TORONTO

STAFF REPORT
ACTION REQUIRED

Long Term Financial Strategy - Debt Restructuring

Date:	November 19, 2009
To:	Budget Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All Wards
Reference Number:	P:\2009\Internal Services\Cf\Bc09032cf – et (AFS #10877)

SUMMARY

The purpose of this report is to recommend a number of changes to the City's debt financing strategy in order to assist in managing the Council approved debt service ratio guideline. This would be accomplished by:

- better matching the useful life of capital projects with the term of debt (and smoothing debt service impacts) by extending the term of new debt issuance debt to up to 30 years for capital projects that create assets with long service life;
- in keeping with the above approach, changing the capital financing for the Waterfront Revitalization and the Spadina Subway Extension projects to debt financing;
- reducing debt service costs by reallocating the reserve funding for the Spadina Subway Extension and various Waterfront Revitalization projects to pay down debt by prepaying and eliminating a portion of the City's future Sinking Fund payment obligations; and
- accelerating the debt pay down by monetizing the Toronto Hydro promissory note owed to the City of Toronto to provide for full redemption by December 31, 2010.

Council adoption of the recommended strategies will assist in managing the City's indebtedness, contribute to the containment of the City's debt service costs, maintain a debt service ratio below 15% of tax supported levies, and thereby maintain or enhance the City's credit profile.

RECOMMENDATIONS

The Deputy City Manager & Chief Financial Officer recommends that:

1. The Toronto Hydro promissory note be monetized by the City no later than December 31, 2010 with the proceeds credited to the Strategic Infrastructure Partnership Reserve Fund (XR1714), and the Deputy City Manager & Chief Financial Officer report to the Executive Committee on the recommended process for monetization.

2. That Council approve a one-time exception to the withdrawal policy of the Strategic Infrastructure Partnership Reserve Fund (XR1714) to authorize the Deputy City Manager and Chief Financial Officer to withdraw $600 million to be used as contributions to the City's sinking funds as a prepayment of specific debt service obligations, and that prior to doing so, the Deputy City Manager and Chief Financial Officer report to the Executive Committee on the timing of the withdrawal and on recommendations for the specific sinking fund debt obligations to be so prepaid.

3. Council authorize the Mayor and the Deputy City Manager & 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 2010 not to exceed $700 million, and to enter into any additional agreements necessary to provide for the reduction of interest rate risk with respect to the interest payable under the debentures, the reduction of currency risk with regard to the principal and interest payable under the debentures, or to minimize the cost or risk associated with the debentures due to fluctuations in interest rates.

4. The Deputy City Manager and Chief Financial Officer be authorized to reopen an existing debenture issue if it is determined that the reopening will be advantageous to the City, depending upon capital market conditions, during 2010.

5. The City's "Financing of Capital Works Policy and Goals" (the "Capital Financing Policy") as required under the *City of Toronto Act, 2006*, be amended so as to increase the City's total direct obligation limit to $4.0 billion net debt over the term of Council ending November, 2010, and that the amended Capital Financing Policy as set out in Appendix "A" to this report be adopted.

6. The appropriate City officials be authorized and directed to introduce any necessary Bills and take the necessary action to give effect thereto.

Financial Impact

Approval of the recommendations contained in this report would reduce the projected peak ratio of debt service as a percentage of the property tax levy from 17.2% to 14.9%. Net debt would be reduced between now and 2012 due to the prepayments to the Sinking Funds from proceeds from the Toronto Hydro promissory note. Beginning in 2012, the City's net debt would increase as the net benefit of prepaying the Hydro promissory note dissipates and is offset by the impact of debt issuance for the Spadina Subway extension and Waterfront Revitalization projects.

The debt service savings from extending the term of debt for certain projects to 30 years would help offset the operating budget impacts of the strategy implemented in 2007 of annual increases of 10% in contributions from the operating budget to the capital budget (CFC's).

DECISION HISTORY

In 2006, Council established the Strategic Infrastructure Partnership reserve fund 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. The one-time proceeds from the divestiture of the City's investment in the Toronto Hydro Corporation promissory note is the funding source for this reserve fund.

In 2007, City Council approved the policies contained in "City of Toronto Financing of Capital Works Policy and Goals". Therein is the requirement that the City's annual costs associated with debt financing shall not exceed 15% of the tax levy and that the City's total direct obligation debt shall not exceed $3.5 billion over the term of Council ending on November, 2010.

ISSUE BACKGROUND

Council adopted the 15% debt service ratio guideline in part to ensure that the operating impact of debt service from capital expenditure financing was limited, so that program operating spending would not be unduly crowded out, and so that the City's credit rating would not be compromised. The guideline is expected to be reached and exceeded due to a spike in capital spending and the resulting debt servicing costs over the next few years. The spike is primarily the result of peaking life cycle costs for TTC fleet replacement and to a lesser extent the Federal stimulus program. Without a change in financing strategies, this will result in projected increases in the operating budget averaging $50 million in each of the next five years.

As well, as part of its approval of the Long Term Fiscal Plan in 2005, Council adopted a principle that "the debt repayment period should not exceed the useful life of the asset for which the debt is incurred".

COMMENTS

In the final report of the Mayor's fiscal review panel titled "A Blueprint for Fiscal Stability and Economic Prosperity – A Call to Action" it is recommended that the City systematically review its assets for potential monetization in order to reduce current tax-supported debt of the City and with it the corresponding debt service charges. Doing so will allow the City room to finance strategic investments in the TTC, infrastructure projects, and other key priorities.

To help mitigate the capital financing and debt charge increases projected over the next few years, a number of policy and financing changes are recommended.

1. Matching the Term of Debt to Capital Asset Life

Under the *City of Toronto Act, 2006*, the maximum term for debt issuance is 40 years or the useful economic life of the asset – whichever is less. Debt issuance limits are established annually through a report to Council. Normal practice is for the City to issue debentures with a term to maturity of 10 years because of the preponderance of state of good repair projects which have a naturally shorter useful life than new, large assets. In some cases this has been extended to 20 years such as for the Sheppard Subway, the Green Lane Landfill site, and the National Trade Centre.

Debt with a term of 30 years or more has been utilized by the Province for municipal infrastructure and by municipalities such as Montreal. The benefits of doing so include: the markets for longer term debt issuance are favourable compared to shorter 10 year terms; longer termed debt enhances the liquidity and marketability of City debt; and with longer term debt, annual debt charges would be significantly decreased.

It is expected that the City will begin to make use of 30 year debentures where appropriate and permissible given the nature and useful economic life of the asset for which the debt is being issued such as TTC subways and subway cars, buildings, waterfront revitalization (including East Bayfront, West Donlands, and Lower Donlands), and certain transportation infrastructure such as bridges. This would be appropriate for an estimated 25% of the City's capital expenditures. It would not be appropriate for projects creating assets with shorter useful economic lives such as information technology assets, vehicles, or equipment. These assets should continue to be financed with 10 year debt or current funds.

Extending the principal repayment of debt issued for appropriate assets over 30 years would help smooth out the near term debt servicing costs of the City's capital expenditure requirements. An extended debenture term to 30 years more closely matches the useful life of the assets being funded and would significantly reduce the impact on the operating fund as compared to 10 year debt.

2. Amending the Capital Funding Sources for the Waterfront Revitalization and Spadina Subway Extension Capital Projects

At present, the Waterfront Revitalization and Spadina Subway Extension capital projects are being funded from the Strategic Infrastructure Partnership Reserve Fund. The funding source for this reserve fund is the repayment of principal from a $980,230,955.00 promissory note issued to the Toronto Hydro Corporation. The note calls for repayment in four equal instalments of $245,057,738.75 on December 31, 2007, December 31, 2009, December 31, 2011, and May 6, 2013. Interest payments calculated at a rate of 6.11%

per annum on the unpaid balance are made at the end of each calendar quarter. These interest payments are credited to the City's operating budget.

The remaining City share from 2010 to 2019 of the Spadina Subway Extension and the Waterfront Revitalization projects is $344.3 million and $255.7 million respectively. The recommended Capital Plan includes funding of the remaining share of these two capital projects through the issuance of 30 year debentures, to better match the timing of the financing charges to the public benefit (all in the future) from the asset. To accommodate this change and the balance of the recommended strategy, it is recommended that the Capital Financing Policy as required under the *City of Toronto Act, 2006* be amended such that the debt limit be revised to $4.0 billion in direct obligation net debt (gross debt less the City's sinking fund accumulated balances). The revised Capital Financing Policy as recommended is attached as Appendix A.

The proceeds from debentures to be issued as recommended in this report will be used to finance capital expenditures that have been incurred or committed for Council approved projects. Authority for borrowing of up to $700 million for City purposes is being recommended in order to finance debenture requirements as contained in the recommended 2010-2019 Capital Budget and Plan, including that required from prior years. This limit includes anticipated debentures to be issued to the Federation of Canadian Municipalities (FCM) under its Green Municipal Fund Program and to the Canadian Mortgage and Housing Corporation (CMHC) under its Municipal Infrastructure Lending Program in 2010.

The Deputy City Manager & Chief Financial Officer confirms that borrowing of up to $700 million to fund 2010 capital expenditures can be financed by the issuance of debentures with terms that do not exceed 30 years. During 2009, debt of $400 million was successfully issued in the capital markets.

3. Monetizing the Toronto Hydro Corporation Promissory Note

It is being recommended that the THC promissory note with the City be monetized prior to December 31, 2010. This can be done in a number of ways including accelerated repayment of the promissory note by Toronto Hydro, or by selling the promissory note or its proceeds to a third party investor(s). Staff will identify and recommend the approach that provides the highest value, taking advantage of the current market conditions (the note would sell at a premium to par value due to current interest rates).

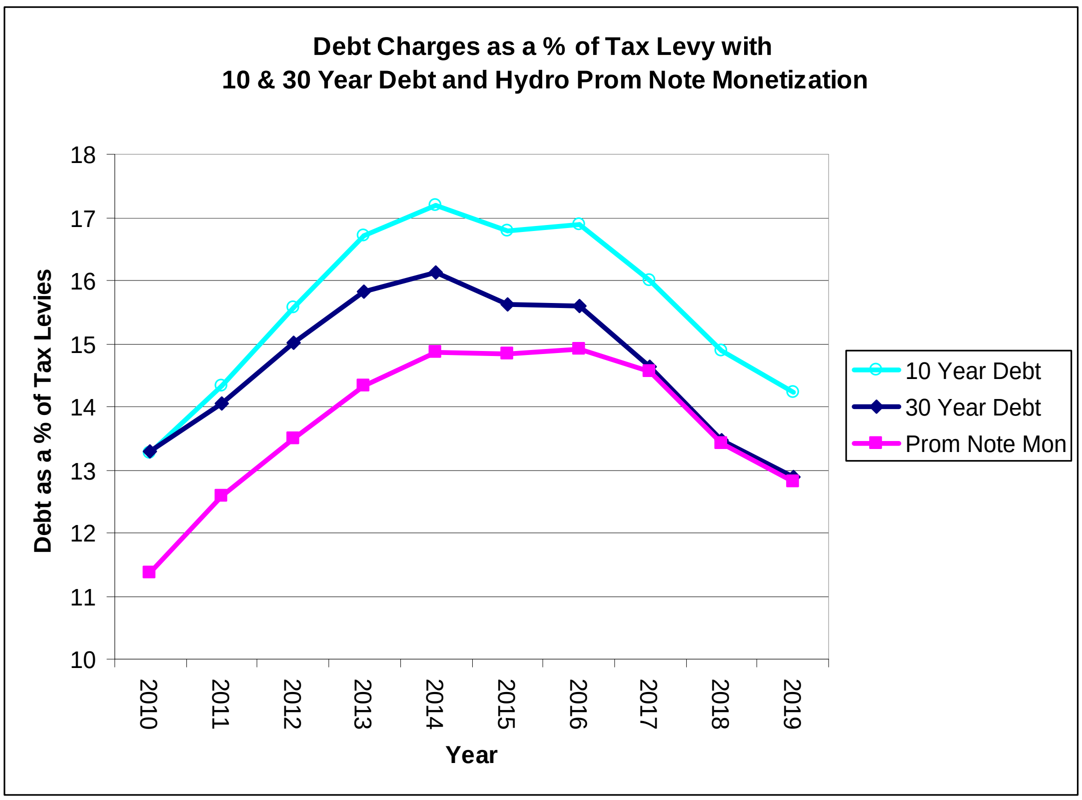
Currently, the withdrawal policy of the Strategic Infrastructure Partnership Reserve Fund only allows for the proceeds of the promissory note to be used for major tax-supported strategic infrastructure projects. An exception to this policy is being recommended to allow the $600 million that had been allocated to the Spadina Subway Extension and Waterfront Revitalization projects to be applied to pay down debt through the prepayment of sinking fund obligations. The specific debt obligations will be specified in a subsequent report from the Deputy City Manager & Chief Financial Officer.

Monetization of the promissory note in 2010 allows the City to pay down future sinking fund obligations (debt) with the funds that would have otherwise been received over a three and a half year period, and thereby smooth out the spike in debt service charges over the next few years as illustrated in the chart in the next section of the report.

4. Financial Impact of Debt Restructuring Proposals

Council adoption of the recommended strategies will assist in managing the City's indebtedness, and contribute to the containment of both the City's debt service costs and the corresponding debt service ratio. Preliminary indications from rating agencies are that these strategies will maintain or enhance the City's credit profile.
Introducing 30 year debt to the City's capital financing (including Waterfront Revitalization projects and Spadina Subway Extension) results in a 1.5% drop in debt as a percentage of tax levies over the long term. A further drop of 1.5% results if the Sinking Fund requirements are paid down by $600 million.

These strategies greatly assist the City in keeping within the 15% guideline. Below is a chart showing the impact on the debt ratio as a percentage of the tax levy from implementing these strategies:



Monetizing the THC promissory note and utilizing the funds to reduce the City's sinking fund obligations results in an estimated $67.3 million favourable impact on the 2010 operating budget as a result of reduced debt servicing costs. This includes taking into consideration the foregone interest earnings on the promissory note of $72.6 million between 2010 and 2013. The tax impact is a 1.5% tax levy reduction related to debt service costs as opposed to a 1.7% increase without the recommended actions.

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SIGNATURE

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Deputy City Manager & Chief Financial Officer

ATTACHMENT

Appendix A – City of Toronto Financing of Capital Works Policy and Goals

Appendix A

City of Toronto Financing of Capital Works Policy and Goals

1. Policy Statement

It is recognized that the City of Toronto has a reputation as a respected participant in global capital markets. Adherence to its financing of capital works policy and goals will enhance this reputation and ensure the City's continued access to these markets in order to raise funds through the issuance of debt securities in an efficient and cost-effective manner for the purpose of capital financing.

The City of Toronto is committed to achieving the lowest cost of funds when financing capital works, based upon current capital market conditions. When making decisions regarding the financing of a capital expenditure through the issuance of debt, Council must be satisfied that the lowest cost alternative is utilized from a total cost of funds perspective.

This policy ensures that Council complies with the debt issuance and management provisions contained in the *City of Toronto Act, 2006* (COTA) and its regulations while providing Council with the flexibility to meet the City's annual capital needs during its term-of-office.

The City seeks to maintain the highest possible credit rating. While the City recognizes that external economic, natural or other events may affect its credit rating, it is committed to ensuring that actions within its control are prudent and necessary as they relate to the issuance and management of short and long term debt.

2. Authority and Accountability

Paragraph 8 of subsection 212 (1) of the (COTA) requires Council to adopt and maintain a policy with respect to the financing of capital works before the City can enter into an agreement to issue debt.

For the term of Council, a report requesting the authority for entering into agreements with purchasers for the sale and issuance of debentures to be delegated to the Mayor and the Deputy City Manager and Chief Financial Officer and confirmed by bylaw will be considered by Council. Capital markets require the City to have the ability to act on financing opportunities on a timely and efficient basis in order to secure the best pricing and terms.

3. Debt to be Used Only for Capital Financing

The City is not authorized by legislation and will not issue debt obligations or use debt proceeds to finance current operations.

The City will utilize debt for the acquisition, construction, renovating, repairing or remodelling of capital works where the project cannot be funded from current operating revenues or other sources and where the Deputy City Manager and Chief Financial Officer considers it to be prudent to finance the project over the useful life of the asset.

4. Capital Financing From the Operating Budget

As part of the City's capital financing policies, if economically feasible and determined to be affordable, Council will allocate funds from its operating budget to be contributed to funding capital expenditures on an annual basis which will have the effect of reducing the amount of required financing for capital expenditures.

5. Debt Limits

Provided that the annual costs associated with debt financing shall not exceed 15% of the tax levy, the City shall finance, from time to time, capital works that the City considers necessary or desirable for the public, in accordance with applicable generally accepted accounting principles for local governments as recommended by the Canadian Institute of Chartered Accountants. The budgeted debt charges that will be incurred due to debt issuance will be included in the annual Operating Budget.

The annual costs associated with debt financing shall not exceed 15% of the tax levy and the City's total direct obligation limit shall not exceed $4.0 billion net debt over the term of Council, ending on November, 2010.

The limit is subject to various factors such as the debt requirements contained in the capital budget, new projects that may not be contained in the approved capital budget but arise through events that could not have been foreseen, spending rates that affect capital project completion, the amount of unfinanced capital and capital market conditions such as the level of interest rates.

6. Short-term Borrowing for Capital Purposes

Since it is the City's practice to temporarily finance its capital expenditures from working capital until it is permanently financed, there are occasions when the City must borrow funds to finance these obligations on a short-term basis.

Council will enact a multi-year temporary borrowing bylaw that will authorize short-term borrowing for a capital project up to an amount approved by Council and will cover their term-of-office.

7. Credit Ratings

The City seeks to maintain the highest possible credit rating that can be achieved without compromising the delivery of services and programs through prudent budgetary and debt management policies and procedures.

The City believes that it enhances its ability to issue debt in the global capital markets when the lowest cost of funds is achievable by being rated by the following rating agencies on a continuous basis:

Moody's Investor Service
Standard and Poor's
Dominion Bond Rating Service

8. Long-term Financial Planning

To enhance the credit rating and prudent financial management, the City will conduct long-term financial planning through the adoption of a five-year capital plan and a long-term fiscal plan that will disclose the amount of debt and its projected cost that will be required to finance capital expenditures over the term of Council.

9. Debt Maturities

Under the COTA, the allowable maximum term for debt issuance is 40 years or the useful economic life of the asset, whichever is less.

Debt will be structured for the shortest term-to-maturity consistent with budgeted affordable annual payments of principal and interest and an appropriate allocation of costs to current and future taxpayers.

10. Debt Structures

Debt should be structured to achieve the lowest net cost of funds, given the constraint of debt maturities and current capital market conditions. To the extent possible, the City will structure its debt obligations to require repayment as soon as feasible so as to recapture its borrowing capacity for future use and minimize costs where possible.

Sinking Fund Debt

Under the COTA, the City is authorized to issue debt that requires an annual payment to be made to a sinking fund controlled by the Sinking Fund Committee so that these contributions, when invested at an actuarial interest rate, will provide for the repayment of the debt at maturity. The Committee is comprised of four citizen members with specialized expertise and knowledge that supports and contributes to the quality of the investment management of these funds and the Deputy City Manager and Chief Financial Officer as Chair of the Committee.

The citizen members are appointed by City Council and the Committee has the sole authority for managing the sinking funds' investments and administrative policies.

Instalment Debt

Under the COTA, the City is authorized to issue debt that will mature in a given year on an instalment or serial basis whereby the principal portion of the debt becomes due and according to a repayment schedule that was established when the debt was issued.
Variable versus Fixed Debt Issuance

Under the COTA, the City may issue up to 10% of its outstanding debt in the form of variable rate debt where the interest rate fluctuates according to a pre-determined formula or benchmark rate such as a Treasury Bill or Government of Canada bond. This type of debt should only be issued if market conditions provide an opportunity for the City to lower its borrowing costs while maintaining the ability to convert the debt into a fixed interest rate if warranted by future capital market conditions.

Re-opening of a Debt Issue

The City will reserve the right to re-open a debenture that has previously been issued and increase its par value if this provides a lower cost of funds than other available borrowing alternatives while increasing the size and liquidity of the original debt issue and broadening the City’s investor base.

Bank Loans

As a source for financing capital works, the Deputy City Manager and Chief Financial Officer shall consider bank loans and recommend to Council that it enters into bank loan agreement if it conforms to this policy and achieves the goals of providing a lower cost of funds and flexible terms than other available debt instruments.

Construction Financing

In order to match projected debt charges with future revenues that will be generated after a facility is constructed and operating, the City may issue construction financing whereby the interest or principal payments or both can be deferred up to five years before payment is required. The Deputy City Manager and Chief Financial Officer will recommend this financing for Council’s approval if it is determined to be in the best interests of the City.

11. Revenue Bonds

The issuance of revenue bonds will be addressed by a statement that will amend this policy when available.

12. Derivatives and Hedging

The use of derivatives and hedging as related to the issuance of debt will be addressed by a statement that will amend this policy when available.

13. Accessing Capital Financing Programs Offered by Other Levels of Government

When evaluating whether to participate in a loan or debt program being offered by the federal or provincial levels of government, the interest rate and terms will be compared to the City's all-in cost of borrowing and the program must provide a lower cost of funds and competitive terms in order to be considered.

14. Issuing Debt on Behalf of another Jurisdiction

If the City is requested by the Toronto District School Board or the Toronto Catholic School Board to issue debt on their behalf, Council will consider the request as it affects the City's overall borrowing program and deal with the report on a timely basis.
The authority for Council to consider a request and the City's authority to issue the debt is contained in the following section 246 of the Act.

"The City may borrow money for the purposes of a school board if the school board exercises jurisdiction in all or part of the City and requires permanent improvements as defined in subsection 1 (1) of the Education Act*. 2006, c. 11, Sched. A, s. 246."*

15. City Legal Support

Council, or a committee under delegated authority, must adopt a specific borrowing bylaw authorizing the issuance of debentures or the entering into a bank loan for the purpose of capital financing that is covered by this policy.

The City Solicitor provides legal advice with regards to the City debt financing transactions and, in the opinion of the City Solicitor, should the scope of the proposed transaction require, recommend to Council that legal advice be obtained from an independent source. This advice would cover the initial proposal and extend to the various contracts and agreements that would have to be executed in conjunction with the transaction.

The debt issuance syndicate is responsible for retaining external counsel who provides the legal opinion for the investors.

16. Reporting and Disclosure Requirements

The Deputy City Manager and Chief Financial Officer shall prepare and present to the Council a detailed report per the requirements of Ontario Regulation 610/06 of the City of Toronto Act 2006, "Financial Activities". This applies to outstanding debt issued under clause 7(1)(d) of 2(d) of the regulation which relate to construction financing debt where the payment of interest, principal or both are deferred during the period of construction.

"(1) If the City has any outstanding debt under clause 7 (1) (d) or (2) (d) in a fiscal year, the treasurer shall prepare and present to the council once in that fiscal year,

or more frequently if the council so provides, a detailed report on all of that debt. O. Reg. 610/06, s. 16 (1).
(2) The report under subsection (1) shall contain,
(a) a description of the estimated proportion of the total debt of the City under clause 7 (1) (d) or (2) (d) to the total long-term debt of the City and a description of the change, if any, in that estimated proportion since the previous year's report;
(b) a statement by the treasurer as to whether, in his or her opinion, all debt under clause 7 (1) (d) or (2) (d) of the Act was issued in accordance with the statement of policies and goals relating to construction financing adopted by the City;
(c) an update of the detailed estimate made under clause 15 (2) (c) with respect to the terms of the City's expectations of revenue generation from the undertaking;
(d) a record of the date of the repayment of each instalment of principal, interest or both principal and interest made during the period of construction of the undertaking for which the debt under clause 7 (1) (d) or (2) (d) was issued;
(e) a statement of the outstanding instalments of principal, interest or both principal and interest repayable during the currency of the debt issued under clause 7 (1) (d) or (2) (d) that will be due and payable in each year; and
(f) such other information as the council may require or that, in the opinion of the treasurer, should be included. O. Reg. 610/06, s. 16 (2)."

The report, if required, shall be presented to Council on an annual basis after the end of the City's fiscal year after the City's accounts are closed.