Review of Restructuring Options

– Chestermere Utilities Inc. (CUI)

October 22nd, 2018

Scope

- On September 4th, 2018, Council made a resolution in respect of the operations and governance of Chestermere Utilities Incorporated (CUI). This resolution provided for the following:
  - Council have determined that the status quo is no longer desirable and that a change in the governance and operations is required.
  - Council retained KPMG LLP ("KPMG") and MacMillan LLP to provide a report examining alternative options for the restructuring, or the dissolution of CUI.
- This presentation summarizes the results of KPMG's review

Limitations

This report has been provided in accordance with the terms of our engagement letter dated August 29, 2018 (the “Engagement Letter”) wherein KPMG LLP (“KPMG”) has been engaged by the City of Chestermere (“City”) to provide an independent assessment of various strategic options available in respect of Chestermere Utilities Inc. and its subsidiaries. This report is subject to the terms and conditions contained in the Engagement Letter and the qualifications and restrictions described herein.

In preparing this report, we have necessarily relied upon financial and other information supplied and representations made to us by management of CUI and the City of Chestermere. We have not independently verified the accuracy or completeness of the information or conducted an audit, nor are we providing any other form of assurance. The procedures we performed do not constitute an audit, examination, or review in accordance with the standards established by the Chartered Professional Accountants of Canada (“CPA Canada”), and we have not otherwise verified the information we obtained or presented in this report.

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Outline of Presentation

- Cost Structure
- Other Operational Issues
- Funding New Infrastructure
  - Developer Funding of Off-site Infrastructure
- Financial reporting Issues
  - Implications of Past Financial Reporting Practice
- Rate Setting Process
- Review of Alternative Options

Cost Structure

- CUI controls only a small portion of its costs:
  - Treated water supply and wastewater treatment services are provided by the City of Calgary("Calgary") as wholesale supplier. Rates charged by Calgary are determined by its municipal council, based on its cost structure. *(Charges equal 30% of revenue from rates.)*
  - EPCOR operates the water and sanitary sewer systems under contract. *(Contractor charges equal 24% of revenue from rates.)*
  - Storm water is discharged into Chestermere Lake under the terms of a long-term servicing agreement with the Western Irrigation District.
  - Salaries and G&A expenses account for 21% of revenues from rates.
- Relatively limited number of employees and small management team.
- Given above external costs, CUI has limited ability to adjust its cost structure in the short term.
- Current high capex spending appears to ramp-down over next few years, which may reduce financial pressures.

Other Operational Issues

- Significant progress has been made on water loss issues, some of which were related to billing system deficiencies.
- Billing system issues remain an important operational issue.
  - Some form of is outsourcing likely required, since current system within municipal IT-platform is not appropriate for a utility environment.

- CUI has not met the City's expectations with respect to providing periodic reporting of its capital and project plans.

Funding New Infrastructure

- For a growing municipality such as Chestermere, funding new infrastructure to facilitate growth has been an important objective. Relevant infrastructure:
  - Infrastructure within a subdivision, which is typically built by developers and transferred to the City/CUI as Developer Contributed Assets ("DCAs").
  - "Off-site" infrastructure, which includes common 'upstream' assets that may benefit multiple developers/users over time.

- Relevant off-site infrastructure:
  - Trunk water and sewer mains
  - Lift pumps
  - Water reservoirs

Funding New Infrastructure (II)

- Levies fund infrastructure provided by different parties:
  - In addition to funding CUI infrastructure, levies may be needed to fund other entities' assets.
  - For example, some levies in Chestermere will be used to fund downstream stormwater infrastructure under the Cooperative Stormwater Management Initiative ("CSMI")

- When municipalities and utilities fund infrastructure in advance of receiving off-site levies, they are compensated for "pre-funding" with an interest allowance:
  - Current funding studies include an interest allowance of 3.10%, based on 20-year debenture rates from the Alberta Capital Finance Authority (ACFA).

- Under the framework above, CUI has funded some utility infrastructure with the expectation that its costs will be repaid through future offsite levies.

Developer Funding of Infrastructure (II)

- Developers are sometimes willing to fund and build some off-site infrastructure that would otherwise be funded and built by CUI:
  - However, the return on funds built into rate calculations (i.e. approx. 3%) is well below typical target returns for private-sector land developers.

- Developers are willing to fund infrastructure development for the following reasons:
  - Funding may facilitate more rapid development of off-site infrastructure, allowing more rapid growth
  - Developers may be able to install infrastructure at lower cost or that is better scaled to meet actual needs, helping to reduce future levy amounts
  - Developers may believe such funding will facilitate municipal approvals for future subdivision development.

Developer Funding of Infrastructure (I)

- Developer funding more likely under the following conditions:
  - An individual developer controls a large share of benefiting land parcels.
  - Property markets are buoyant.

- Design approval and inspection processes will be needed to ensure that the infrastructure installed meets municipal standards and will provide reliable service.
- Even with developer funding, CUI and/or the City will likely continue to play an important role in infrastructure funding.

Financial Reporting Issues

- CUI reports under International Financial Reporting Standards (IFRS).
- In financial statements up to the end of Fiscal 2017, CUI chose to include certain secondary items in revenue:
  - The value of contributed assets. This is the value of 'Developer Contributed Assets' (or DCAs), recorded as revenue when these assets are received. This is a non-cash item.
  - Offsite revenues collected. This reflects cash received from off-site levies at the time they are collected, if the associated assets are already in place.

- An alternative methodology, including under IFRS, would have been to recognize revenue from these items over the lifespan of the associated assets:
  - Would provide better matching between revenues and the amortization expenses for related fixed assets.
  - The alternative methodology will be adopted going forward with recent changes in IFRS standards (i.e. IFRS 15)

Financial Reporting Issues (II)

- The alternative methodology, prompted by IFRS 15, will result in changes in financial ratios calculated for CUI going forward:
  - Ratios that will change include interest coverage ratios and debt:equity ratios.
  - Based on the terms of existing loan agreements, these changes in ratios may constrain future borrowing relative to what would have otherwise been available and may also require some adjustments to agreement terms.

- An amended loan agreement has been prepared with TD and will help address some potential issues with transition to IFRS 15.

Financial Reporting Issues (III)

- Using Accounting Standards for Private Enterprise ("ASPE"), rather than IFRS, could potentially allow CUI to retain its current approach for accounting for off-site levies and DCAs:
  - Would reduce the impacts from IFRS 15 on financial ratios, and on existing loan agreements, as noted above.
  - Would also, however, forego the benefits of the improved matching of revenues and expenses associated with a revised accounting approach.
  - Given its additional flexibility, ASPE could also be used to smooth the transition to an alternative revenue recognition methodology.
  - Because the benefits of matching revenues with expenses are important, we see no compelling rationale for changing to ASPE in order to preserve or extend prior policies for revenue recognition

- In our assessment, accounting issues are not a key factor in the choice of organizational structure for CUI going forward.

Financial Reporting Issues – Implications of Past Practice

- Because CUI has recognized revenue when it receives Developer Contributed Assets (DCA's), existing shareholder equity is higher than it would have been under the alternative treatment:
  - As noted earlier, the alternative treatment is to treat the receipt of DCAs as Deferred Revenue, and recognize the value of these assets in Revenue, and hence in Net Income, over the life of the asset.

- Although equity is thus higher than it otherwise would be, the additional equity will be reduced over time by the recognition of amortization expense for DCAs:
  - Reported earnings will be depressed going forward while assets funded by DCAs remain in place.

- These impacts will need to be taken into account in future financial forecasting processes.

Rate Setting Processes

- Rates are to be set annually based on Cost of Service (COS) principles for a regulated utility:
  - Return on Capital for Debt and Equity Investors.
  - Depreciation (Return of Capital)
  - Recovery of Operating Expenses.

- Strict adherence to COS principles likely difficult for a small utility:
  - Capital expenditures “cyclical” and “lumpy”
  - CUI has limited levers available to cover associated cash-flow shortfalls associated with capex:
    - Municipality unlikely to make cash injections
    - Since no dividends to City are paid, these cannot be cut back in times of need.

- Some form of rate smoothing likely required, with considerable variation in actual equity returns from year to year

Alternative Options

- Municipalization
- Retain CUI as Shell (“Hybrid”)
    - For Existing Debt Only
- Merger / Amalgamation
- Partnerships / Outsourcing
- New Lines of Business

Municipalization

- CUI would be folded back into the municipality, to operate as a municipal department

Advantages	Disadvantages
– More direct control by City Council over utility operations, ensuring accountability. – Better integration of decision making with municipal planning and development functions. – Single point of contact for outside stakeholders for development approvals and co-ordination of municipal services. – Reduced costs through elimination of duplication in management and operations. – Debt issued by the City may carry a lower interest rate than CUI. – Reduces costs associated with maintaining a separate legal entity, including costs of maintaining a Board of Directors. – Addresses potential political desire for change	– Transition costs associated with wind-up of CUI and re-integration with City. – Existing debt arrangements will need to be renegotiated. – Increases pressure on municipal debt limits, reducing the future financial flexibility of City / CUI and the ability to access needed capital. – Utility financial accounts will be less clearly separated from municipal financial accounts, making the rate setting process less transparent and more open to cross-subsidization. – City loses benefit of having an entity and associated management team that is focused specifically on utility operations. – May increase risks of staff unionization.

Retain CUI as Shell ("Hybrid")

- CUI retains its legal and financial status as a corporation, allowing it to hold existing CUI debt and to raise new debt, as required, separately from the municipality.
- Most positions, including most management positions, would be folded back into the municipality, which would provide management and operations support to CUI under contract. Status of existing management and staff to be determined.

Issues

- Council can choose to sit on the Board of Directors, in lieu of independent directors.
- Members of Board of Directors have a statutory obligation to act in the financial interests of the corporation.
- May be desirable to retain one full-time employee to exercise executive authority. This may help to limit legal liability for the municipality from CUI actions.
- Because it is exempt from AUC regulation, CUI retains considerable discretion in setting utility rates.
- Formal transfer pricing arrangements will need to be in place for services provided by the City to CUI.
- Key mechanism for ensuring accountability to consumers and ratepayers is likely through Council's requirement to approve utility rates and utility capital plans

Retain CUI as Shell ("Hybrid") - II

Advantages	Disadvantages

– Retains financial flexibility, with ability to raise debt outside of MGA debt limits
– Shareholder has additional flexibility in selecting Board members:
  – Can select members with outside expertise in utility operations, if desired.
– Likely provides more financial and organizational flexibility for pursuing new lines of business
– Stand-alone, dedicated organization may be more attractive to potential business partners.
– Recommendations to Council on utility rates are provided by a nominally independent entity
– Financial accounts are clearly separated from the municipality, providing more cost transparency.
	– Additional ongoing costs associated with maintaining separate corporate structure
	– Provides less direct municipal control over utility operations:
	  – May thus provide less opportunity to jointly reduce operating costs.

Sub-Option – Retain CUI Only for Existing Debt

- CUI would be retained as a shell to hold existing debt and to collect future offset levies related to existing assets. However, CUI would not be used to raise any new debt and would be wound up once all existing debt is retired.
- Converges to municipalization option in long-term, with similar advantages and disadvantages.

Issues

– In practice, this option will likely entail the immediate transfer of business operations, including revenue collection, to the municipality, keeping the shell only for servicing the existing debt and collecting future offset levies outstanding.

– Will need to secure consent from existing lenders.

– This option can address a desire to wind up CUI while minimizing transition issues associated with existing debt.

– Lengthy transition and wind-up process will add complexity, including with respect to financial reporting issues, governance, and management.

Merger / Amalgamation

The municipality would amalgamate CUI with other municipal water utilities, where these are also in the form of corporate entities.

Issues

- A limited number of potential candidates for merger.
- Ownership shares of member municipalities likely based on relative equity positions.
- Rates could be set for individual utilities, or on an amalgamated basis.
- Agreement on rate setting philosophy will be required, most likely based on full equity return.
  - Chestermere, however, could choose to rebate its dividend to its consumers to lower their rates.
- Precedents suggest that Board members must be independent of Council.
- Municipalities' interests must be aligned.
- Significant process of due diligence required with no guarantee that a mutually agreeable deal can be arranged.
- Agreement will be required on governance principles, including rules for member entry and exit, equity valuation, and financial policy.

Merger / Amalgamation (II)

Advantages	Disadvantages
– Provides access to management and operating expertise and additional economies of scale. – Risks are pooled across participating municipalities, minimizing impact of individual adverse events or projects.	– Chestermere may have a minority share position and thus its decision-making authority will be constrained. – Potential for disagreements among shareholder municipalities. – Additional complexity of governance arrangements

Partnerships / Outsourcing

- CUI or the municipality uses outside suppliers and investors to provide services or facilities under contract, or to jointly invest with CUI in new business ventures.
- As an existing example, EPCOR currently operates CUI's water, storm and sanitary sewer systems under contract and provides project management services for new non-linear infrastructure.

Issues

- Can occur under each of the municipal, shell and merger structures.
- Need to ensure that utility's objectives and needs are clearly understood and articulated.
- Need to ensure that partners' interests are aligned.
- Need to ensure that prospective partners and/or suppliers have relevant expertise and financial capacity

- Outside investors/partners assume costs and risks associated with new investment or the operation of certain functions.
- Utility benefits from expertise and scale provided by external suppliers and partners

- Will require additional costs for procurement, and over-sight and administration.
- City / utility has less direct control and less flexibility to change direction once agreements are in place.

Enter into New Business Ventures

- CUI or the municipality enters into new lines of business that offer the potential to earn additional revenue and income.
- Potential lines of business suggested:
  - Renewable power generation (hydro-electric, solar, and Energy From Waste)
  - General contracting (e.g. underground infrastructure for other municipalities.
  - Solid waste handling or recycling for other parties.

Issues

– Policy decision will need to be made with respect to relationship with existing lines of business and degree of financial separation. For example:
  – Can cross-subsidies exist?
  – Who bears risks and rewards of new business initiatives? Shareholder or ratepayer?

– Likely easier to pursue from within stand-alone utility corporation than by the municipality.

– CUI's sources of competitive advantage will need to be established or identified, if long-term success is to be expected.

– Given extent of CUI's outsourcing of existing operations, CUI has a very limited base of in-house resources to pursue new ventures.

– Capital for new investment will need to be found, either through equity injections from the municipality, from retained earnings

Enter into New Business Ventures (II)

Advantages	Disadvantages
– Provides an opportunity to earn additional financial returns in return for assuming associated business risks and investment.	– Will require additional investment capital to grow new lines of business: – Likely from equity injections from the municipality, retained earnings, or reduced shareholder dividends. – Debt can also be used to fund new investment, although this will use up the borrowing capacity of the corporation and increase its financial risk. – CUI assumes risks associated with investment in new business areas. – May divert management attention from core utility business.

Summary Observations

- CUI faces constraints from its lack of scale and limited internal expertise. This can be addressed in fundamentally two different ways:
  - Expanding outward, and pursuing mergers, partnerships and/or new business ventures. These approaches necessarily entail some risk.
  - Consolidating operations back in the municipality.
- If selected, municipalization can be combined with outsourcing, as appropriate.
- The need to retain CUI as a shell (i.e., the Hybrid model) may depend on the constraints imposed by MGA debt limits:
  - The impact of these limits will depend on growth plans and mechanisms for funding future infrastructure.
  - Even if MGA debt limits can be managed under a municipalization scenario, there are some benefits to retaining a separate corporate entity (e.g. flexibility and transparency), although there are costs for maintaining a separate organization.

Concluding Remarks

- Questions?

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