City of Kelowna

MEMORANDUM

DATE: August 12, 2002
FILE: 5500-03

TO: City Manager

FROM: Director of Finance and Corporate Services

RE: BC Gas Legacy Opportunity – 2001 Additions

Prepared by Deputy Director of Finance

RECOMMENDATION:

THAT the City exercise its option to lease the BC Gas distribution system 2001 additions contained within the City of Kelowna boundary and having a declared capital cost of $605,089 and a net book value at the City's option exercise date of $592,483;

AND THAT the Deputy Director of Finance initiate all processes to obtain necessary approvals prior to October 10, 2002 as required in the Additions Option portion of the Lease Agreement;

AND THAT Council authorize the Mayor and City Clerk to execute the Agreement to Lease for 2001 additions, subject to a counter petition opportunity being initiated concurrently with this report and expiring on September 30, 2002;

AND FURTHER THAT costs associated with this acquisition in the amount of $633,957 be funded from the BC Gas Legacy Opportunity Reserve and the 2002 Financial Plan be amended to reflect this expenditure.

BACKGROUND AND COMMENTS:

On June 4, 2001, the City entered into an Agreement to Lease with BC Gas Utility Ltd. that defined terms relative to a lease-in/lease-out transaction for natural gas distribution system assets within the City boundaries.

The 2001 agreement included associated bylaws for entering into the transaction and the borrowing of $49.3 million. While the capital lease has a term of 35 years, it is anticipated that an early termination option will be exercised by BC Gas consistent with the Operating Lease expiry on October 31, 2018, which is 17 years from the Agreement to Lease closing date. The net present value benefit to the City of the original transaction has been estimated at $6.7 Million.

The Agreement to Lease includes an Additions Option that provides the City with an opportunity to lease, once each calendar year, BC Gas' distribution system capital additions from the prior year under the same basic terms and conditions as the original lease. BC Gas has reported additions for the months of November and December, 2001 totaling $605,089. The entire capital lease must be prepaid and will be based on the net book value on the effective date being November 1, 2002. The payment from the City to BC Gas will be:

2001 Additions	$605,089
Less: Depreciation through October, 2002	(12,606)
Net Book Value at Close Date	$592,483
Add: GST (recoverable through Input Tax Credit)	41,474
Payable to BC Gas	$633,957

BC Gas will add the value of these assets to the operating lease agreement amount currently in place. The first semi-annual rent payment from BC Gas to the City is estimated to be approximately $31,400 payable on April 30, 2003.

Economic Benefits

The calculated net present value benefit to the City is between $100,000 and $200,000 over the 16-year period to the Operating Lease expiry date. This range represents the anticipated excess funds after repayment of principal and interest under current conditions. There are a number of variables that will impact the legacy payment over the term, therefore a conservative approach to total economic benefit has been modeled. Benefits are shared on an 85%/15% basis between the City and BC Gas.

The transaction is expected to have high positive cash flows in the early years that will reduce over time. Annual deficits in the later years of the agreement may require financing through either internal sources or from a combination of internal sources, borrowing and BC Gas Utility Ltd. carrying of costs to the termination date. All modeling completed has contemplated the highest carrying cost option in order to reflect a conservative financial return.

Risk Assessment

A key objective of the original agreement was for the City to avoid the risks associated with outright ownership of the assets. Opinions were received from our consultants, Deloitte & Touche and Consolidated Management Consultants that together confirmed the City's risk exposure to financial and commodity market factors was either eliminated or minimized. This objective remains unchanged through the lease in/lease out of all capital additions. The combination of 'utility level risk' and the City's secured position with respect to gas distribution asset ownership in the event of default makes this transaction attractive for the City.

The assessment of economic benefits and risk has been completed in consultation with David Craig of Consolidated Management Consultants.

Funding for this transaction is available in the BC Gas Legacy Opportunity Reserve which has a current balance of $1.8 Million.

C.P. Kraft

c.c. Deputy Director of Finance