TO:	**CHAIR AND MEMBERS STRATEGIC PRIORITIES AND POLICY COMMITTEE MEETING OF FEBRUARY 12, 2018**
FROM:	**ANNA LISA BARBON MANAGING DIRECTOR, CORPORATE SERVICES AND CITY TREASURER, CHIEF FINANCIAL OFFICER**
SUBJECT:	**2019 DEVELOPMENT CHARGES BACKGROUND STUDY: INTERIM FINANCING FOR GROWTH INFRASTRUCTURE PROJECTS**

RECOMMENDATION

That on the recommendation of the Managing Director, Corporate Services and City Treasurer, Chief Financial Officer, the following report regarding the use of the City's working capital as an interim source of financing for growth infrastructure projects **BE RECEIVED** for information, it being noted that future interest costs will be borne by the Development Charges Reserve Funds.

PREVIOUS REPORTS PERTINENT TO THIS MATTER

Strategic Priorities and Policy Committee, "2019 Development Charge Study Policy Review Scoping Report," August 29, 2016

Strategic Priorities and Policy Committee, "Approval of the 2014 Development Charges By-law and DC Background Study," June 23, 2014

BACKGROUND

In August 2016, Staff sought endorsement of policy matters to be reviewed as part of the 2019 Development Charges (DC) Background Study. Among the items approved was 'Financing Construction in Progress'; the following report reflects the results of that review.

For many years, it has been the practice of the City to finance expenditures on capital projects from its general working capital in the intervening period prior to debt issuance. The working capital accumulates through the City's business operations and has been collected from taxpayer and user rate-based sources. Historically, there has not been a DC contribution towards the use of this working capital due to limited DC-funded debt.

The policy review examined the financing of capital projects where a portion of the cost is attributable to growth. There are three points of note that informed the review and analysis contained in this report:

i. **UWRF to CSRF:** In 2014, Council approved a DC policy shift to retire the Urban Works Reserve Funds (UWRF) and move the funding of capital projects triggered by growth to the City Services Reserve Funds (CSRF). Under the rules of the UWRF, identified minor/major growth infrastructure work was financed by the initiating developer until such time as the UWRF had sufficient funds to pay an approved claim. The financing costs associated with this approach were borne directly by the initiating developer. Since then, the financing costs have shifted to CSRF funding for major works, so all development now contributes to the potential cost of financing projects identified in the DC Study. Consequently, a greater demand is put on the City's taxpayer funded working capital, to the point it now is necessary to implement procedures to ensure 'growth pays for growth'.

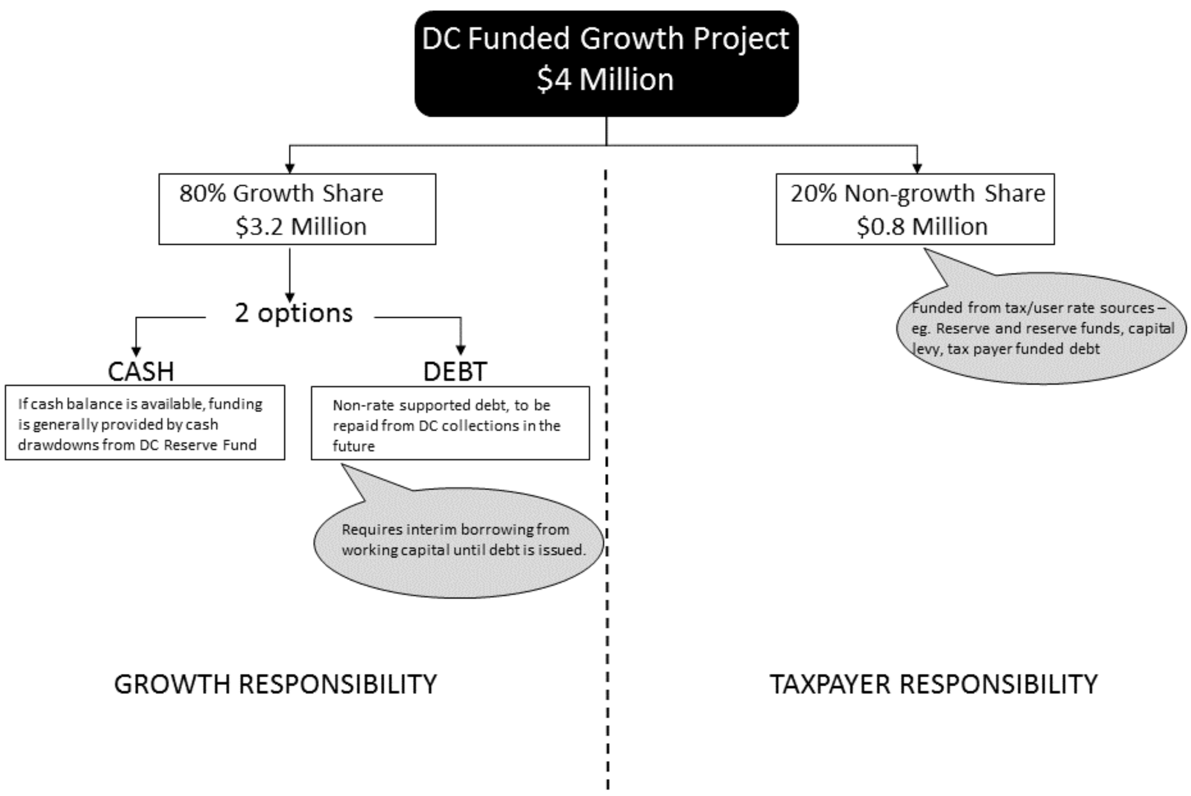
ii. **Sizable increase in infrastructure construction:** The 2014 DC Study identified expected hard services (Roads, Sanitary, Stormwater Management, and Water Distribution) CSRF expenditures of $1.2 Billion by 2023. In the coming years, major investments in growth infrastructure will be made, especially in sanitary sewers, stormwater management facilities and road improvements. This level of investment is heighted in comparison to previous years and now exclusively funded through the CSRF.

iii. **Increasing use of DC-funded debt:** Investments in growth infrastructure generally precede development. Although DC reserve fund cash balances are the first choice for funding construction, debt financing is often required to pay for investments that result in revenue collection over a large period of time. In the coming years, Staff anticipate that an increasing use of debt will be required to fund the DC Study capital program.

ANALYSIS

As the City builds new infrastructure, growth related capital projects are funded either from accumulated DC's in the applicable CSRF, or in the absence of sufficient CSRF balances, are debt financed.

The diagram below depicts these possible financing methods and responsibilities for a hypothetical infrastructure project:



Where a growth project requires debt financing, the project is generally completed before municipal debentures are issued, requiring an interim source of funding. As a result, prior to project completion (during the construction phase) taxpayer-supported working capital is used to finance both the growth and non-growth shares of the project.

This interim use of working capital to finance the growth share of projects is referred to herein as 'Financing Construction in Progress'. There is an opportunity cost in the form of lost interest income for the use of working capital to fund debt sourced growth projects.

To assess the current extent of this use of working capital, a review of prospective growth projects was undertaken. The determination of the anticipated amount of future DC debt ('net borrowing position') for each growth project can be broken down into two steps:

1) Theoretical maximum DC contribution to project cost [$]

$$= A \times B$$

Where:

A = Actual Expenditures to Date (project cost)
B = Total Growth Share (%)

2) Anticipated amount of future DC debt (net borrowing position) [$]

= [(A x B) – (C + D)]

Where:

C = Previously Issued DC Debt
D = DC Reserve Fund Cash Draws

To demonstrate the calculation of the amount of future DC debt, an example project with the following parameters is outlined below;

- $4 million in actual expenditures
- 80% growth share
- $1 million in previously issued DC debt
- $500 thousand in DC reserve fund cash draws

= [($4 million x .8) – ($1 million + $500,000)]

= $1.7 million 'net borrowing position'

Assuming 1.7% interest/annum on the 'net borrowing position' yields $2,408 for 1 month interest or approximately $28,900 in interest costs for the year.

Using the above formula, the scope of the overall 'net borrowing position' for all growth projects was determined at a point in time last year, which resulted in a figure of approximately $22.4 million. This position is expected to increase gradually over time with an increasing number of debt-funded projects and the associated use of the City's working capital prior to debenture issuance. Once the debt is issued, the working capital fund is replenished, decreasing the amount of the 'net borrowing position'. This cycle would be repeated at different times for numerous DC-funded growth projects.

If we assume the calculated 'net borrowing position' of $22.4 million is representative of the average position throughout an entire year, the interest payable by the CSRF to taxpayer-supported working capital would be approximately $380,000 on an annual basis. Presently, these interest contributions are not being made, resulting in the City's working capital absorbing costs that should be borne by growth.

Impact on DC rates:

The City's 2014 DC Study rate calculations already incorporate provisions for financing costs, as permitted in the DC legislation. The financial model used to calculate DC rates assumes recovery of interest when the Reserve Funds are projected to be in a deficit position (which is generally the case when debt is required to finance growth infrastructure spending). Therefore, the contribution of interest costs for the use of working capital described above should have no impact on DC rates.

Implementation:

Consistent with authority provided in Section 35 of the *Development Charges Act* and Section 24 of the 2014 DC By-law, Staff will commence CSRF-funded payment of interest costs associated with the use of the City's working capital for debt financed growth infrastructure projects. The action taken will include a reconciliation of the 'net borrowing position' of each City Service Reserve Fund against the City's pool of working capital, and the computation of interest on that position. Interest rates used in the calculation will be adjusted periodically based on changes in the Bank's Prime Lending Rate.

Disclosure of this administrative procedural change aims to satisfy the corporate objectives of transparency and full disclosure of the administration of City Services Reserve Fund operations.

Consultation:

As with all DC Policy related discussions, the analysis and direction addressed in this report was reviewed with the DC External Stakeholder Committee. The Committee is comprised of members from the London Development Institute, London Home Builders Association, and the Urban League.

CONCLUSION

As the use of debt to provide long term financing for DC funded projects grows, there is a greater impact on the City's taxpayer-supported working capital balance.

The analysis discussed above was used to measure the burden of DC growth projects on the City's general working capital. The analysis suggests a considerable usage of this tax-supported working capital is occurring, and the expectation is that this use will increase. The DC rate calculation models incorporate financing costs, which are used to calculate DC rates; therefore no impact to current rates is anticipated from DC contributions for the use of the City's working capital to fund interim construction costs.

Acknowledgements:
This report was completed with the assistance from staff in Financial Planning and Policy.

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