the presentation Re: Management of Hydro Sales Proceeds, presented to the April 3, 2017 Committee of the Whole meeting, be received;

AND THAT staff be directed to report back to a future Council in Committee meeting on the framework for a draft by-law governing the expenditures of the Hydro Divestiture Reserve Fund.”

Staff have incorporated the feedback from the aforementioned previous meetings into a Hydro Legacy Fund Policy and By-law to formalize the recommended approaches, as presented in this report.

ANALYSIS:

In 2013, when Council reviewed Hydro One’s proposal to purchase the shares of HCUI, a fundamental condition was that the principal proceeds from the sale be preserved in perpetuity. Upon receipt of the sale proceeds of net \$72.4 million in July 2015, the funds were invested with the intent that future income would be generated that could be used for specific municipal purposes. To date, some decisions have been made, on a case by case basis, which utilize a portion of these earnings. It is now prudent to formalize Council’s intent through establishment of a policy and related by-law.

The draft Hydro Legacy Fund Policy included as Attachment #2 to this report incorporates several key principles that Council has discussed, such as:

- leave the principal sale proceeds intact and only consider use of the interest earnings;
- set aside \$7 million as a litigation allowance to fund any expenditures whereby Haldimand County indemnified HONI through the Share Purchase Agreement;
- index the principal sum annually, excluding the litigation allowance, to keep pace with inflation;
- accrue annual investment earnings, which are subject to fluctuating markets, based on a long term, prudent benchmark rate of return;
- use of the investment earnings, in priority order: indexing of the principal; funding of a major capital initiative that benefits Haldimand County taxpayers; tax relief through reduction of the annual levy; and/or investment in a strategic economic initiative that is projected to generate employment and assessment;
- Council approval, via resolution, of all permitted uses of the Hydro Legacy Fund;
- transparency and accountability through regular and detailed financial reporting; and
- awareness of the activities associated with the Hydro Legacy Fund through media releases, social media, website and signage associated with capital projects.

With regards to the accrual of investment earnings based on market gains, staff recommend that this approach be retroactive to January 1, 2017. That means, for the period of July 1, 2015 to December 31, 2016, interest earnings recorded in the Hydro Divestiture Reserve Fund only reflect actual realized gains (actual cash has been received and deposited by the County.) Starting in 2017, the accrual process will be used to better reflect the expected earnings from the revised investment strategy that was adopted in mid 2016. This approach will require an annual setting of a benchmark rate of return to adjust for market growth in the value of the investment portfolio, as well as an annual reconciliation process whereby actual realized earnings based on maturity or cashing in of any of the investments will be compared to the accrued (unrealized) earnings and adjustments made accordingly. This reconciliation process will be further detailed in upcoming revisions to the Cash Management and Investments Policy 2001-11.

It should also be noted that the draft policy does not incorporate any form of advisory committee related to the Hydro Legacy Fund. It is felt that Council is better equipped to make decisions that are in the overall best interest of the municipality and reflective of the intent to preserve this Legacy Fund in perpetuity. To assist in this governance responsibility, ongoing awareness of the investment performance is necessary, along with consideration of all Corporate priorities through the strategic planning process and long range capital budgeting and related financing.

The approved Hydro Legacy Fund Policy will be incorporated as a schedule to the required by-law, which is reflected as Attachment #3 to this report. One particular aspect of this by-law (and policy) is unique. As any Council cannot fetter the rights of a future Council to run the operations of the municipality as it deems necessary, there is a risk that this by-law may be repealed, amended or overridden. Aside from the practical considerations that may cause a Council to hesitate before disregarding the intent of maintaining the principal balance of the legacy fund in perpetuity (for example, a financial penalty for prematurely cashing in a “locked in” financial instrument), staff have incorporated a public hearing process. In the event that a future Council wishes to amend or override a provision of the Hydro Legacy Fund Policy and/or the related By-law, such decision can only be considered at a Public Meeting, open to input from the public without the requirement of registering as a Delegation. In addition, the municipality will be required to provide Public Notice, at least four weeks in advance of such a meeting, and include details of the proposed motion to be voted on.

Based on feedback from Council over several meetings since the sale of HCUI was approved, it is hoped that the proposed Hydro Legacy Fund Policy meets the intent of providing a secure, long term financial benefit to the taxpayers of Haldimand County.

FINANCIAL/LEGAL IMPLICATIONS:

The investment earning potential of the Hydro Legacy Fund is expected to provide a major source of revenue to finance future County initiatives. In addition, Council has directed that \$300,000 per year of interest income from the Hydro sale proceeds be used to reduce the annual tax levy.

The 2017 Investment Report will be presented to an upcoming Council in Committee meeting that will reflect all of the activities/transactions as outlined in the attached Hydro Legacy Fund Policy. At that time, the uncommitted value of any available investment income will be reflected in the statement, as will other sources and uses of funds that impact the Hydro Legacy Reserve Fund.

Revisions will be required to the County’s Cash Management and Investments Policy 2001-11 to clearly outline the accrual and reconciliation process related to investment earnings. This will be addressed in a report in the first half of 2019.

STAKEHOLDER IMPACTS:

Not applicable.

REPORT IMPACTS:

Agreement: No

By-law: Yes

Budget Amendment: No

Policy: Yes

ATTACHMENTS:

1. Discussion Paper – Hydro Divestiture Fund (provided at Council workshops in January, March & April 2017)
2. Draft Hydro Legacy Fund Policy
3. Draft Hydro Legacy Reserve Fund By-law