Attachment 2 – City Funding and Financing Strategy

This attachment provides additional information regarding the funding and financing strategy for SmartTrack phases 1 and 2.

Transit Infrastructure Project Financing

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

Financing refers to the financial mechanisms or tools used to raise the initial funds to pay for the construction of the project. Debt (including debentures and 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 interest.

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 traditional way in which a municipality finances infrastructure investments would be by issuing debt for the capital cost. The repayment obligation (debt charges) would typically be funded over time through property tax revenue, but other sources can also be used such as development charge revenue, or in the case of SmartTrack, property tax increment revenue from new development. Sometimes other orders of government or the private sector will contribute to a project, reducing the financing requirements to be borne by the municipality.

Although rarely used in Canada, revenue-matched debt instruments can be an alternative debt vehicle to finance public infrastructure projects. The attractiveness of revenue-matched instruments is that the debt repayment stream can be linked to the projected revenue stream arising from the project once construction is completed. The City has issued a revenue bond related to one of its arenas, in which repayment is linked to the revenue performance of the arena.

In the case of SmartTrack, the projected tax increment revenue from new development is small in the early years, but grows significantly over time. By being able to more closely match debt repayment with the revenue stream with a revenue-matched debt instrument, the need for raising funding from other sources (e.g. property taxes) can be minimized.

Currently, however, revenue bonds cannot be secured by property tax revenue outside of the *Tax Increment Financing Act*, for which the necessary implementing regulation has never been made. There are also other variations of general obligation bonds that can achieve similar objectives, such as amortizing installment debentures or zero coupon bonds. City staff will be engaging members of its debt syndicate and legal expertise in developing an appropriate debt structure instrument and seeking any legislative or regulatory amendments that may be required.

The challenge with revenue-matched debt instruments is that lenders recognize that the revenue streams are uncertain, and will typically require a payment guarantee or would significantly discount the anticipated revenue streams commensurate with the risk. In other words, the amount they would be willing to lend for the rights to the revenue would be significantly less than the projected amount of the revenue stream. For this reason, public sector entities usually provide a payment guarantee or simply finance the project themselves and in either case assume the risk of the revenue stream.

Given the advantages of revenue-matched debt instruments, Corporate Finance staff will report back on a recommended approach once the capital cost estimates have been refined and Council confirms its definitive commitment to the project.

Capital Expenditures for SmartTrack

The Class 4/5 capital cost estimates for the SmartTrack Project have been provided by Metrolinx in the Initial Business Cases (IBC) for RER/ST Integration and the Eglinton West LRT. These cost estimates do not include short-term financing that may be incurred by Metrolinx, nor the cost of risk transfer through the AFP process contemplated by Metrolinx, if any. The cost of the project is currently estimated at $3.7 billion (YOE$).

SmartTrack Phase 2 (Eglinton West LRT) will have benefits to the City of Toronto, City of Mississauga, and Greater Toronto Airports Authority. As such a contribution from the City of Mississauga and the Greater Toronto Airports Authority will be sought for the portion of the Eglinton West LRT alignment falling outside the City of Toronto's jurisdiction. It is also expected that the Federal Government will contribute to a portion of capital costs, leaving the City with a preliminary estimated $2.01 billion capital contribution obligation for SmartTrack Phases 1 and 2. A summary of the capital costs and capital funding contributions is shown in Table 1 below:

Table 1: Summary of SmartTrack Capital Costs

CAPITAL COSTS	YOE $millions
Metrolinx Capital Expenditures:	
SmartTrack GO Stations (Class 4/5 Estimate)	1,252
Eglinton West LRT (Class 4/5 Estimate)	2,468
Total Capital Expenditure	3,720
External Capital Contributions:	
Mississauga/GTAA Contribution Assumption	470
Federal (assumption: 50% share with City)	1240
Sub-Total - External Financing	**1,710**
City Capital Contribution	**2,010**
Total Capital Contributions:	**3,720**

The traditional approach for financing the City's share of capital costs for SmartTrack would be by way of issuing traditional debentures as the capital obligations arise, consistent with the City's current approach to financing large capital projects. The issuance of debentures gives rise to annual debt charges sufficient to repay principal and interest over the term of the debenture.

City Funding Sources

The issuance of debentures for the SmartTrack Project will give rise to debt charges that will have to be funded over the term of the debentures. The funding sources identified and recommended for this Project are:

1. an allocation of incremental tax revenue (TIF's) from new development along the SmartTrack corridor;
2. development charges (DC's) for the eligible costs of SmartTrack imposed on new development city-wide; and,
3. property tax increases[1], as a default source for any funding shortfalls.

A Reserve Fund could be established to receive these dedicated funding sources (with the exception of the development charges, which must be segregated within its own development charges reserve fund group), and used to fund the debt charges.

Tax Increment Financing

Tax Increment Financing is a broad term, and the working of TIF differs across jurisdictions. In the literature, various terms are used to describe the TIF concept, such as "land value capture" or "value-uplift," however, there is no consistent meaning to these terms, and one has to refer to the context in which it is being used. The approach is generally the same: to commit future increases in property taxes to pay for current investments in infrastructure. The presumption is that these investments will lead to increased private development and property values, which in turn will result in higher tax revenue that, but for the investments, would not otherwise have occurred (referred to as the 'tax increment').

The future increases in tax revenues within a defined area are pledged as the funding source and/or security to obtain the financing/borrowing for the investments. At the maturity of the debt, all of the tax revenues revert back to the taxing authorities.

In 2006, the Province of Ontario introduced the *Tax Increment Financing Act* as a financing tool for municipal redevelopment on a pilot basis. Its intent was to provide a mechanism to allow a municipality to capture the education tax increment revenue and use it to supplement their own funding sources for those eligible projects (TYSSE and the Toronto Waterfront). The necessary regulations have never been made, and this tool has not been used in Ontario. To the extent that the Province of Ontario has indicated that the education portion of the property tax will not be made available to the City, the *Tax Increment Financing Act* has no bearing on the City's funding for SmartTrack. Accordingly, any discussion of TIFs in this report relates only to the municipal portion of property taxes.

The determination of tax increment revenue 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 challenge is that it cannot be determined with certainty that when a development occurs, whether it would have occurred

[1] Tax increase refers to residential tax increase; and by City policy 1/3 of any residential tax increase is imposed on non-residential tax classes.

regardless of the investment in transit or if it truly was incremental. For this reason, it is necessary to rely on forecasts made by experts of development activity under an assumption of with and without the investment in transit.

City staff also considered tax increment revenue from 'value uplift.' Value-uplift in this context refers to the increase in value of existing properties due to proximity to infrastructure that potentially enhances the value of neighbouring properties. The determination of tax increment revenue from existing property value uplift is less straightforward and not directly measureable. Historically, all properties in Toronto have appreciated in value over time. The difficulty is in making the determination that an increase in value, greater than would otherwise have occurred, is solely attributable to creation of SmartTrack. This determination will inherently encompass a degree of subjectivity. Staff have also determined that any value uplift would be quite small relative to tax increment revenue from new development. For these reasons, tax increment revenue from value uplift is not being considered as a funding source for SmartTrack at this time. Accordingly, any subsequent discussion of TIF's in this report relates only to the municipal tax increment revenue arising from new development.

Development Forecast

Strategic Regional Research Associates (SRRA) has prepared a forecast of development activity in the City and along the GO/SmartTrack corridor under scenarios that include the investment in SmartTrack and without investment in SmartTrack. These forecasts are based on employment and population projections produced for the City of Toronto's 2012 Employment Uses Policy Study together with the Provincial Growth Plan forecast.

Using these forecasts of population and employment growth, they identified specific areas within the City where increased development would occur, under current planning constraints and under relaxed planning constraints, based on their expertise of the real estate market, including realistic assumptions of office and residential absorption.

These forecasts can found in the SRRA report dated January 2016, titled "Commercial & Multi-Residential Forecasts for the Review of SmartTrack," which can be accessed through the following link:

http://www1.toronto.ca/City%20Of%20Toronto/City%20Managers%20Office/Transit%20Initatives/Files/Population%20and%20Employment%20Projections.pdf

The purpose of identifying development areas is to provide a basis for estimating incremental tax revenues arising from SmartTrack and for testing the applicability of other area-specific revenue tools, such as development charges and tax increment financing. The TIF Zone map areas provide the geographical boundaries wherein municipal property tax revenue may be allocated to the SmartTrack project.

The projected tax increment can be estimated by comparing the variance in growth projections between the two forecasts.

It should be re-emphasised that the use of TIF's do not impact individual property tax payers in any adverse way. It is simply an internal allocation of tax revenues from a defined area to a specific purpose. A tax payer in a TIF zone will always continue to pay the same tax rate as any other taxpayer throughout the City.

The development forecasts produced by SRRA are summarized below. Their planning horizon was 25 years. Commercial gross floor area (GFA) is forecasted to grow by 19.9 million ft^2 over 25 years in the TIF Zone without SmartTrack, and by 35.0 million ft^2 in the TIF Zones with SmartTrack. This indicates that SmartTrack will result in an increase in commercial growth within the TIF zones of 15.1 million square feet relative to a scenario without Smart Track.

However, SRRA's analysis indicates that Smart Track will attract some growth to the TIF zones that would have otherwise occurred in the rest of Toronto. After accounting for this, the Smart Track's projected net City-wide impact on growth in commercial GFA is reduced to 10.8 million ft^2 over the 25 year period.

In order to operationalize TIF as a funding tool, on the basis that net City-wide growth in commercial GFA is 10.8 million ft^2, relative to the 35.0 million ft^2 commercial growth projected occur in the TIF Zone, therefore it can be said that 31% of all commercial growth in the TIF Zone is attributable to SmartTrack on the basis of these projections (10.8 million ft^2 / 35.0 million ft^2). Accordingly, any subsequent calculation of incremental tax revenues in this report is based on this assumption of 31% being the incremental growth in the TIF Zone related to commercial growth.

Table 2: Growth in Commercial GFA (000's ft^2) 2017-2042

	Reference Case (no SmartTrack)	With SmartTrack	
TIF Zones	19,925	35,010	(+15,085)
Rest of City	25,315	20,991	(-4,324)
Total	45,240	56,001	(+10,761)

In a similar way, SRRA has forecasted the growth in residential units at 60,188 units in the TIF Zone without SmartTrack over 25 years and by 86,419 units in the TIF Zone with SmartTrack. This residential forecast relates to high-rise development (condominiums and apartments). However, after accounting for the displacement of residential development from other areas of the City, the Smart Track's projected net City-wide impact on growth in residential units is reduced to 23,737 units over the 25 year period.

Therefore it can be said that 27% of all residential growth in the TIF Zone is attributable to SmartTrack on the basis of these projections (23,737 units / 86,419 units). Accordingly, any subsequent calculation of incremental tax revenues in this report is based on this assumption of 27% being the incremental growth in the TIF Zone related to residential growth.

Table 3: Growth in Residential Condo Units 2017-2042

	Reference Case (No SmartTrack	With SmartTrack	
TIF Zones	60,188	86,419	(+26,231)
Rest of City	259,054	256,560	(-2,494)
Total	319,242	342,979	(+23,737)

It would be a City policy decision to notionally allocate all or a portion of the tax increment revenue to fund the debt charges associated with the SmartTrack Project. The risks that must be mitigated in this approach, however, are twofold. If all of the future incremental property tax revenues are pledged for the capital project, then insufficient funding would be available to fund the increase in demand for services arising from this growth. Similarly, forecasted development activity and property value increases may not materialize, leaving a shortfall in funding availability for debt charges. The default position in this case would be to turn to property taxes to cover any shortfall.

For the above reasons, staff believe it to be prudent to allocate only 50% of the projected tax increment revenue from new development to the SmartTrack Project. This also leaves some funding room should actual development activity fall short of the forecast level, in which case the TIF capture level could be revisited by City Council.

As noted earlier, in order to operationalize this, this means that 50% of 31%, or 15.5% of the *actual observed* growth in tax revenue from new commercial GFA in the TIF Zones will be allocated to the SmartTrack Project. Similarly, 50% of the 27%, or 13.5% of the *actual observed* growth in tax revenue from new residential units in the TIF Zones will be allocated to the SmartTrack Project.

Analysis of TIF Funding Potential

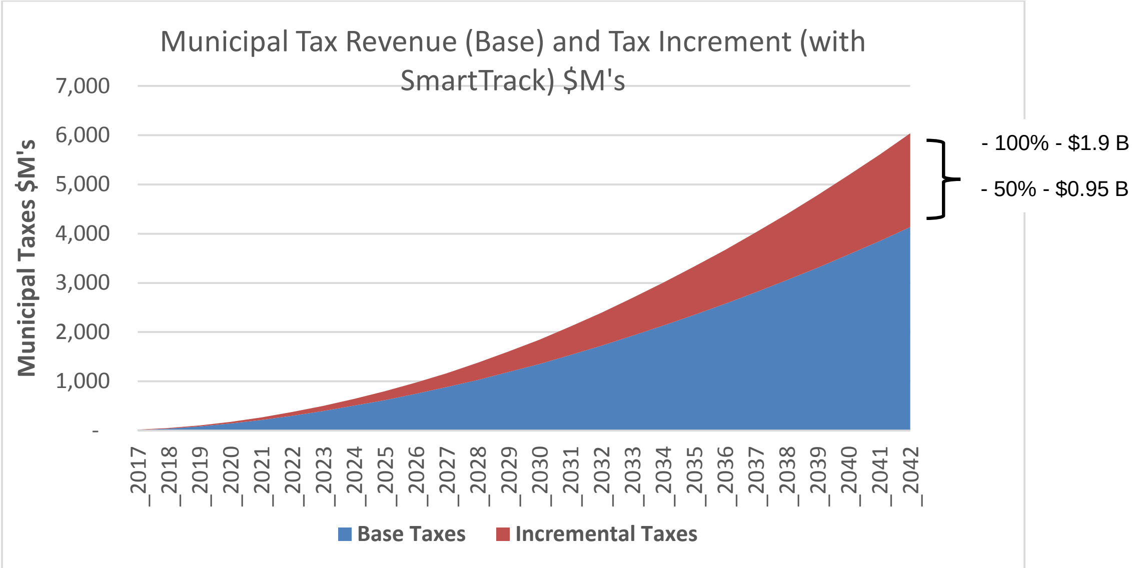
Based on the real estate forecast inputs prepared by SRRA, City staff have developed estimates of the projected TIF revenues over a 25 year period from 2017 to 2042, as shown below. TIF revenue is projected to be $1.9 billion over 25 years, and $0.95 billion based on allocating 50% of the revenue to the SmartTrack Project.

Table 4: Tax Increment Revenue Projection (2017-2042, YOE $)

TIF Capture Percentage	**YOE $B**
100% TIF Capture Percentage	1.9
50% TIF Capture Percentage	0.95

Figure 1 depicts the taxes and total tax increment over 25 year forecast period.

Figure 1: SmartTrack Total Tax Increment (2017-2042)



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

Due to the length of time in completing a detailed background study and implementing a development charges bylaw for the SmartTrack Project, Development Charges revenues for SmartTrack are not expected to commence until 2019.

The current Development Charges Revenue projection carried out by Watson & Associates based on SRRA real estate growth data is $440 million over twenty five years, as shown in the following table:

Table 5: Development Charges Revenue Projection (2017-2042, Nominal $)

	Nominal $M
Development Charges, net of Exemptions *	440

* Current DC Policy provides for DC exemptions for commercial (except for ground floor) and industrial developments, and other relief from affordable housing, etc.

These estimates will be refined as the project becomes more fully defined and the level of information improves.

In implementing a development charges bylaw, the City will also need to consider a number of policy options, such as potential phase-in provisions, policy exemptions to achieve specific municipal goals (e.g. affordable housing, employment uses). It is noted that development charges forecast assumes continuation of the City's city-wide approach to development charges.

Property Tax Funding

As noted earlier, property taxes are the default source for any funding shortfalls. A one-time 1% tax increase raises $26.8 million annually (based on current policy of one-third of the increase on non-residential).

The City is considering alternative revenue tools for operating and capital purposes. Should suitable alternate revenue sources be identified, they could serve as an alternative to a property tax increase. Accordingly, in this report, any reference to property tax increase could be substituted for alternative revenue sources.

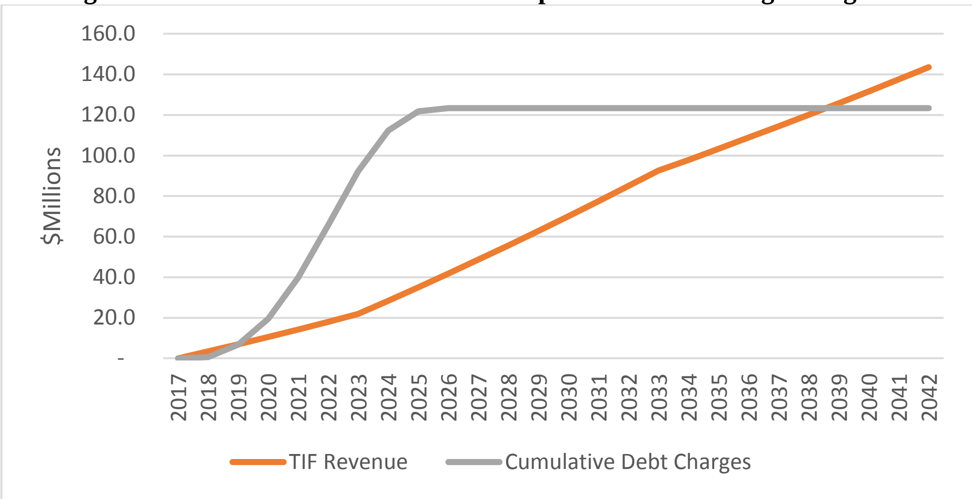
The debt charges resulting from the issuance of $2.01 billion in debenture financing is shown in the following table:

Table 6: Capital Funding Requirement for City's Contribution (Traditional Debenture Financing)

	Debenture Amount Required ($M's)	**Cumulative Annual Debt Charges ($M's)**
2018	9.2	0.6
2019	100.2	6.7
2020	210.2	19.6
2021	329.1	39.8
2022	421.5	65.7
2023	433.9	92.3
2024	326.4	112.4
2025	153.0	121.8
2026	26.5	123.4
	2,010.0	

However, given the revenue profile noted earlier, there may be insufficient revenues (TIF's and DC's) to meet these funding obligations in the early years, and a tax increase may be required to cover the funding gap until such time incremental revenues increase to the required magnitude of debt charges. At the inflection point, a surplus in revenue would be realized. In other words, a higher tax increase is required in earlier years than would otherwise be required if the debt repayment obligation could be more closely matched with the projected revenue stream.

Figure 2: Illustration of TIF Revenue compared to Debt Charge Obligation



In order to cover the shortfall, a tax increase of 2.1% is projected based on the City's preliminary capital cost obligation and assuming 100% of TIF revenue is allocated for debt repayment. Assuming the more prudent allocation of 50% of TIF revenue, a tax increase of 3.0% is projected. The following table summarizes the required tax increase based on traditional debenture financing, assuming an allocation of 100% of TIF revenue, 50%, and using no TIF revenue.

Table 7: Tax Increase Requirement based on Traditional Debenture Financing

TIF Capture	Tax Impact
100%	2.1%
50%	3.0%
0%	3.9%

Table 8 illustrates the financing approach using traditional debenture debt.

Table 8: SmartTrack Phases 1 and 2 Illustrative 10-Year Capital Financing and Funding Plan (50% of TIF allocated for Funding) ($millions)

	2018	2019	2020	2021	2022	2023	2024	2025	2026		
CAPITAL FINANCING											
Metrolinx Capital Expenditures:											
SmartTrack GO Stations (Class 4/5 Est.)	5.8	73.1	145.8	247.0	293.3	274.9	173.4	38.6	-		1,251.8
Eglinton West LRT (Class 4/5 Est.)	11.3	108.1	237.4	345.3	474.4	526.3	442.7	267.3	55.6	-	2,468.4
Total Capital Expenditure	**17.0**	**181.2**	**383.2**	**592.2**	**767.7**	**801.2**	**616.2**	**305.9**	**55.6**		**3,720.2**
External Funding Sources:	**7.8**	**81.0**	**172.9**	**263.2**	**346.3**	**367.3**	**289.7**	**152.9**	**29.1**		**1,710.2**
City Financing Contribution (Debentures)	**9.2**	**100.2**	**210.2**	**329.1**	**421.5**	**433.9**	**326.4**	**153.0**	**26.5**	-	**2,010.0**
Total Financing	17.0	181.2	383.2	592.2	767.7	801.2	616.2	305.9	55.6		3,720.2
Operating Impact of Financing:											
Cumulative Debt Charges (30-Yr Debt)	**0.6**	**6.7**	**19.6**	**39.8**	**65.7**	**92.3**	**112.4**	**121.8**	**123.4**		
CITY FUNDING SOURCES											
Est. TIF - New Development (50% of increment)	1.7	3.4	5.2	7.1	9.0	10.9	14.2	17.5	20.9		
Est. Development Charges *	-	22.2	22.2	22.2	18.7	18.7	18.7	18.7	18.7	-	-
	1.7	25.6	27.4	29.3	27.7	29.6	32.9	36.2	39.6		
Additional Cumulative $ Required	-	-	-	-	29.6	59.7	90.4	90.4	90.4		
Equivalent Tax Increase %					**1.00%**	**1.00%**	**1.00%**		-		**3.0%**
RESERVE CONTINUITY											
Opening Balance											
Est. TIF - New Development (50% of Tax Increment)	-	1.1	20.2	28.3	17.9	9.5	6.6	17.7	22.7		
Est. Development Charges *	1.7	3.4	5.2	7.1	9.0	10.9	14.2	17.5	20.9		
Tax Increase	-	22.2	22.2	22.2	18.7	18.7	18.7	18.7	18.7		
Withdrawals for Debt Charges	-	-	-	-	29.6	59.7	90.4	90.4	90.4		
Interest	(0.6)	(6.7)	(19.6)	(39.8)	(65.7)	(92.3)	(112.4)	(121.8)	(123.4)	-	-
Reserve Closing Balance	**0.0**	**0.2**	**0.3**	**0.2**	**0.1**	**0.1**	**0.2**	**0.2**	**0.3**		

Funding Approach – Revenue Matched Financing

By using a financing instrument that more closely matches repayment obligations with the projected funding stream, such as a revenue bond like instrument, the magnitude of current tax increases can be minimized. However, given the risks that revenue streams may not materialize as expected, issuers of such financing instruments would typically seek a payment guarantee from the borrower, or they would otherwise discount the revenue stream to such an extent that it would not yield much in the way of borrowing amount.

Assuming a payment guarantee by the City, and an interest rate commensurate with that guarantee, it is estimated that a tax increase of 2.0% would be required (assuming an allocation of 50% of TIF revenues), compared with 3.0% using traditional debenture financing, as shown in the following table.

Table 9: Tax Increase Requirement based on Revenue-Matched Financing

NPV $M's	TIF @ 100%	TIF @ 50%
TIF	857.1	428.6
DC	252.1	252.1
Proceeds from Revenue-Matched Debt	***1,109.2***	***680.6***
Cost	1,558.6	1,558.6
Residual to be Financed	***(449.4)***	***(878.0)***
Debenture Borrowing Required	449.4	878.0
Debt Charge	27.6	53.9
Equivalent Tax Increase	***1.0%***	***2.0%***

Under current legislation, revenue bonds as it relates to TIF revenues cannot be secured by municipal property tax revenue outside of the *Tax Increment Financing Act*. Corporate Finance staff will be engaging members of its debt syndicate and legal expertise in developing an appropriate debt structure to finance SmartTrack, which would be reported on once final costs of SmartTrack are known and a commitment by City Council to proceed is required to be made.

Tax Incremental Equivalent Grants (TIEG Program) and TIF

A Tax Increment Equivalent Grant (TIEG) is an economic development tool wherein the City provides grants directly to developers to build eligible property developments. The program is based on the assumption that development would not occur 'but for' the incentive made directly to the developer to build.

Since 2008, the City has been offering a TIEG program (called IMIT for Imagination, Manufacturing, Innovation, and Technology). This provides for a municipal property tax rebate program for eligible commercial uses, and in particular reference to SmartTrack, for office uses around transit nodes. Eligible recipients are entitled to receive a rebate totalling at least 60% of municipal taxes over 10 years, on a sliding scale. The recipients would receive 100% rebate in year 1, 90% in year 2, and so on to 20% by year 10. In other words, the grants to the recipient are front-ended.

From 2008 to June 2016, it is estimated that the City has committed to making $500 million in grant payments to eligible recipients, which will be paid out from new incremental taxes over the next few years. Most of the properties receiving grants are located near major transit nodes.

Tax Increment Financing (TIF) is a city-building tool wherein the City makes direct investments in strategic infrastructure with expectation that such investments will increase property values and incent private-sector property developments. The belief is that making direct investments in infrastructure will lead to increased private development and property values, which in turn will result in higher taxes that, 'but for' the investments, would not otherwise have occurred.

In both cases, the critical assumption is that the development would not occur 'but-for' the investment directly to the developer (TIEG) or in infrastructure (TIF).

Staff estimate that if the IMIT program were continued along the SmartTrack corridor, on a go forward basis, the City would be required to make an estimated $300-$500 million in grant payments from tax increment to developers of new developments over the next decade or so, thus reducing the amount of funding available to pay for SmartTrack.

City staff estimate that if TIEG's are continued in TIF zones, this would result in the need for an additional 0.5% to 1% property tax increase to fund the forgone commercial tax increment revenue.

City Council has previously directed that a review of the IMIT program be made. A staff report back on the results of this review, as well as the applicability of TIEG's in TIF zones, will be made in Q1 2017.