APPENDIX 9

CAPITAL FINANCING AND FUNDING UPDATE

Since January 2015, a working group consisting of staff from the Ontario Ministry of Finance and the City's Corporate Finance Division has been engaged in the development of a capital financing and funding strategy for the SmartTrack project. The objective of this working group is to undertake a review and analysis of potential *funding* tools that could be applied to this project, and to investigate the options and market interest for *financing* a project of this magnitude.

The terms *funding* and *financing* are often confused and used interchangeably, but they refer to different things.

Financing refers to the financial mechanisms or tools used to raise the initial funds to pay for the construction of the project. Financing is usually required when there are differences in timing between project expenditure cash flows (often required upfront) and project revenues, which may not occur until much later. Debt, bonds, equity, and capital lease arrangements are typical financing tools to raise the initial funds for the project, but there are many other tools and structures that can be used depending on circumstances and level of participation and risk allocation between the public and private sector. The use of financing creates a future obligation to repay the money back with a return on capital investment.

Funding refers to the sources of project revenue, including future revenue streams that the project owner will use or pledge to repay the financing of the project over time.

The development of a financing and funding strategy requires information on the incremental capital costs and timing, and potential revenue sources available to be applied to the project. This information, together with solutions for any funding gap that may be identified, will assist in determining the best financing and funding option for this project. Key inputs on incremental capital costs estimates will not be available until Q1 2016.

This report provides an update on the work of the Financing and Funding Working Group to date and outlines next steps. A follow up report is anticipated in the Q1 2016 that will detail the results of the funding and financing analysis, and recommendations on a preferred approach to move forward.

1. GOVERNMENT CAPITAL FUNDING CONTRIBUTIONS

The Province, through Metrolinx, has the responsibility to develop, finance and operate the regional transportation system. As part of the 2014 Provincial Budget, the Province committed $16 billion over 10 years to transit infrastructure in the GTHA, and identified parts of the GO Rail Transit network for transformation into Regional Express Rail (RER) as a key priority in this infrastructure spending (see Appendix 1 for an overview of the RER program).

The SmartTrack concept was introduced shortly after the RER announcement. This report provides an update on the status of the work to assess how SmartTrack integrates with RER. The full capital costs associated with the project have yet to be determined.

In its 2015 Budget, the Province indicated that key elements of the SmartTrack proposal would require new partnership funding of approximately $5.2 billion from the City and the federal government[1].

In June 2015, the Federal Government announced a new Public Transit Fund, which is intended to provide significant permanent support for large-scale public transit projects to address traffic congestion, reduce travel time for goods and people, and support economic growth in Canada's largest cities. The Federal Government specifically committed to contributing up to one-third of the costs for the SmartTrack public transit system proposal, up to a maximum amount of $2.6 billion, once a formal application is received and approved[2].

The Federal contribution to SmartTrack will be made by way of a predictable payment stream over 20 to 30 years rather than an upfront contribution. This will allow borrowing against this payment stream and provides flexibility to use traditional or alternate financing mechanisms to raise the Federal Government's contribution towards the project capital cost. In other words, the Federal Government is committing the *funding* for its share of the *financing* of the project.

The primary objective of the finance working group is to now identify potential funding sources for the City's share of the SmartTrack capital costs.

2. SOURCES OF CITY FUNDING

There are a wide variety of revenue sources to fund the capital, lifecycle and operating costs of transit projects. This section focuses on potential revenue sources to support the capital financing of the SmartTrack proposal. Funding for lifecycle and operating costs will be reported on once the service concept and system details are fully known in 2016.

The City's traditional way to pay for infrastructure investments is by issuing debenture debt for the capital cost. The debt is repaid over time through a funding source, typically an increase in property taxes.

In a June 2013 response to Metrolinx's request for input into revenue generation tools to fund its second wave of its "Big Move" regional transportation capital projects, City Council recommended that development charges, fuel tax, a parking levy, and/or sales tax be considered for implementation by the Province/Metrolinx. Further, revenue sources specific to vehicle use such as highway tolls or other road pricing should be considered for future implementation upon completion of the first phase of Metrolinx projects[3].

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[1] http://www.fin.gov.on.ca/en/budget/ontariobudgets/2015/ch1b.html#c1-9

[2] June 18, 2015, News Release "PM announces Further Details New Public Transit Fund". http://pm.gc.ca/eng/news/2015/06/18/pm-announces-further-details-new-public-transit-fund

[3] http://www.toronto.ca/legdocs/mmis/2012/cc/bgrd/backgroundfile-45908.pdf

Council indicated at that time that it did not support the following tools to fund regional transportation projects: congestion levy; employer payroll tax; land transfer tax; land value capture; personal income tax; property tax; transit fare increase; and utility bill levy.

Land transfer, vehicle and billboard taxes have already been considered/implemented by City Council for other objectives (Council has since repealed its vehicle registration tax). City Council is currently considering highway tolls in the context of funding the Gardiner Expressway rehabilitation.

This section focuses on three revenue tools being considered for the capital funding of the SmartTrack proposal:

- tax increment financing ("TIF") revenues along the SmartTrack primary benefiting areas;
- development charges; and
- the sale of development rights on City-owned land along the SmartTrack corridors.

The methodology and approach being used to quantify these three revenue tools are discussed further below.

2.1 SmartTrack Development Areas and Development Forecasts

The proposed SmartTrack project may lead to increased development potential and property values along the GO RER corridor.

Strategic Regional Research Alliance (SRRA) has been commissioned to prepare population and employment forecasts under scenarios that include and exclude SmartTrack. SRRA has expertise of the local real estate market. Using their population and employment forecasts, they will identify specific areas within the City where increased development is projected to occur. SRRA's forecasts will also consider scenarios under current planning constraints and relaxed planning constraints.

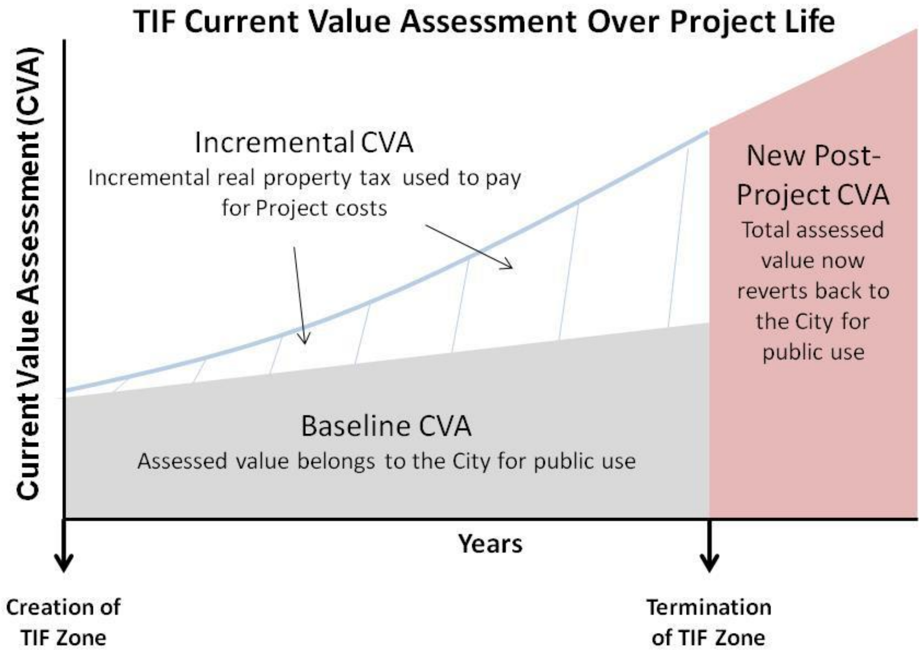
SRRA's analysis of development potential has not yet been completed. SRRA's methodology and assumptions will be independently verified through a peer review by Cushman & Wakefield. It is anticipated that the peer reviewed development forecasts will be available in Q4 2015.

2.2 Tax Increment Financing

Tax increment financing (TIF) is a financing tool that can be used by local governments to fund infrastructure and community improvement projects and stimulate economic development in designated geographic areas. Although TIF's have a long history of use in the United States, it is only more recently emerging as a financing and funding tool in Canada.

In broad terms, the TIF approach is to commit future increases in property taxes to pay for current investments in public infrastructure. The approach assumes that these public infrastructure investments will lead to increased private land development and property values, which will in turn result in higher taxes that, but for the investments, would not have otherwise occurred. The differential increase in tax revenues is referred to as the 'tax increment'. The future tax increases within a defined area are pledged as the funding source to secure the borrowing for the investments, usually in the form of a TIF bond. Once the debt is retired, the tax increment reverts back to the taxing authorities. The TIF concept is illustrated below.

Figure 1. TIF Current Value Assessment over Project Life



In 2007, Calgary's Downtown Rivers District redevelopment was the first project in Canada to use the tax incremental financing approach (called Community Revitalization Levy 'CRL' in Alberta). The City of Calgary levies and collects the CRL within the redevelopment area through the property tax system and then allocates the funds to Calgary Municipal Land Corporation (CMLC) to implement the Rivers District Community Revitalization Plan. The CRL is based on the difference between the base year assessment (2007) and 'incremental assessment' arising from the increase in property values. The CRL does not increase taxes; it only diverts a portion of the taxes to the Rivers District project. It is being reported that CMLC had committed approximately $357 million to this infrastructure and development program, which in turn has attracted $2.4 billion of planned development. That development potential is expected to deliver $725 million of CRL revenues over the next 20 years.

In 2009, Manitoba passed the Community Revitalization and Tax Increment Financing Act to spur development in Winnipeg’s downtown. In 2012, CentreVenture, a development corporation of the City of Winnipeg, was created to make TIF available for the development of a Sports, Hospitality and Entertainment District, in partnership with the Province. The public investment for this project was $25 million, to be recouped from 80% of anticipated future tax increment revenue.

In Ontario, a Tax Increment Financing Act was enacted in 2006 as a financing tool for municipal redevelopment on a pilot basis. The two pilot projects included the subway expansion into York

Region (Toronto-York-Spadina Subway Extension "TYSSE") and the redevelopment of the West Don Lands. The Act set out the general terms under which the Province would provide municipalities with grants equivalent in value to the incremental education taxes generated as a result of the new infrastructure in a TIF zone. However, the necessary regulations prescribing how TIF's are to be calculated and the particulars on funding agreements between the Province and municipalities have yet to be made, and this tool has yet to be used in Ontario.

2.2.1 TIF Approach

The principal objective of using TIF's for SmartTrack is to provide a stable and predictable source of funding that will support the financing of the project. The tax increment available for funding the project will be determined by the difference between the baseline CVA and any increase in assessed valuations in the TIF zone.

The incremental tax is made up of two components:

- the tax increment arising from <u>new development</u> in the TIF zones, presumed to be incremental due to the investment in transit; and,
- the tax increment uplift in <u>existing property</u> values in the TIF zones due to proximity to higher order transit.

2.2.2 Tax Increment from New Development

The determination of tax increment from new development is relatively straightforward and does not require any special legislation or tools. Once a TIF zone has been determined, new development taking place in that zone will be physically observable, and the new taxes generated directly measurable from its current value assessment.

The allocation of new taxes being attributable solely to SmartTrack is somewhat more subjective. The allocation would be accomplished by comparing a forecast of new development in the absence of SmartTrack with the forecast of new development with SmartTrack being built. SRRA is preparing these new development forecasts. As discussed above, the regulations that will determine precisely how the Province and a municipality contribute their incremental tax revenues towards funding an infrastructure project have not yet been made available.

As it is anticipated that much of the Smart Track project will form part of an integrated regional rail network, it is likely that the overall construction financing for these works will be carried out by the Province. As such, it is conceivable that agreement may be reached with the Province for it to issue TIF bonds supported by future incremental tax revenue.

2.2.3 Tax Increment from Existing Property Value Uplift

The determination of tax increment from existing property value uplift is less straightforward and not easily measureable. Historically, all properties in Toronto, with few exceptions, have appreciated in value over time. Determining the tax increment is difficult because it assumes that the increase in value is greater than would have otherwise occurred, and is solely attributable to the creation of SmartTrack. This determination will inherently encompass a degree of subjectivity.

A number of published studies have found a relationship between property values and proximity to higher order transit.[4,5,6,7,8] The general findings support the notion that investments in higher order transit and proximity to these investments increases property values.

Toronto's own study of development around the Sheppard East Subway between 1998 and 2014 found that:

- increases in assessed values along Sheppard East outstripped that occurring city wide, particularly in the residential class;
- growth in condominium units along Sheppard East outstripped that occurring city wide; and
- average condominium values along Sheppard East were 3%-5% greater than City wide.

That study concluded there was a positive impact (in terms of growth and values) in the Sheppard East corridor, however the growth could not be conclusively said to be attributable solely to the construction of the Sheppard East Subway. The 3%-5% value uplift observed in the Sheppard East Corridor is not inconsistent with a number of studies made in other jurisdictions.

Currently, there is no legislative or regulatory mechanism to enable the capture of value uplift on existing properties within a TIF zone. The City would work with the Province to create the necessary legislative and regulatory framework to enable the City and the Province to capture property value uplift within SmartTrack TIF zones.

2.2.4 Preliminary Conclusions on TIF Funding

Tax increment financing may be an appropriate revenue tool for consideration for funding the SmartTrack project. The principal benefit of using TIF is that it would allow the project to access the incremental taxes that are expected to be generated as a result of implementing Smart Track. Agreement between the City and Province on key terms of a TIF structure will better inform the degree to which this funding tool is attractive for the City.

A downside of TIF's is that once the taxing authority pledges all of its incremental property taxes to the project, other funding sources will need to be used to fund all of the future incremental

[4] Knapp, G., C. Ding and L. Hopkins. "Do Plans Matter? The Effects of Light Rail Plans on Land Values in Station Areas." Journal of Planning Education and Research, 21 (2001):
[5] Kate Ko and Xinyu (Jason) Cao. The Impact of Hiawatha Light Rail on Commercial and Industrial Property Values in Minneapolis. Journal of Transportation 2013
[6] Robert Cervero and Michael Duncan. Land Value Impacts of Rail Transit Services in Los Angeles County. National Association of Realtors Urban Land Institute, June 2002
[7] Robert Cervero. Effects of Light and Commuter Rail Transit on Land Prices: Experiences in San Diego County. . National Association of Realtors Urban Land Institute, May 2003
[8] Terry L. Clower, Bernard Weinstein, Michael Seman. Assessment of the Potential Fiscal Impacts of Existing and Proposed Transit-Oriented Development in the Dallas Area Rapid Transit Service Area. Center for Economic Development and Research University of North Texas, November 2007

service pressures created as a result of the new development in the TIF zone. A further challenge is that this source of funding may not be viable if sufficient gains in new development and property values do not occur or occur at a slower pace than anticipated. The City's engagement of market experts together with a peer review process should help mitigate some of the risk associated with the TIF approach.

3. DEVELOPMENT CHARGES FUNDING

Development charges are one-time, upfront fees levied on land development projects under the provincial *Development Charges Act* (DCA). The fees help fund a portion of the growth-related share of capital costs.

Under current DCA legislation, prior to implementing a development charges bylaw, municipalities must, amongst other things, undertake a detailed background study supporting the level of the charge. The following must be evaluated in preparing the statutory Background Study, which typically take 12 to 18 months to complete:

- The increase in need for service attributed to growth
- Estimated capital costs
- Historic service levels
- Forecast population and employment growth
- Forecast of anticipated amount, type and location of new development
- Deductions for grants and subsidies, benefits to existing development (non-growth shares), statutory deduction (e.g. 10%), and post-planning period benefits
- Cash flow timing and financing costs
- Benefitting areas (municipal wide or area-specific)
- Allocations between residential and non-residential uses

Required inputs to support a detailed Background Study are currently being undertaken through the work of other working groups in this project. Currently, Watson & Associates Economists Ltd. (Watson), a consulting firm, has been retained by the City to prepare high level estimates of potential development charge revenues for SmartTrack. These estimates will be refined as the project becomes more fully defined and further information is available.

In implementing a development charges bylaw, the City will also need to consider a number of policy options, such as potential phase-in provisions, and policy exemptions to achieve specific municipal goals (e.g. affordable housing, employment uses). These policies will have a corresponding impact on potential development charges revenues. It is noted that the benefiting area and development forecasting work, noted above, assumes continuation of the City's city-wide approach to development charges.

3.2 Province's Development Charges Act Review

Earlier this year, the Province announced its intention to review the DCA, in response to concerns raised by municipalities, including the City of Toronto. The proposed changes will address some of Council's requests for amendments to the DCA, including:

- permitting the use of forward-looking service levels to determine maximum eligible costs as opposed to average service levels over the past ten years (subject to regulation for each designated service); and,
- exempting transit from the mandatory 10% reduction.

3.3 Preliminary Conclusions on Development Charges Funding

Development charges funding is an appropriate revenue source for consideration to help fund the growth-related share of SmartTrack. The DCA requires a Background Study be undertaken and a statutory public meeting be held in advance of adopting or amending a development charges bylaw. High level development charges estimates are being prepared, which will be refined as more information becomes available. Detailed inputs are needed, which are not yet available, before a development charges bylaw can be imposed under current DCA legislation.

9.4 SALE OF DEVELOPMENT RIGHTS ON CITY-OWNED LANDS

An analysis of City-owned properties along the SmartTrack corridor was performed to determine whether any value could be generated from bringing available and underutilized City-owned properties to market and to allow for future redevelopment on these sites to help fund the SmartTrack project.

Numerous city-owned lands were identified in an initial screening process. Many of these parcels were determined to be prohibited for sale or transfer under the City's Official Plan and related policies (e.g. parklands, rights-of-ways, etc.). Other parcels were determined to be required for ongoing operating requirements (e.g. transfer stations, work yards, etc.), with a low development opportunity. Further, some of the more valuable sites were found to have already been pledged to Build Toronto.

This filtering process led to a number of potential sites that may have potential for future redevelopment based on location, site area and market demand. CBRE has been commissioned to further evaluate City-owned sites in the SmartTrack corridor. For sites determined to have redevelopment potential, CBRE will estimate its value to the City for the purposes of funding the SmartTrack project. It is anticipated the work of this consultant, in consultation with City staff, will be completed in Q1 2016.

9.5 POTENTIAL CAPITAL FINANCING SOURCES AND STRUCTURES

The City has retained consultants with expertise in the capital financing market to identify potential alternate financing sources and structures the City may use to raise its share of the capital costs of SmartTrack. The scope of this work includes:

- quantifying the financial risk associated with potential project revenue streams, based on their expertise in rail projects;
- determining the amount of capital financing that private investors would be prepared to provide in return for the right to future project-related revenue streams from the City, with and without recourse to the City;

- examining various financing structures and risk allocation options, including a global scan of transit financing structures used in other jurisdictions; and
- undertaking a preliminary market sounding of potential private investor interest specific to the SmartTrack project.

It is expected the consultants will evaluate the merit of various financing models, including:

- Availability models, in which the public sector would secure additional funding if TIF and DC revenues are insufficient;
- Concession models, in which the private sector would share in the risk of revenue streams being insufficient; and
- Special Purpose Vehicles, in which the assets (and corresponding liabilities) of the project are transferred to a separate entity;

The results of this work will inform the City on the most appropriate financing structure to pay for its share of the SmartTrack project. It is anticipated the Consultants will report on their findings in Q1 2016.