TORONTO

# STAFF REPORT ACTION REQUIRED

# Capital Financing and Debenture Authorities

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| **Date:** | February 1, 2007 |
| **To:** | Budget Committee |
| **From:** | Deputy City Manager and Chief Financial Officer |
| **Wards:** | All |
| **Reference Number:** | P:\2007\Internal Services\Cf\bc07005Cf – et (AFS #2374) |

## SUMMARY

This report requests Council's approval for the sale and issuance of debentures in 2007 to finance tax-supported capital expenditures, the reaffirming of the guideline for the ratio of debt service charges to property taxes and ensuring that the City's capital financing and borrowing authority, including City Program, Agencies, Boards and Commissions, is delegated to the Deputy City Manager and Chief Financial Officer.

These measures are necessary to support the City's efforts to further enhance its fiscal sustainability and credit worthiness.

## RECOMMENDATIONS

**The Deputy City Manager and Chief Financial Officer recommends that:**

(1) authority be granted for the Mayor and the Deputy City Manager and Chief Financial Officer to enter into an agreement or agreements with a purchaser or purchasers for the sale and issuance of debentures, to provide an amount in 2007 not to exceed $500 million;

(2) the 2007 sinking fund levies of $167,683,949.02 for the City of Toronto and $2,293,802.99 for the Toronto District School Board be approved;

(3) the 15% debt charges as a per cent of tax levy guideline approved by Council in 2006 be reaffirmed for 2007 and the recommended debt issuance and resultant debt charges to finance the 2007 Capital Budget adhere to this capital management guideline;

(4) City Programs and Agencies, Boards and Commissions' capital financing requirements be included in the Five Year Capital Budget and submitted through the Deputy City Manager and Chief Financial Officer (DCM/CFO) for consideration of Council;

(5) authority be granted for the introduction of the necessary Bills in Council to give effect to the foregoing; and

(6) the appropriate City of Toronto officials be authorized to take the necessary actions to give effect thereto.

## FINANCIAL IMPACT

If the entire borrowing authority is utilized during 2007, the maximum financial impact is $12.5 million in debt charges that would be reflected in the 2007 Operating Budget in the Non-Program Budget – Capital and Corporate Financing Account, assuming an interest rate of 5.00% per annum. For 2008, the estimated annualized debt charges resulting from the 2007 issuance of $500 million is $60 million.

There are no additional financial impacts contained in this report.

## DECISION HISTORY

Recommendation 10 from the 2006 Capital Budget Report as approved by Council in June, 2006 stated that:

"(10) the City Manager and the Deputy City Manager and Chief Financial Officer be requested to report to the Policy and Finance Committee during the 2007 Capital Budget process, on innovative Capital Financing Strategies that protect the public interest, including the use of (CIP's), Community Investment Plan, (TIF's), Tax Incremental Financing and Development Charges, and partnerships with non-profit organizations, foundations and private businesses."

## ISSUES BACKGROUND

### Authority to Issue Debentures

Section 102 of the City of Toronto Act, 1997 (No. 2), which previously empowered Council annually by by-law to authorize the Mayor and the Treasurer to negotiate and enter into agreements for the issuance and sale of debentures to finance capital expenditures previously approved, does not apply to the City as there is no such provision contained in the *City of Toronto Act 2006*. However, it has been determined through discussions with external legal counsel who provide the opinions associated with the

City's debenture issuance as well as various investment banks and dealers that this bylaw will clarify whom is authorized to act on behalf of the City when issuing debt.

The practice of Council adopting this bylaw, although not required by the *City of Toronto Act 2006*, will be reviewed during 2007 and, based upon this review, a recommendation for 2008 and future years will be presented to Council.

**Approval of the 2007 Sinking Fund Levies**

Section 255(4) of the *City of Toronto Act 2006* states:

"If in any year an amount is or will be required by law to be raised for a sinking fund or retirement fund of the City, the city treasurer shall prepare for city council, before the budget for the year is adopted, a statement of the amount." This requirement is addressed in this report.

**15% Debt Charges as a Per Cent of Tax Levy Guideline**

Council had previously adopted a guideline for the maximum debt service to property tax ratio of 10% in 1998. This ratio was first established as a guideline by Council to represent a longer term limit on debt financing and the resulting allocation of the operating budget toward financing capital expenditures. However, significant increases in the capital expenditure levels due to aging infrastructure, particularly in major capital program areas such as transit and transportation, has led to increasing the ratio to 15% during the 2006 capital budget process.

**Dedicating a portion of the Strategic Infrastructure Partnerships Reserve Fund account for reinvestment into new City-wide energy-related projects**

The currently approved uses of the proceeds from the Toronto Hydro Corporation promissory note are "to fund the City's major tax-supported strategic infrastructure programs (such as Spadina Subway Extension or rail transit elsewhere in the City, and Waterfront Redevelopment), in partnership with other orders of governments, and major strategic tax-supported environmental capital projects with external funding partners;'

When it established the reserve fund, Council referred the following motion back the CFO for a report to committee:

> "AND BE IT FURTHER RESOLVED THAT, recognizing that the proceeds of the Toronto Hydro Corporation Promissory Note is a transfer to the City of the equity invested by Toronto residents in their former hydro utilities, that 25 percent of the proceeds of the Promissory Note of Toronto Hydro Corporation be set aside in a new reserve account to be set-up, which will reinvest this equity into new City-wide energy-related projects, energy conservation projects, green energy projects and in projects which assist in achieving the goal of Toronto's energy plan."

## COMMENTS

### Authority to Issue Debentures

In order to maintain flexibility and the ability to finance capital expenditures that were previously approved but not yet permanently financed and preliminary debenture requirements as contained in the 2007 Capital Budget that will be considered by Council at the same meeting as this report is considered, authority to issue debentures up to a $500 million limit for City purposes is being requested.

The proceeds from debentures issued under this authority will be used to finance capital expenditures that have been incurred or committed for approved projects.

The debenture authority approved by Council for 2006 was $550 million. Due to favourable capital market conditions and timing considerations, debenture issuance in the amount of $500 million was completed during 2006 to finance the City's capital requirements.

### Approval of the 2007 Sinking Fund Levies

When the City issues debentures, the COTA requires that the principal repayment must be amortized over the term-to-maturity of the debenture or an annual amount be contributed to a sinking fund. Sinking funds are required by this legislation and are established to ensure that adequate financing is available to refund the debt at maturity. Currently, the City has three separate sinking fund portfolios (4%, 5% and 6%) associated with its debenture issues. Each portfolio represents a specific actuarial rate of return that is used in calculating the required annual sinking fund contribution.

The Sinking Fund Committee, consisting of four citizen members appointed by Council and the Chair who is the DCM/CFO, is responsible for the administration and management of all sinking fund investment portfolios. As trustee of these portfolios, the Sinking Fund Committee exercises its fiduciary responsibility by achieving the specified actuarial rates of return while ensuring compliance with legislative and policy limits. This is accomplished through the prudent investment management of the annual sinking fund contributions, the re-investment of interest income, and achieving capital gains as appropriate.

In accordance with the requirements of section 255(4) of the COTA, I submit and certify the following statement:

> Amounts required by by-law (as amended by the Ontario Municipal Board orders to reduce levies) to be raised in 2007 by Council for deposit in the City of Toronto Sinking Fund are provided for as follows:

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| City of Toronto | $ 167,683,949.02 |
| Toronto District School Board | 2,293,802.99 |
| Total | $ 169,977,752.01 |

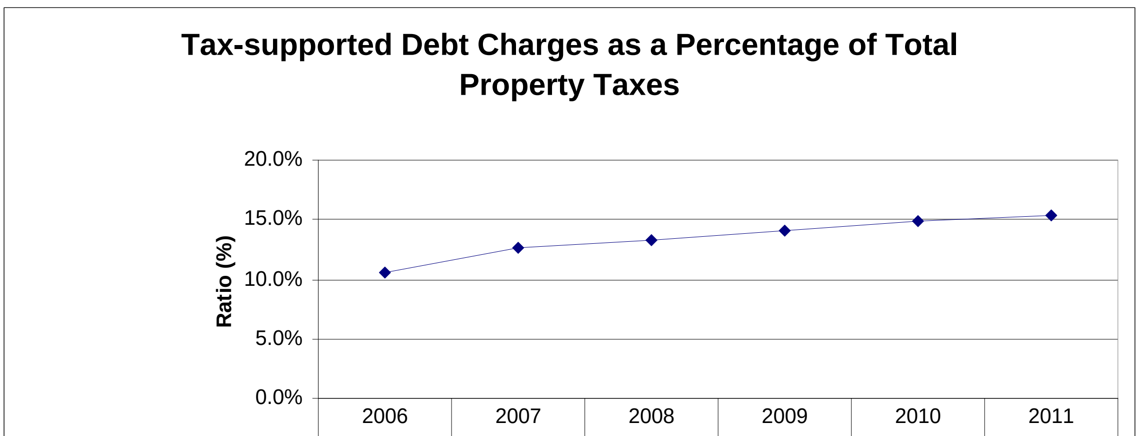
The sinking fund deposit for the City's requirements forms part of the City's 2007 operating budget and is included in non program budget - Capital & Corporate Financing, "Debt Charges". While Council is required to levy the sinking fund deposit on behalf of the Toronto District School Board, it is not included in the City's operating budget as it is fully recovered from the Board.

**Debt Service Ratio**

At its meeting of June 27-29, 2006 (Policy and Finance Committee, Report 5, Clause 25) Council reaffirmed that the maximum limit of debt service charges as a percentage of total property tax be established at 15 percent as a benchmark for evaluating capital plan expenditures levels.

Based on projected debt requirements of the plan, the City's debt service ratio is expected to reach the target in 2011. The plan is based on modest tax revenue growth in line with current assessment growth and inflationary rate increases. However, excluded from the plan is the impact of financing the recent Green Lane landfill purchase.

One reason that the plan will exceed the targeted ratio is that it does not incorporate increases in capital from current, even though the debt service ratio target was adopted in concert with a capital from current strategy that would have increased contributions by $10 million each year. Unfortunately, these increases have not been affordable for inclusion in the operating budget. This situation is unlikely to change unless significant uploading of income redistributive programs, or sharing of growth taxes, is achieved, in accordance with the City's multi year plan. Alternatively, the City could cut expenditures by an additional $90 million from the 5 Year Plan.




| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Recommended Plan | 10.6% | 12.6% | 13.3% | 14.1% | 14.9% | 15.4% |

**Capital Financing Tools Available to the City**

City staff is reviewing all capital financing options available under COTA. Currently, the City has access to a relatively wide variety of financing tools and strategies, including traditional debenturing, capital leases and loan guarantees. However, it should be noted that although certain financing arrangements, e.g. capital leases, are not recorded on the City's balance sheet, these arrangements are still considered to be long-term obligations in the financial statements and are recognized by the credit rating agencies. Therefore, this type of financing does not confer the City with a financial benefit unless the option provides a competitive cost of funds in addition to features such as the management of equipment obsolescence, the provision of extended warranties and a more flexible repayment schedule that is not always offered by a debenture.

Appendix A outlines the capital financing tools that are available to the City. These are categorized by A) Direct City Financing, such as traditional debt, secured debt, capital from current and reserves; B) Joint with Third Parties, such as loan guarantees, City grants, equity investments, and joint use agreements; and C) Privately Financed. The Appendix illustrates the applicability of each of these instruments and describes how they affect the City's interests through impacts on the balance sheet or effects on the operating budget. Finally, examples are provided showing where the City has used these in the past or are contemplating them in the future. As shown, the City has used a number of different tools in specific situations which have collectively enhanced the financing of various projects.

When evaluated on a pure lowest cost-of-funds basis, the traditional debenture issue generally provides the lowest cost when compared to other financing methods as listed in Appendix A. This is a function of the City's reputation and its ability to access global capital markets in an efficient basis as well as its strong credit rating as compared to other entities.

However, there are other forms of capital financing that involve tax incentives, guarantees and leasing arrangements that can provide the City with cost-effective financing as well as a means to manage and transfer project risk to third parties while preserving the City's overall borrowing capacity.

Several of these alternative methods to finance infrastructure only became available to the City on January 2, 2007, such as Revenue Bonds which are not guaranteed by the City and are usually secured against future user fees and Tax Incremental Financing (TIFS) which relies on property taxes from future assessment growth for funding. City staff are seriously reviewing all of these innovative financing methods for future capital projects.

While it is noted that the COTA confers natural person powers to the Agencies, Boards and Commissions, if these organizations receive a capital financing proposal from a third party, it should be provided through the Deputy City Manager & Chief Financial Officer for an evaluation and comparison to the City's cost of funds before it is presented to Council for approval. It should be noted that the City's capital markets staff are active and effective participants in global capital markets and obtain funds at the lowest available cost. Therefore, the Deputy City Manager and Chief Financial Officer is in the best position to evaluate these proposals since staff receive continuous market coverage and is aware of the most recent financing trends and products.

The City's current loan guarantee and leasing policies are being reviewed and will be presented to Council during the year and will contain a recommended protocol for ABC's. A report on hedging strategies as related to the issuance of debt is being drafted and will be presented to Council during 2007. These strategies can be used to mitigate the impacts of future interest rate changes and may be useful for protecting the City between the time a debenture issue goes to the market and the closing date.

A report that recommends an appropriate financing strategy for the Green Lane Landfill Site will be provided to Council in early summer 2007. Also, a report on tax incremental financing (TIFS) policy will be presented to Council after the provincial regulations have been proclaimed.

**Dedicating a Portion of the Strategic Infrastructure Partnerships Reserve Fund Account for reinvestment into new City-wide energy-related projects**

Energy–related projects with City-wide implications may already be eligible for funding from the Strategic Infrastructure Partnerships reserve so long as they are "major strategic tax-supported environmental capital projects with external funding partners". As an example, Council recently approved funding of an Enwave Energy Corporation capital call (of a confidential amount) from this reserve. To the extent that energy related projects arise that are not eligible for funding from the reserve, there are a number of funding options already in existence. Consequently, no amendments to the purpose of the reserve are recommended.

## CONTACT

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## SIGNATURE

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Joseph P. Pennechetti
Deputy City Manager and Chief Financial Officer

## ATTACHMENT

Appendix A – Capital Financing Tools available to the City of Toronto

**Appendix A - Capital Financing Tools available to the City of Toronto**

| Instrument | Applicability | City's Interest | | Comments | Examples |
|---|---|---|---|---|---|
| | | **Protecting the Balance Sheet** | **Minimizing Operating Impact** | | |
| **A. Direct City Financing** | | | | | |
| **1. Long Term Financing** | **Where there is a future new benefit being introduced to taxpayers** | | | | |
| - Traditional Debt | Where asset life matches or exceeds term of debt | Debt is a long term liability. Term determines how long balance sheet is impacted | Credit rating and capital markets determine cost. Funded in the non-program budget. | ▪ Generally the cheapest form of financing for most capital projects<br>▪ Spreads operating impact over term of debt, with preponderance of repayment impact occurring in subsequent year. Consequently tends to be overused, resulting in growing debt and debt service burden. | Subway expansion, major state of good repair items (e.g. bridge replacement) |
| - Energy Retrofit Program | Similar to traditional debt except that repayment is funded by the operating program from project related savings. | Debt is a long term liability. Term is limited to no more than 10 years. | Funded in the operating program budget | ▪ Because repayment is from within program operating budgets, expenditures may be approved outside the program capital debt plus capital from current affordability targets.<br>▪ Debt issued is in effect self liquidating in that the savings generated offset the debt charges. | Arena retrofits, community centre retrofits |

## Appendix A - Capital Financing Tools available to the City of Toronto

| Instrument | Applicability | City's Interest: Protecting the Balance Sheet | City's Interest: Minimizing Operating Impact | Comments | Examples |
|---|---|---|---|---|---|
| -Zero Coupon Debt/ Construction Financing | Where there is a deferred revenue or other operating offset | Similar to above. Deferring principal payments means debt is on books longer. | Overall cost is usually higher due to the costs of financing the deferral of interest payments, but the instrument is useful to help smooth cash flows for new projects | ▪ Should not be used to arbitrarily be used to reduce debt costs in the earlier years. | ▪ Possible use for Green Lane landfill site – to match debt charges with operating cost (disposal and haulage)<br>▪ A new revenue generating facility, e.g. an arena |
| -Secured Debt, e.g. revenue bonds, Tax Increment Financing | Where there is a need to isolate debt repayment risk from City or transfer it to a third party<br><br>More applicable for new infrastructure or services | Balance sheet is protected: no City guarantees should apply | No direct operating impact. Future revenues may be foregone during repayment period | ▪ Generally more costly than traditional debt.<br>▪ May be attractive if associated with an inducement or revenue enhancement such as a share of future education taxes<br>▪ Transaction costs high because deals are complicated and lenders' risk is high<br>▪ May impact City's credit rating if it results in excessive fragmentation of property taxes or balance sheet<br>▪ Bondholders assume repayment risk, although may have recourse to underlying project assets, i.e. no implicit City guarantee, project carries on regardless, control of certain assets may be lost if default on debt payments. | Spadina Subway |

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| Instrument | Applicability | City's Interest | | Comments | Examples |
|---|---|---|---|---|---|
| | | Protecting the Balance Sheet | Minimizing Operating Impact | | |
| - Loans from special purpose agencies | The City has received financing from third party vendors or government agencies repayable from project related revenue or savings streams | Repayment obligation may be reported as debt (e.g. TAF /FCM) or a capital lease (energy retrofit firms), in either case, a long term liability | The repayment cost is funded from project related operating savings, which are sometimes guaranteed by third parties to ensure no operating budget impact | ▪ The cost of financing ranges from highly attractive with sometimes burdensome contractual and reporting obligations (FCM Green Municipal Infrastructure Fund programs) to less attractive arrangements which are nominally or significantly more costly than City debt (TAF, vendor take back financing). Often used in combination with City debt. | Energy retrofits |
| - Capital Leases | For acquiring smaller assets with shorter useful life | Leases are long term liabilities | Carrying costs usually more expensive than traditional debt | ▪ Domestic leases are usually more costly than City financing<br>▪ More flexible than debenturing for matching financing with asset with shorter useful life<br>▪ May be appropriate where there are other "bundled" services, e.g. asset disposal, maintenance | Some vehicles, computers, photocopiers |
| **2. Upfront Funding** | **Where there is a past or current benefit to taxpayers** | | | | |
| - Capital from current | Ongoing state of good repair/ maintenance | Appropriate level of capital from current in the operating budget would reduce reliance on debt for maintenance of existing assets. | In the near term (1 – 5 years), capital from current imposes a higher tax or water fee burden than comparable debt financing. However, over the long term, capital from current occupies significantly less budget room than | ▪ Implementing an appropriate capital from current level requires fiscal discipline, capital funding certainty, and sufficient fiscal capacity. These factors have retarded efforts to increase capital from current levels in recent years for property tax supported funding. However, the City has successfully increased capital from current funding from water rates.<br>▪ Useful for smaller value assets and/or for those with shorter useful life | Annual tax based operating budget allocation ($124m) and water rate allocation ($260m). |

## Appendix A - Capital Financing Tools available to the City of Toronto

| Instrument | Applicability | City's Interest | | Comments | Examples |
|---|---|---|---|---|---|
| | | Protecting the Balance Sheet | Minimizing Operating Impact | | |
| | | | debt (33% less than 10 year debt). | | |
| - Reserves | Future known capital requirements | Enhances balance sheet | Requires higher operating contributions but avoids future debt interest costs<br><br>Can contribute to general interest earnings in the operating budget (if reserves not reserve funds) | ▪ Ideal form of financing for asset replacements since contribution schedule can be calculated to produce 100% of replacement cost at the time asset is at end of useful life<br>▪ Enhances balance sheet prior to asset replacement is required.<br>▪ Can include proceeds from revenues from Sections 37 and 45 of the Planning Act.<br>▪ With adequate advance contributions this is the least expensive or budget intensive form of financing. However, like capital from current, adequate fiscal capacity, certainty and discipline are required to make reserve contributions a priority. | ▪ Vehicle replacements, facility repairs, Metro Hall<br>▪ Technique is used for condos through the Condominium Act |
| - Monetizing future revenue streams | One time capital investments | Can enhance balance sheet | Reduces future revenues | ▪ Should not be used for ongoing capital or operating requirements. Conversion of a future revenue stream to an up front source of capital funding should only be entertained when a valid business case for the conversion is present, or to forestall a fiscal crisis. | Enwave Income Trust would have fit this category but financial viability was affected by changes to federal tax laws. |

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| **B. Joint with Third Parties** | | | |

## Appendix A - Capital Financing Tools available to the City of Toronto

| Instrument | Applicability | City's Interest | | Comments | Examples |
|---|---|---|---|---|---|
| | | **Protecting the Balance Sheet** | **Minimizing Operating Impact** | | |
| - Loan Guarantees | Provided by the City to facilitate third party debt financing in exchange for access to facilities or services that are priorities for the City. | -Encumbers the City's balance sheet as a contingent liability | Little or no impact unless borrower defaults on loan, in which case City may need to top up, take over, or renegotiate payment obligations | ▪ "Seductive" option since no planned cost to City – on the other hand, relies on the strength of the third party's business plan and execution to prevent costs from accruing to the City.<br>▪ City turns over operating control to a third party | Lakeshore Lions Arena, Ricoh Coliseum |
| - City Grants | City funding of third party initiatives to achieve City purposes | Generally no direct impact, unless used for asset that City would have otherwise acquired | May require operating contributions | ▪ Can often leverage funding from third parties, e.g. other orders of government | SkyDome |
| - City Equity Investments | Where there is a potential return on investments and/or outcome that satisfies public policy objectives and where there is an appropriate funding partner | Can enhance balance sheet if positive returns. Financial losses can diminish the balance sheet Initial investment requires funding from some balance sheet item. | Can provide operating budget revenues through dividends | ▪ Investments must be consistent with the City of Toronto Act.<br>▪ Public policy objectives must be satisfied.<br>▪ Equity investment must be funded, either through financial commitment or contribution of property<br>▪ Funding partner must be compatible with City's objectives. | Enwave District Energy, Waterfront |
| - Joint use agreements/ long term leases | Used for generating revenues from City assets | City maintains asset ownership | Rents help the City defray costs | ▪ Can be used to leverage underperforming City assets, e.g. land | Guild Inn, Royal Woodbine Golf Course |
| - Joint use agreements – public entities | Where joint use of assets benefits both the City and other public organizations | Generally minimal impact unless joint capital investments reduce City share of costs | Costs may be reduced if shared with other organizations | ▪ Co-location of City and other public services can reduce costs since one facility may satisfy both organizations' service needs | Harbourfont Community Centre (joint with school board), School Pools |
| - Capital Pre-payment by City | Where City's initial investment will be repaid by | Initial reduction in assets as City pre pays capital costs – | No direct impact | ▪ Must satisfy a public policy objective<br>▪ Benefiting organizations must demonstrate that they do not have the | Yonge Dundas Square, Bloor Street Transformation |

**Appendix A - Capital Financing Tools available to the City of Toronto**

| Instrument | Applicability | City's Interest | | Comments | Examples |
|---|---|---|---|---|---|
| | | Protecting the Balance Sheet | Minimizing Operating Impact | | |
| | third parties | with ultimate repayment, balance sheet is restored | | capacity to fund themselves and that they can repay the City's investment | Project through Business Improvement Area |
| - Assumed Assets | Where a third party provides assets to the City in exchange for some right | Can enhance balance sheet | No direct impact | ▪ Can be a useful financing tool as long as rights provided to third party are balanced or exceeded by assets assumed by the City. | Developer contributed assets |
| **C. Private (Provincial Terminology)** | | | | | |
| - Build Finance (BF) | Typically small retrofit or facility expansion style projects | Private sector finances project during construction phase<br>City maintains ownership | | ▪ Touted as method of guaranteeing construction cost (although this can be achieved with proper contract management) | |
| - Design, Build Finance Maintain (DBFM ) | Large construction projects | Private sector finances project, City records long term repayment obligation over asset life<br>City maintains ownership | | ▪ Touted as method of guaranteeing construction cost and long term asset maintenance (although this can be achieved with proper contract management) | Private arenas, Highway 407 |