2.7 Investment in Icewater Seafoods Inc.

Introduction

Background

High Liner Foods Incorporated operated a groundfish processing plant at Arnold's Cove from 1979 to 2004. The plant was engaged in primary processing of groundfish, (principally cod).

The plant, a large capacity state-of-the-art facility, operated approximately 45 weeks per year and employed up to 425 employees from Arnold's Cove and surrounding area.

Most recently, the plant had sourced approximately 80% of its raw material on the world market (frozen at sea) with the remaining 20% sourced from company-owned offshore trawlers and from inshore fishers in Placentia Bay and surrounding area. Approximately 50% of its processed product was sold as finished goods in Canada and the United States, with the balance going to markets in the United Kingdom and France.

As a result of a shift in corporate focus, during 2002, High Liner announced that it intended to sell its Arnold's Cove fish plant operations. However, the sale effort was unsuccessful and the company considered the following alternatives:

- offer the fish plant to the existing plant manager, at a nominal cost, provided an acceptable business plan could be put in place that included the finished product from the fish plant being sold to High Liner; or
- decommission the fish plant and sell the assets, including the Enterprise Allocations (groundfish quotas), on the open market.

To acquire and operate the fish plant, the plant manager formed Icewater Seafoods Inc. and approached Government seeking financial assistance.

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Audit Objectives and Scope

Our objectives were to:

Objectives

- review the process followed by Government in providing financial assistance to Icewater Seafoods Inc. relating to the Arnold's Cove fish plant; and
- determine whether there was compliance with applicable legislation and policies.

Scope

We completed our review in November 2005. We interviewed officials of the Department of Finance (responsible for the Newfoundland and Labrador Industrial Development Corporation [NIDC]) and the Department of Fisheries and Aquaculture. We also reviewed financial and other documentation at both departments.

Conclusions

Summary

In 2004, the Province agreed to provide $3.5 million in financial assistance to Icewater Seafoods Inc. relating to the fish plant in Arnold's Cove. In return, the Province, through NIDC, would receive 35,000 Preference II shares of the company. As part of this transaction, the Province, again through NIDC, received a groundfish quota from High Liner Foods Incorporated comprised of allocations for 9 groundfish species totaling 3,676 metric tonnes for 2004-05. In addition, the company agreed to pay NIDC a minimum annual lease fee of $50,000 relating to this quota.

Our review indicated the following:

Contrary to its policy of not providing loan guarantees and direct financial assistance to primary fish processing companies, Government effectively provided $3.5 million in financial assistance to Icewater Seafoods Inc. relating to the operation of the Arnold's Cove fish plant.

Contrary to Cabinet direction which stated that all carrying costs be recovered, Icewater is required to pay a minimum annual lease payment of $50,000 and will only approach the total carrying costs (estimated at approximately $200,000 annually) if the defined annual cash flow of Icewater reaches $2.5 million.

Government contravened the *Financial Administration Act* when, in 2004, it pre-committed $1.75 million in the Department of Finance for the 2005-06 fiscal year. In this instance, the pre-commitment related to an advance to a Crown agency (NIDC) to enable the agency to meet its funding requirements under a Subscription Agreement related to its investment in Icewater Seafoods Inc. The Department was not a signatory to the Subscription Agreement and the pre-commitment of funds to NIDC did not provide for goods or services to be provided to the Department. Therefore, the pre-commitment would not meet the requirement in the *Financial Administration Act* for *"…an agreement to be entered into for the purchase of goods or services to be delivered in a subsequent fiscal year."*

Government used a Crown corporation (NIDC) to provide the financial assistance in order to address concerns raised by the Federal Government relating to a provincial government holding a groundfish quota. Officials indicated that normally the financial assistance would have been provided through a Government department.

Without the required prior knowledge and approval of NIDC, Icewater Seafoods Inc. transferred a quota for 300 metric tonnes of halibut to a Newfoundland and Labrador based company.

Furthermore, contrary to Government's stated position NIDC gave the company approval to transfer another quota for 72 metric tonnes of halibut to Nova Scotia. Therefore, the primary processing was not performed in this Province.

Findings and Recommendations

Overview

In late 2003, High Liner indicated it had not found a buyer for the Arnold's Cove fish plant and that it was prepared to decommission the plant and sell the assets, including the Enterprise Allocations (groundfish quotas), on the open market.

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Icewater originally approached Government requesting a $5.7 million loan guarantee. For various reasons, including past problems with loan guarantees to primary processors, Government identified an alternate means of providing funding to Icewater.

On 9 June 2004, the Minister of Fisheries and Aquaculture announced that a MOU had been signed between the Province, High Liner and Icewater related to the operation of the Arnold's Cove fish plant.

On 14 October 2004, a transfer agreement was completed under which High Liner transferred, at nominal cost, all groundfish quotas and historical rights associated with the Arnold's Cove fish plant, as well as a groundfish harvesting licence and seven associated vessel designations (licences) to NIDC.

There were primarily two Government entities involved with the investment.

Newfoundland and Labrador Industrial Development Corporation (NIDC)
NIDC operates under the authority of the *Industrial Development Corporation Act* to provide long-term financing to industrial and resource-based companies.

The affairs of NIDC are managed by a Board of Directors with records being maintained by Department of Finance employees. The Province's investment in Icewater was made through NIDC.

Department of Fisheries and Aquaculture
The Department of Fisheries and Aquaculture provides services and assistance to fishing and aquaculture participants in the Province in its efforts to support and promote the development of sustainable and viable fishing and aquaculture industries. It administers several programs in fulfilling this mandate.

The Department was initially approached by an Icewater official seeking assistance in the purchase of the Arnold's Cove fish plant operations.

The primary benefits to the Province from these arrangements are:

- maintaining employment in the Arnold's Cove area resulting from the fish plant operations; and

- retaining the related groundfish quotas for the Province.

2.7 Investment in Icewater Seafoods Inc.

During our review we made observations on the following matters:

- Agreements in place;
- Sources of financing;
- Compliance with Department of Fisheries and Aquaculture policy;
- Compliance with the *Financial Administration Act*;
- Sale/transfer of groundfish quotas;
- Potential reductions in proceeds from investment; and
- Monitoring of lease agreement.

Comments on these matters follow.

Agreements in Place

Details of agreements in place

During our review we identified the 7 agreements in place related to the Icewater transaction, which closed on 14 October 2004. Figure 1 provides details on these Agreements.

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Figure 1
Agreements between the Province and Icewater

Agreement	Parties to Agreement	Purpose
Memorandum of Understanding 8 June 2004	Minister of Fisheries and Aquaculture Icewater Seafoods Inc. and Icewater Harvesting Inc. High Liner Foods Inc.	Establishes general terms and conditions under which negotiations would occur with a view to the conclusion of a final agreement by 30 June 2004
Assignment Agreement 8 October 2004	High Liner Foods Inc. NIDC	Indicates that High Liner’s interest in groundfish enterprise allocations, fishing licence, etc. associated with the Arnold's Cove fish plant have been assigned to NIDC
Lease Agreement 8 October 2004	NIDC Icewater Seafoods Inc. Icewater Harvesting Inc.	Outlines terms of the lease of the groundfish enterprise allocations, fishing licence, etc. associated with Arnold's Cove fish plant that were assigned to NIDC were in turn leased to Icewater
Subscription Agreement 8 October 2004	NIDC Icewater Seafoods Inc. Icewater Harvesting Inc.	Provides for the NIDC’s subscription of 35,000 Preference II shares of Icewater Seafoods: - 17,500 shares at closing in October 2004 ($1.75 million); and - 17,500 shares on / before 1 April 2005 ($1.75 million)
Unanimous Shareholders Agreement 8 October 2004	Icewater Seafoods Inc. High Liner Foods Inc. NIDC Former plant manager (owner)	Provides for the certainty of the payment of dividends by the Icewater Board to NIDC
Subordination and Acknowledgement Agreement 17 December 2004	Bank of Nova Scotia NIDC Icewater Seafoods Inc.	Agreement requested by the Bank in response to Icewater’s needs for financing (operating $3 million and bridge financing $1.5 million)
Subordination Agreement 5 March 2005	NIDC Bank of Nova Scotia Business Development Bank of Canada Icewater Seafoods Inc. and Icewater Harvesting Inc.	Acknowledges that there is no security interest for the Banks related to NIDC's lease of the quotas to Icewater

2.7 Investment in Icewater Seafoods Inc.

Sources of Financing

In order for the Icewater plan to be successful it was determined that additional financing from outside sources was necessary for operating capital and equipment enhancement. Sources of financing identified, including loans, wage and benefit concessions and investments, are outlined in Figure 2.

$10.75 million secured in financing

Figure 2
Sources of Financing - Icewater

Source	Type of financing	Amount
NIDC	Preference II shares	$3,500,000
Bank of Nova Scotia	Operating loan (Note-Temporary bridge financing of $1,750,000 provided until 2nd NIDC payment received in April 2005)	3,000,000
Business Development Bank of Canada	Loan	1,750,000
Atlantic Canada Opportunities Agency	Not specified	1,000,000
Workers/FFAW	Wage and benefit concessions	850,000
Arnold's Cove Holdings (Former plant manager)	Equity investment (funds loaned from High Liner)	400,000
Town of Arnold's Cove	Loan	250,000
Total Financing		**$10,750,000**

Compliance with Department of Fisheries and Aquaculture Policy

Nature of transaction does not comply with DFA policy

DFA Policy

In June 2004, the Minister of Fisheries and Aquaculture stated Government was working with High Liner on a solution to keep the Arnold's Cove fish plant in operation. The statement included:

- An assurance that the Province's policy of not providing loan guarantees and direct financial support to primary processing companies remains in place; and

- A commitment that any solution must be consistent with the policy of not subsidizing the operations of processing plants.

2.7 Investment in Icewater Seafoods Inc.

Contrary to its policy of not providing loan guarantees and direct financial assistance to primary fish processing companies, Government effectively provided $3.5 million in financial assistance to Icewater Seafoods Inc. relating to the operation of the Arnold's Cove fish plant.

Nature of transaction does not comply with Cabinet direction

Cabinet Direction

Cabinet directed NIDC to enter into agreements for the investment in Icewater ensuring that all carrying costs associated with the investment should be recovered. Based on our review, we identified that:

- Cabinet directed the NIDC Board of Directors to review and approve necessary agreements for this transaction to occur. During their review, the Board identified that the minimum leasing costs ($50,000 annually) that had been negotiated would not cover all carrying costs. These were estimated at $200,000 annually.

  Based upon our review of surcharge provisions in the agreement, Icewater's annual cash flow would have to reach about $2.5 million in order for its total required annual lease payment to reach $200,000. Annual cash flow is defined in the lease agreement as consolidated Icewater earnings before income taxes, depreciation, and amortization less capital expenditures and current income taxes paid or payable for the year.

- The Board communicated to the Ministers of Finance and Fisheries and Aquaculture the fact that it felt that the Province should at least recover the carrying charges (estimated cost of borrowing approximately $4 million over the 20 year lease) on the investment of $3.5 million. In a meeting with the Ministers and certain officials, including the Deputy Minister of Finance, it was indicated that Cabinet was informed.

- Minutes of a NIDC Board of Directors meeting reflect the fact that the lease fee structure would have to remain unchanged, bearing in mind the lengthy discussions that had already taken place and a concern that a proposed increase in the minimum lease fee could “scuttle the deal”.

Based on current circumstances, these lease payments are not sufficient to cover the carrying charges of the investment in Icewater and therefore the investment in Icewater does constitute financial assistance to a primary processing company. As well, contrary to Cabinet direction which stated that all carrying costs be recovered, Icewater is required to pay a minimum annual lease payment of $50,000 and will only approach the total carrying costs (estimated at approximately $200,000 annually) if the defined annual cash flow of Icewater reaches $2.5 million.

Compliance with the *Financial Administration Act*

Pre-committing NIDC funding did not comply with the Act

Due to the lack of available funding during the 2004-05 fiscal year, the Province could not make a complete investment of $3.5 million in Preference II shares at the time of the closing of arrangements on 14 October 2004. Instead the following occurred.

- A Subscription Agreement was signed between NIDC, Icewater Seafoods Inc. and Icewater Harvesting Inc. that allowed for an initial investment of $1.75 million at the time of closing and a second investment of $1.75 million as late as 1 April 2005 (i.e. the next fiscal year).

- To facilitate this Agreement, the Province employed Section 26(4) of the *Financial Administration Act* that allows funds to be pre-committed for *"the purchase of goods or services"* in a subsequent fiscal year. Cabinet directed the Department of Finance to pre-commit $1.75 million for the 2005-06 fiscal year.

- Icewater arranged bridge financing for $1.75 million to cover operating requirements until it received the second share subscription in April 2005.

Government contravened the *Financial Administration Act* when it pre-committed the $1.75 million in the Department of Finance for the 2005-06 fiscal year. The Department was not a signatory to the Subscription Agreement and the pre-commitment of funds to NIDC did not provide for goods or services to be provided to the Department. Therefore, the pre-commitment for the Department of Finance would not meet the requirement in the *Financial Administration Act* for *"…an agreement to be entered into for the purchase of goods or services to be delivered in a subsequent fiscal year."*

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Sale/Transfer of Groundfish Quotas

Federal Government concerned with the Province holding quotas

Government used a Crown corporation (NIDC) to provide the financial assistance in order to address concerns raised by the Federal Government relating to a provincial government holding a groundfish quota. In documentation on file they indicated that it was unprecedented.

Officials indicated that normally the financial assistance would have been provided through a Government department.

Transfer of quota not approved

Under terms of the lease agreement, Icewater is required to obtain approval of NIDC prior to the transfer of any groundfish quota to another party. Trading of groundfish quotas in the industry can occur as companies attempt to optimize their fishing efforts.

We noted an instance where a trade occurred without the prior required NIDC approval. Correspondence dated 12 November 2004 between a representative of Icewater and the Department of Fisheries and Aquaculture indicated that the Department was notified that a transfer of 300 metric tonnes of Greenland halibut to a Newfoundland and Labrador based company had been previously made by Icewater without seeking prior approval of NIDC.

Transfer of quota out of the Province

The Province has a stated position that fish caught in waters adjacent to Newfoundland and Labrador should be processed here.

We noted an instance where a transfer occurred which resulted in fish not being processed in this Province. The 12 November 2004 correspondence also indicated that a request was made for the transfer of 72 metric tonnes of Atlantic halibut to a company in Nova Scotia to be landed in Nova Scotia. This request was approved by the Chair of NIDC in writing.

Potential Reductions in Proceeds from Investment

There are a number of conditions contained in the agreements entered into by NIDC that present potential reductions in proceeds due to the Province from this investment. These include:

Ranking of Preference II shares

In several instances the Province's interests have been subordinated to other parties involved with Icewater, including:

Subordination of share rights

- Under the Subscription Agreement, NIDC's Preference II shares are ranked junior to Preference shares held by High Liner as part of the plant sale arrangements. Consequently, with respect to the payment of dividends or the distributing assets in the event of the liquidation, dissolution or winding-up of Icewater, the NIDC investment ranks behind High Liner for any recoveries.

- Assets of the Arnold's Cove fish plant have been pledged as security against a loan from the Business Development Bank of Canada.

- Under a Subordination Agreement, the Bank of Nova Scotia has a claim with respect to an operating line of credit against certain assets of the Icewater ahead of NIDC.

Preference II Share Redemption Value

Reduction in share value

Under a provision related to the share redemption price in the Subscription Agreement, the $100 par value of each of NIDC's Preference II shares is reduced by $5 per share (for all 35,000 shares) every year that a dividend is not payable under the Agreement. This equates to

- a potential annual reduction of the original investment of $175,000; and

- a potential reduction of the full share value of $3.5 million over the 20 year lease.

As previously noted, the Province will not recover its investment, including carrying costs, from the minimum required lease payments over the initial 20 year lease period.

Monitoring of Lease Agreement

Receipts

Under the terms of the Lease Agreement, Icewater Seafoods Inc. and Icewater Harvesting Inc. are required to:

Initial payment not due until 31 March 2006

- provide NIDC with annual audited consolidated financial statements within 90 days of each year end; and

- permit NIDC to have its auditors review books and financial documentation necessary to verify the amounts applicable under the Lease Agreement.

There are no lease fees due until 31 March 2006, as any fees chargeable for 31 March 2005 were waived under terms of the Lease Agreement.

As financial statements were not due during the period of our review, we were unable to assess the collectibility of receipts at this time. However, we note that during the NIDC review, officials indicated that Icewater operations were judged to be marginal at best in the initial years.

Icewater Operations

Icewater operations below planned levels

We note that documentation on file at the Department of Fisheries and Aquaculture indicated the following concerns with Icewater operations:

- lower employment levels than planned;
- lower production levels than planned;
- unfavourable international prices for raw materials; and
- difficulties with a key piece of machinery acquired to improve production yields and efficiency.

Employment level

One of the objectives for this initiative is to maintain employment in the Arnold's Cove area. During our review, we noted that there is no requirement in the agreements reviewed to maintain a minimum employment level.

Recommendations

Department of Fisheries and Aquaculture

The Department of Fisheries and Aquaculture should ensure that assistance provided to groundfish processing plants is consistent with Government policy.

Department of Finance/NIDC

The Department of Finance and the Newfoundland and Labrador Industrial Development Corporation should:

- *comply with Cabinet direction to ensure that all carrying costs associated with the investment in Icewater Seafoods Inc. are recovered; and*
- *comply with the* Financial Administration Act.

Department of Finance's / NIDC's Response

Carrying Charges

The Department does not agree with the statement that NIDC was directed "to enter into agreements for the investment in Icewater ensuring that all carrying costs associated with the investment should be recovered". The issue of carrying charges related to an initial option under consideration, which would have seen a separate corporation established to acquire the quotas with borrowed funds. NIDC was not mentioned in the approval in principle by Cabinet. The direction from Government in April, 2004 also required the Departments of Fisheries and Aquaculture and Finance to submit options for financing the purchase of the groundfish allocations, for final approval by Cabinet.

In the end, NIDC was chosen as the vehicle to facilitate the transaction, through grant funding provided by the Province. The final negotiated assignment and lease agreements were subsequently submitted to Cabinet for approval, before being executed by NIDC in October, 2004. The lease fee arrangement was highlighted in our Cabinet Submission and it is the Department's view that Cabinet approval of the final agreements constituted acceptance of the lease fee structure and revision of the approval in principle.

Financial Administration Act

As you have noted, sufficient funding was not available during 2004-05 to enable NIDC to complete its investment and Government provided the additional funding in 2005-06. Section 26(4) of the Financial Administration Act *addresses the pre-commitment of funds for a subsequent fiscal year and references "goods or services". It could be interpreted that Section 26(4) does not permit the pre-commitment of funds to facilitate a grant payment, although the grant was in fact required to enable NIDC to purchase an additional 17,500 preference shares of Icewater pursuant to the Subscription Agreement dated October 8, 2004. However, the Department decided to follow the spirit of the legislation for prudent financial management reasons.*

Department of Fisheries and Aquaculture's Response

It is the position of the Department of Fisheries and Aquaculture that the acquisition of groundfish enterprise allocations from High Liner Foods Incorporated and the subsequent lease of these quotas to Icewater Seafoods Inc. was consistent with government's policy of not providing direct financial assistance to the primary fish processing sector. Government decided to permanently acquire these allocations, together with all associated historic rights and seven vessel designations, for the future benefit of the Province. The cost of $3,500,000, which would be in the form of an investment in preference shares of Icewater Seafoods Inc., was well below the value as assessed by an independent appraiser. The instrument of payment was mutually agreed by Icewater, High Liner, and government, and in no way represented a subsidy paid by government to Icewater. If NIDC does not recover its investment through dividends or the redemption of the preference shares by Icewater Seafoods, at the end of the twenty year lease term NIDC still owns the groundfish quotas for the long term economic benefit of the Province.

It is government policy that fish landed in Newfoundland and Labrador meet minimum on shore processing requirements. With respect to the transfer of Atlantic halibut quota, this species is generally sold fresh into the U.S. market to maximize value, with minimal on shore processing. The transfer in question was undertaken to ensure that the best value was recovered from this quota, with proceeds used to acquire frozed cod for processing at Arnold's Cove. Subsequent to the initial transfer of 300 tonnes of Greenland halibut, which was transferred to another Newfoundland and Labrador based company without NIDC's prior approval, NIDC has made arrangements to ensure that all future transfers are directed to it for approval.