TORONTO CITY CLERK

Clause embodied in Report No. 2 of the Policy and Finance Committee, as adopted by the Council of the City of Toronto at its meeting held on March 1, 2 and 3, 2004.

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Statement of Lease Financing Policies

(City Council on March 1, 2 and 3, 2004, adopted this Clause, without amendment.)

The Policy and Finance Committee recommends the adoption of the following report (February 19, 2004) from the Chief Financial Officer and Treasurer:

Purpose:

To provide a statement of lease financing policies and goals as required by Ontario Regulation 46/94 as amended by Ontario Regulation 266/02 under the *Municipal Act, 2001.*

Funding Sources, Financial Implications and Impact Statement:

An estimate of costs incurred due to lease financing will be included in an annual report that will outline any financing leases as a proportion of the City' outstanding long-term debt.

Recommendations:

It is recommended that:

(1) the Statement of Lease Financing Policies and Goals for the City of Toronto contained in Appendix A be approved;

(2) the Chief Financial Officer and Treasurer report to Council, on an annual basis, concerning the financing lease activity and its proportion to the City's total outstanding debt, including a statement certifying that these leases were made in accordance with the City's Statement of Leasing Policies and Goals as well as other items that are deemed to be relevant;

(3) City Agencies, Boards and Commissions comply with the City's Statement of Lease Financing Polices and Goals; and

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

Background:

Ontario Regulation 266/02 was filed under the *Municipal Act* in the fall of 2002 and continues under the *Municipal Act, 2001* (the "Act"). It amends the municipal capital facilities regulation

(Ontario Regulation 46/94) to require municipal councils to adopt a statement of lease financing policies before they can enter into a finance lease agreement.

Comments:

The new provincial regulations require the adoption of a statement of lease financing policies and goals that include disclosure and due diligence requirements for financing leases. This type of lease is generally defined as an agreement that requires the lessee (City of Toronto) to make guaranteed payments and is considered to be equivalent to debt financing the cost of the asset to be acquired. The regulations do not affect operating and property leases for which the City essentially rents an asset that will be returned to the lessor at the end of the lease. It does not cover leases of buildings unless, for example, the City leases with an option and intention to own the premises at the end of the agreement.

The attached statement of lease financing policies applies to financing leases and is not applicable to operating leases.

(A) Requirements for Financing Leases:

(1) Financial Analysis:

Before Council approves a specific financing lease, as defined by the Regulation, it is required to adopt a statement of the City's lease financing policies and goals. Such statement must include a discussion of the financial and other risks for the municipality of financing leases and may provide for a special category of financing leases which, in the opinion of both the Treasurer and Council, would not result in a material impact for the municipality and which would, therefore, not require compliance with the policy.

Before entering into any particular financing lease transaction, the Chief Financial Officer and Treasurer is required to prepare a report to Council with recommendations, an assessment of the costs and financial and other risks associated with the proposed financing lease, including:

(i) a comparison between the fixed and estimated costs and the risks associated with the proposed lease and those associated with other methods of financing;

(ii) a statement summarizing, as may be applicable, the effective rate or rates of financing for the lease, the ability for the lease payment amounts to vary, and the methods or calculations, including possible financing rate changes, that may be used to establish that variance under the lease;

(iii) a statement summarizing any contingent payment obligations under the lease that in the opinion of the Treasurer would result in a material impact for the municipality, including lease termination provisions, equipment loss, equipment replacement options and guarantees and indemnities;

(iv) certification that the total leasing payments are within the City's updated debt and financial obligation limit;

(v) a summary of the assumptions applicable to any possible variations in the lease payment and contingent payment obligations; and

(vi) other matters that the Chief Financial Officer and Treasurer or Council considers advisable including whether the scope of the financing lease warrants obtaining independent financial advice.

A detailed cost/benefit and present value analysis that compares the total cost of the proposed lease to the cost of financing through the issuance of debt or a bank loan will be required.

If at any time after this report is adopted by Council, circumstances change with respect to the lease that are considered by the Chief Financial Officer and Treasurer to be material to the transaction before it is finalized, the Treasurer must update the report and present it to Council for its approval.

The Chief Financial Officer and Treasurer is required to recommend to Council that external financial advice be obtained before proceeding with a leasing transaction if, in his or her opinion, the scope and complexity of the proposed transaction warrants this action.

(2) Legal Support:

Council must adopt a specific bylaw authorizing entering into any financing lease that is covered by the City's policy.

The City Solicitor is required to provide legal advice on any proposed financing lease and, should the scope of the proposed transaction warrant, recommend to Council that legal advice with respect to the proposed financing lease 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 leasing transaction.

(3) Reporting and Disclosure Requirements:

If the City has one or more financing leases outstanding in a fiscal year, the Chief Financial Officer and Treasurer is required to report to Council on an annual basis, or more frequently if requested, a report that contains, at a minimum, the following information:

(i) a description of the estimated proportion of the City's total financing arrangements that has been undertaken through financing leases to its total long-term debt and a description of the change, if any, in the estimated proportion since the previous years' report;

(ii) a statement by the Treasurer as to whether, in his or her opinion, all financing leases were made in accordance with the statement of leasing policies and goals; and

(iii) any other information that Council may require or that, in the opinion of the Treasurer, should be recorded.

Chief Financial Officer and Treasurer's Leasing Activity Statement for 2003:

During 2003, the City and its agencies, boards and commissions did not enter into any financing leases as defined by the provincial regulations, based upon the best available information.

The MFP lease is considered to be a financing lease and was entered into before the provincial regulations became effective. As of January 1, 2004, the lease represents a total financial obligation of $20.5 million in principal and interest payments excluding end of term purchase options. This maximum amount represents 1.49 percent of the City's total outstanding net debt of $1,375.0 million as of December 31, 2003.

During 2003, Council approved several operating leases for photocopiers that contain purchase options. While it was not originally intended that these options be exercised, the Chief Financial Officer and Treasurer will be involved in any decisions and will report to Council in the annual report on leasing activity if purchase options are employed, to ensure compliance with the policies contained in this report.

(B) Lease Financing Polices and Goals:

The recommended Statement is attached as Appendix A to this report.

Material Impact/Exclusions:

The regulation defines material impact as "costs or risks that significantly affect, or would reasonably be expected to have a significant effect on, the prescribed debt and obligation limit." The debt and obligation limit is determined the Ministry of Municipal Affairs on an annual basis and governs the debt capacity of a municipality and the amount of long-term liabilities and commitments that it may incur.

As ordinary operating and property leases for which the City is required to make payments beyond the Council term do not have costs or risks associated with them which would significantly affect, or would reasonably be expected to effect, the debt and financial obligation limits, the recommended Statement creates a special class, composed of such leases, which is exempt from the requirements of the Statement.

However, it is felt that all true financing leases, as they have been defined earlier in this report, regardless of the total value of the required payments, should be considered to be material to the City's financial situation and not be exempted from these requirements at this time. A review of this materiality policy will be conducted during 2004 and proposed changes, if required, will be present to Council for approval.

Agencies, Boards and Commissions (ABC's):

While the Regulation does not apply to ABC's, it would be prudent for the City's ABC's to be bound by the same financing lease policy as the City itself. Accordingly, this report recommends that the Statement apply to the ABC's by virtue of the requirement imposed by section 65 of the Ontario Municipal Board Act that local boards obtain the approval of the City prior to proceeding with any work if any portion of the costs of the work will, or may be, raised after the term for which City Council or the board was elected.

Conclusion:

With the adoption of the City's "Statement of Lease Financing Policies and Goals" as contained in Appendix A, Council and the Chief Financial Officer and Treasurer will fulfil the legislative requirement of Ontario Regulation 266/02 pertaining to financing leases. Compliance with this policy will ensure that any true financing leases are evaluated, utilized and managed in a responsible and prudent manner in order to protect the City's financial position.

Contacts:

Len Brittain, Director, Corporate Finance
Tel: 416-392-5380; e-mail: lbrittai@toronto.ca

Martin Willschick, Manager, Treasury Services
Tel: 416-392-8072; e-mail: mwillsch@toronto.ca

Appendix A

City of Toronto Statement of Lease Financing Policies and Goals

(1) Statement of Policy:

The City of Toronto is committed to achieving the lowest cost of funds, based upon current capital market conditions, when financing capital funding requirements. When making decisions regarding the financing of a capital asset, City Council must be satisfied that the lowest cost alternative is utilized from a total cost of ownership perspective. This analysis would allow the City to pay a reasonable premium over the cost of issuing debentures if it can be offset by achieving savings in areas such as the asset administration, maintenance and disposal.

(2) Authority and Accountability:

Ontario Regulation 266/02 was filed under the Municipal Act and requires municipal councils to adopt a statement of lease financing policies before they can enter into a finance lease agreement for any lease for the provision of municipal capital facilities that will require payment by the municipality beyond the term for which the council was elected. "Financing lease" is defined by the Regulation as "a lease allowing for the provision of municipal capital facilities if the lease may or will require payment by the municipality beyond the term for which the council was elected".

(3) Principles:

City Council and the Chief Financial Officer and Treasurer are responsible to ensure that financing leases are recognized as a form of capital financing and are subject to prudent financial management.

The decision to enter into either a finance lease or issue debt to finance a capital project is based upon a detailed net present value and cost/benefit evaluation of the financing lease proposal relative to ownership of the asset as well as other financing alternatives. In order to achieve consistency in the decision making process, the Finance Department will conduct this analysis on a uniform basis for proposals being considered by city departments and will review the analysis submitted to the Finance Department for review by the City's agencies, boards and commissions.

The City could enter into a financing lease if it is determined that it provides the lowest cost of funds, based upon current capital market conditions or pay a reasonable risk premium over the all-in cost of issuing debt or borrowing the funds from an approved financial institution.

Any additional costs must be justified through savings that would be achieved from the benefits of leasing as compared to ownership such as the administration and maintenance of the asset and the transfer of risk in the asset's residual value and disposal at the end of its useful economic life.

(4) Scope:

This Statement applies to all leases that will be entered into by City of Toronto, as well as those entered into by the City's agencies, boards and commissions.

(5) Special Category Excluded from Compliance:

Operating leases and property leases that will be entered into by the City of Toronto and its agencies, boards and commissions form a special category of leases under this Statement for which compliance with this Statement is not required. In the opinion of the Treasurer and of Council, such leases would not result in a material impact for the municipality. Prior to entering into any lease the Treasurer shall review the lease arrangement to ensure that the lease is within this category of leases and that its costs and risks, in combination with all the other leases of this category entered into or proposed to be entered into in that year, do not result in a material impact for the City.

In accordance with the Regulation, material impact is defined as "costs or risks that significantly affect, or would reasonably be expected to have a significant effect on, the prescribed debt and obligation limit."

Since the Regulation and this Statement are being implemented for the first time during 2003, all true financing leases, as defined by s. 6 of this Statement, regardless of the total value of the required payment, should be considered to be material to the City's financial situation and not be exempted from these requirements at this time.

(6) Definitions:

(i) Financing lease:

A financing lease is an agreement, which covers most of the useful life of the capital asset. This agreement is typically non-cancelable (or cancelable at a significant penalty) and is based on the lessee (the City of Toronto) effectively guaranteeing the residual value of the leased asset at the end of the lease term. The lessor (an outside firm) usually allows the lessee to buy the formerly leased asset upon payment of a pre-determined residual value.

Because the lessee has to make guaranteed lease payments and has to support a guaranteed residual value under a finance lease, the lease is considered to be equivalent to debt financing the whole cost of the leased asset. The finance lease structure ensures that the lessor recovers the full cost of the asset and earns its required rate of return over the lease term. Consequently, it is considered similar to a debenture issue because substantially all the risks and benefits of the ownership of the leased asset accrue to the lessee.

(ii) Operating lease:

An operating lease essentially is a rental agreement that generally has a shorter term than a finance lease and usually shorter than the life of the asset, and may be cancelable without a significant penalty. The lessee does not guarantee any residual value, and at the end of the lease term, the lessee must return the asset to the lessor, who will either sell the asset or lease it to other users.

In an operating lease, substantially all the risks and benefits incidental to ownership of the leased asset remain with the lessor. The lessee has the use of the asset without bearing any residual or obsolescence risk. This transfer of risk away from the lessee usually is reflected in higher lease rentals. The lessor also is entitled to any increase in the value of a formerly leased asset.

(iii) Property lease:

A property lease is a lease of real property by which the City acquires a right to use and occupy the real property.

(iv) Discount rate:

The appropriate discount rate to apply in calculating the net present value of future cash flows relating to a financing lease is the City of Toronto's cost of funds applicable to the term of the proposed lease. Details of the City's cost of funds can be obtained from the Chief Financial Officer and Treasurer.

(v) Debt financing:

When the cost of the capital project is to be funded by debt financing, the City's cost of funds also should be used in determining the net present value of future cash flows, including the debt repayments and the residual value, over the life of the debenture or bank loan.

(7) Provisions and Requirements for Council Approval:

The Chief Financial Officer and Treasurer is required to prepare a report to Council with recommendations, an assessment of the costs and financial and other risks associated with the proposed financing lease for the entire term of the financing lease, including:

(i) a comparison between all of the fixed and estimated costs and the risks associated with the proposed lease and those associated with other methods of financing;

(ii) a statement summarizing, as may be applicable, the effective rate or rates of financing for the lease, the ability for the lease payment amounts to vary, and the methods or calculations, including possible financing rate changes, that may be used to establish that variance under the lease;

(iii) a statement summarizing any contingent payment obligations under the lease that in the opinion of the Chief Financial Officer and Treasurer would result in a material impact for the municipality, including lease termination provisions, equipment loss, equipment replacement options and guarantees and indemnities;

(iv) a summary of the assumptions applicable to any possible variations in the lease payment and contingent payment obligations; and

(v) other matters the Chief Financial Officer and Treasurer or Council considers advisable including whether the scope of the financing lease warrants obtaining independent financial advice.

Council must consider and assess the Chief Financial Officer and Treasurer's report including whether, in its opinion, the costs of financing for the proposed financing lease are lower than other methods of financing available to the municipality, and whether the risks associated with the financing lease are reasonable.

Council must also obtain financial advice with respect to the proposed financing lease from the Chief Financial Officer and Treasurer and shall consider, based upon the advice of the CFO and Treasurer, if the scope of the proposed transaction warrants, obtaining financial advice from an independent source.

(8) Lease vs. Purchase/Net Present Value Analysis Criteria:

The responsibilities of City Council and the Chief Financial Officer and Treasurer to ensure prudent financial management and compliance with the provincial legislation requires that any decision to enter into a financing lease be based on a detailed net present value and cost/benefit evaluation of the lease proposal relative ownership and capital financing alternatives.

This evaluation must include a calculation of all cash flows and costs associated with each of the relevant acquisition alternatives. The cost of the lease must be compared (on a net present value basis) with other leases to ensure that the lowest cost of a financing lease is identified. In this regard, lease proposals provided on a bundled basis with additional services should be unbundled to be compared with other leasing proposals.

From this evaluation, the lowest cost of funds lease proposal should be compared (again on a net present value basis) with the cost of alternative available capital financing methods that would be used if the asset or capital project was to be purchased. When comparing bundled lease proposals, the service aspects of the bundled quote, such as the administration of the assets, maintenance and disposal, would have to be incorporated into the cost calculations of the alternative methods of acquisition.

Many financing leases contain a variety of clauses that could increase the cost of leasing for the City, thus affecting the outcome of the cost/benefit analysis. These critical documentation issues should be considered and quantified during the analysis in order to ensure that all aspects of the proposed transaction are recognized.

(9) Credit Rating Issues:

Based upon the materiality and risk profile of the proposed financing lease, the Finance Department will discuss this information with the credit rating agencies who maintain a rating for the City in order to ascertain if, in their opinion, the proposed lease will have either a neutral, positive or negative impact on the City's credit rating. If a report to Council requesting approval is required, this information will be disclosed in the report.

(10) City Legal Support:

Council must adopt a specific leasing bylaw authorizing the entering into a financing lease that is covered by this Statement. A separate bylaw is required for each financing lease transaction that is covered by this Statement.

The City Solicitor is required to provide legal advice on any proposed financing lease, and, in the opinion of the City Solicitor, should the scope of the proposed transaction warrant, recommend to Council that legal advice with respect to the proposed financing lease 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 leasing transaction.

(11) Accounting Treatment for Financing Leases:

From an accounting standpoint, a distinction is made between a capital lease and an operating lease. Operating leases are usually found in property or equipment rentals where there is no intent to acquire the item. Lease charges are charged against operating cost centres over the term of the lease.

Capital leases are usually structured so that a majority of the benefits and risks incident to ownership of the item is transferred to the lessee (the City). In these cases, the City would record a capital expenditure and finance that cost in the capital accounts, similar to the accounting treatment for debenture debt proceeds. The financing charges would be offset on the City's balance sheet as capital lease charges to be recovered in future years and an obligation for the principal portion of the capital lease.

(12) Budgetary Treatment for Financing Leases:

Lease charges would be allocated on an annual basis in the current operating budget, as an amount would need to be levied each year, similar to debt charges.

(13) Reporting and Disclosure Requirements:

If the City has one or more financing leases outstanding in a fiscal year, the Chief Financial Officer and Treasurer is required to report to Council on an annual basis, or more frequently if requested, a report that contains, at a minimum, the following information:

(i) a description of the estimated proportion of the City's total financing arrangements that has been undertaken through financing leases to its total long-term debt and a description of the change, if any, in the estimated proportion since the previous years' report,

(ii) a statement by the Chief Financial Officer and Treasurer as to whether, in his or her opinion, all financing leases were made in accordance with the statement of leasing policies and goals, and

(iii) other information that Council may require or that, in the opinion of the Chief Financial Officer and Treasurer, should be recorded.