City of Kelowna

MEMORANDUM

DATE: September 13, 2001
FILE: 5500-03

TO: City Manager

FROM: Director of Finance and Corporate Services

RE: BC GAS LEGACY OPPORTUNITY – FINANCING

RECOMMENDATION:

THAT Council authorize the Municipal Finance Authority to negotiate a fixed interest rate on or near October 1, 2001 for the fixed portion of funds being borrowed for the capital lease agreement. Borrowing will take place on or close to April 15, 2002 with an anticipated retirement date of October 1, 2018;

AND THAT Council authorize a reduction of $3.0 million in the fixed portion of funds to be borrowed, with this same amount to be borrowed as part of the annual floating portion of the total borrowing of approximately $49.0 million.

BACKGROUND:

Long-Term Borrowing

The financial model for the City's Legacy Opportunity agreement with BC Gas is based on a number of factors including matching the City's fixed and floating borrowing to BC Gas' debt to equity ratio of 2:1 (2/3 fixed; 1/3 floating). On October 1, 2001, the spread between the City's long-term debenture interest rate and the BC Gas borrowing rate will be fixed. This spread has been hovering at about .6% and reflects the 'AAA' bonding agencies rating of the Municipal Finance Authority (MFA).

Considering current market interest rates, the MFA has advised that it is not intending to go to the financial markets with any long term borrowing until the spring of 2002. As the Bank of Canada has reduced its overnight rate a number of times over the past year, there have been market concerns that inflationary pressures will increase over time. This has resulted in a widening of the spread between short-term and long-term rates than had been the case prior to the lowering trend of short-term rates. This trend is expected to continue for the balance of 2001.

In financing the legacy opportunity transaction, the City is able to borrow all funds required through either the MFA interim financing or short-term borrowing program. In order to meet the agreement requirement to fix the spread on October 1, 2001, the City is able to request the MFA to go to the financial markets on or near the agreement closing date to guarantee the long-term rate, through a future swap to April 15, 2002, on the City's fixed portion of the debt. The swap will set the borrowing rate on the fixed portion of the City's borrowing for the entire period to October 1, 2018.

The MFA has advised that receipt of a Council resolution approving this arrangement is sufficient authorization for the transaction to be completed. Once the fixed rate spread is set in the agreement with BC Gas, the City will neither benefit nor lose as long-term rates change over time on this portion of the borrowing. As the City benefits only from the margin on the spread, the swap arrangement is considered the most prudent course of action to take.

Short-Term Borrowing

The BC Gas current return on equity is regulated by the BC Utilities Commission and adjusted annually. It is presently set at 9.25%. The financial model estimated the City's floating rate to be 6.01% or a spread between BC Gas and the City of 3.24%. Interim financing rates are presently less than 4.50% and are not projected to rise until sometime in 2002.

The current spread between interim borrowing and 20-year debenture rates provides the City with an opportunity to explore options that may result in improved cash flow over the life of the agreement without significant financial exposure. It is recommended that $3.0 million, which was to be borrowed over 17 years, be borrowed annually (together with the 1/3 floating portion for a total of $19.3 million), and reviewed on a regular schedule to determine the best course of action to maintain positive cash flows considering the following options:

- Continue to borrow annually as long as there is a financial benefit to the City
- Lock in at a fixed rate to October 1, 2018 when long-term rates are lower than at present and not expected to drop significantly more, thereby mitigating future risk
- Borrow from City reserves and pay the current investment earnings rate of interest in years when rates are unattractive but are projected to be lower in the future

A matrix of interest rate tolerance has been developed for this portion of the City's borrowing. The analysis models interest rates by year over which a benefit can no longer be achieved if rates were to continue at that level for the balance of the operating agreement. The model can also be revised to reflect ongoing projections of future rates.

The floating portion of the City's borrowing may remain in the interim borrowing program until April 30, 2002. At that time, a rate will be fixed to October 1, 2002. Fixed rates will then be set annually each October 1 through to 2018. Alternatively, staff and the MFA are exploring borrowing the first year amount on October 1, 2001 in order to give greater certainty and mitigate the risk associated with the interim borrowing program.

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C.P. Kraft

cc: Deputy Director of Finance