ADMINISTRATIVE REPORT

Date: May 15, 2005
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TO: Vancouver City Council

FROM: General Manager of Corporate Services / Director of Finance

SUBJECT: 2006 - 2008 Capital Plan Financial Limits

RECOMMENDATION

A. THAT Council set the property tax-supported financial limit for the 2006 - 2008 Capital Plan at $265 million as follows:

- *$135.0 million from general borrowing authority;*
- *$75.0 million from sewer borrowing authority; and*
- *$55.6 million as Capital from Revenue;*

this limit to be used for planning purposes and subject to review at the time Council approves the final Capital Plan in September 2005.

B. THAT Council set an upper limit of $36.0 million in City-wide Development Cost Levy (DCL) funding within the 2006-2008 Capital Plan, the allocation of these funds being based on the City-wide DCL By-law.

C. THAT Council set the financial limit on the Waterworks Capital Plan at $54.3 million as outlined in this report.

CITY MANAGER COMMENTS

The City's needs for capital expenditures to renew and upgrade the infrastructure and facilities necessary to provide services to the public are significant. In each capital planning process, departments and boards request funding for a variety of programs and projects based on Council priorities and their individual assessment of need. The 2006 – 2008 Capital Plan is likely to be a difficult one from both of these perspectives. In addition, this plan will be the only realistic opportunity to prepare the City for the 2010 Olympics. While the City's exposure to costs associated with *hosting the games is limited, there are opportunities that have been identified where City funding has the potential to leverage investment in City infrastructure and facilities. There is also the question of whether and how the City wishes to create an Olympic Legacy.*

However, these" needs" must be balanced with fiscal responsibility. Council has established policies with respect to the impacts the capital expenditure program should have on the City's resources. These policies address the "capacity" of the City to provide capital funding and are the subject of this report. The recommended financial limits that follow from these policies do have an impact on future operating budgets, resulting in incremental tax increases of as much as 3.2% over the three year period. In addition, there will be additional operating costs that arise from the resulting capital program that will also put pressure on the budget. However, despite these concerns, the limits recommended in this report are supported by the Director of Finance and the City Manager because they are consistent with the prudent financial management reflected in the existing Council policy.

Making decisions about how much funding to provide without knowing what is being requested is difficult. However, addressing the issue of funding "capacity" first ensures that the capital plan is developed in a fiscally prudent manner which considers the costs that will be borne by taxpayers. It also ensures that funding decisions are made in the context of the City's overall financial health and the requirements associated with our AAA credit rating. Finally, setting financial limits based on capacity ensures that during the public consultation process there is an understanding that there can be a significant cost to expanding the plan to accommodate lower priority program and project expenditures.

With these limits, the Capital Plan Staff Review Group will complete the task of developing the Draft 2006 – 2008 Capital Plan and will report that plan to Council in the near future. That report will be followed by a public consultation process. In September, when Council must finalize the plan, there will be an opportunity to review the components of the plan and the financial limits. At that time, Council will be in a position to make its capital expenditure plan decisions on the basis of comments from staff, input from the public and Council priorities.

The City Manager RECOMMENDS approval of A, B and C.

COUNCIL POLICY

Council has a policy of developing long range strategic plans to guide the City's capital expenditure program. These long range plans are translated into more manageable three-year Capital Plans which define specific expenditure programs and a supporting financing strategy.

Funding for the Capital Plan is provided from a variety of sources and based on a number of policies that are detailed more completely in this report.

PURPOSE

The purpose of this report is to recommend financial limits that will govern the development of the 2006 - 2008 Capital Plan.

BACKGROUND

The City provides a variety of programs and services to its citizens. Funding for the annual operating costs of these programs and services are provided for in the Operating Budget. The infrastructure and facilities that make delivery of these services possible are provided through the Capital Budget.

The City plans its capital expenditures over periods that correspond to the life-cycle of its assets. Sewer and water infrastructure maintenance and replacement are planned over periods of up to 100 years and Council has used these long range plans to establish policies about maintenance and replacement. Major maintenance and replacement of buildings and other facilities are planned on a nine-year cycle ensuring time for appropriate planning and property acquisition and for the pursuit of opportunities to co-locate facilities to reduce costs. These longer range plans are brought to a more manageable three year planning horizon through the Capital Plan process that was outlined to Council on March 1, 2005.

The Capital Plan details the projects and programs that will be undertaken during the three years of the plan. An associated financial plan defines the sources of funding that will be utilized and how these sources will be allocated to the capital expenditure program. There are a number of sources of funding available to the Capital Plan, including:

- capital-from-revenue for general projects, reflected through the transfer from the annual operating budget to fund the pay-as-you-go portion of the Capital Plan;
- debenture debt approved by the voters for general projects;
- debenture debt approved by Council for sewer and water projects;
- contributions from development in the form of development cost levies or community amenity contributions that assist in dealing with the costs that growth imposes on the City;
- cost sharing from senior governments or their agencies; and
- funding from outside organizations, including community centre associations, social and cultural groups.

Development of the 2006 – 2008 Capital Plan began in the fall of 2004. The process and issues to be addressed in the plan were reported to Council in a Report Reference on March 1, 2005. Development of the plan is being conducted by the Capital Plan Staff Review Group, co-chaired by the Deputy City Manager and the Director of Finance and comprised of representatives from the major service groups. In order for the Staff Review Group to complete its work, Council guidance on the funding that will be available in the Capital Plan is required.

With these limits, the Staff Review Group will complete the allocation of funds to programs and projects and prepare the draft plan for presentation to the Corporate Management Team and then Council by the end of June. The draft plan will then go to the community for input. Final

Council approval of the 2006 – 2008 Capital Plan and the associated financial plan will be sought in September and the questions to the electorate seeking the necessary borrowing authority will be put as part of the municipal election in November.

The balance of this report discusses the financial policies that have governed development of the capital expenditure plan, the role played by each of the funding sources and their impacts on the City's financial position and recommends a funding limit for the 2006 – 2008 Capital Plan.

DISCUSSION

Current Financial Polices

The City has a number of financial policies and practices in relation to its capital expenditure program. These policies seek to establish the appropriate funding sources for capital expenditures and to ensure that the capital expenditure program remains within limits that preserve the financial health of the City – and especially our AAA credit rating. While there would be advantages to spending more, the reality is that without appropriate limits, the capital expenditure program could place an undue burden on taxpayers and jeopardize the City's financial position.

The following briefly summarizes the pertinent policies and objectives:

- the capital program is planned on a long term horizon to ensure orderly maintenance, replacement and upgrading of civic infrastructure and to ensure that the financial implications of the program can be managed within the fiscal constraints faced by the City.
- the City has established policies that define how development cost levies (DCLs) and community amenity contributions (CACs) can contribute to the capital costs that arise as a result of demands from population growth. These policies are laid out in the *Financing Growth Study* approved by Council in 2002. Ongoing operating costs associated with these expenditures are appropriately funded from new property tax revenues related to development.
- use of borrowed funds allows the cost of capital expenditures to be financed over several years, periods more related to the life of the asset. Each capital plan incorporates the use of debt as a financing tool.
- borrowed funds are generally paid back over ten years to ensure that outstanding debt does not accumulate to unacceptable levels. The use of ten-year debt ensures that a systematic borrowing program can be administered and that interest costs are maintained at a level that does not put undue pressure on the operating budget.
- the Capital Plan also incorporates a pay-as-you-go component involving funding from current taxes to maintain a balance between borrowed and "current" funding. Use of current tax revenues to fund capital expenditures also assists in managing the overall levels of debt and the constraints of future debt repayment obligations.
- pay-as-you-go funding also ensures that a portion of the capital expenditure program can be funded without the need for and limitations associated with plebiscite approval.
- While the Capital Plan strives to identify program/project expenditures over the three year period, there are emergent issues that must be addressed during the course of the planning period for which funding should be set aside. Commonly referred to as Supplementary Capital this component was funded at $3.0 million ($1.0 million annually) in the 2003-2005 Capital Plan.

- internal financing of capital expenditures is appropriate in situations where the capital expenditure can be justified on the basis of a business case, providing a source for repayment without impacting on property taxes.
- The City actively pursues external funding to support its capital expenditure program by taking advantage of senior government or Crown agency funding programs, partnership funding from community organizations and developer and property owner funding.

These policies and objectives have been applied on a consistent basis over the years and have resulted in considerable stability and predictability in capital expenditure planning and funding. These policies, along with a commitment to maintaining the City's existing infrastructure, are one of the reasons why the City has been able to maintain a AAA credit rating and benefit from easy and low-cost access to financial markets, both in Canada and internationally.

Establishing Financial Limits for the Capital Program

In developing the 2006 - 2008 Capital Plan it is important for the Staff Review Group to have a funding target within which the recommended projects must be accommodated. This financial limit – referred to as the Capital Envelope - allows the group to determine priorities and to assess the relative priority of projects that fall near the limit.

The financial limit is for planning purposes only. In finalizing the 2006 - 2008 Capital Plan in September, Council will make final decisions about the funding to be included in the plan based on input from the Director of Finance, the Staff Review Group, departments and Boards and the public.

There are three components to the Capital Envelope:

i. Operating Budget funding for the tax supported component of the capital plan – debt charges and capital from revenue - both of which impact on property taxes;
ii. funding from development cost levies that must be targetted to "growth-related" capital projects defined in the applicable DCL By-laws; and
iii. user fee funding from the Water Utility which affects water user fees.

While there are other outside sources of funding available to support the capital program these do not directly affect the amount of City funding that will be directed to the program and are not the focus of this report. In developing the draft Capital Plan, the Staff Review Group will take into consideration known or anticipated external funding sources to ensure that City funds are allocated to take advantage of this funding as appropriate. These sources will be reported to Council with the draft Capital Plan.

For illustration, Table 1 summarizes the funding in the 2003 – 2005 Capital Envelope and the associated funding sources.

Table 1: 2003 – 2005 Capital Plan Envelope

Funding Tool	Funding Source	Amount	%
Plebiscite Approved Borrowing Authority			
■ Public Works & Fire Facilities	Tax Support	$ 78,100,000	
■ Parks & Recreation	Tax Support	18,700,000	
■ Cost-Shared Projects	Tax Support	20,000,000	41.1%
Council Approved Borrowing Authority			
■ Water	Utility Fees	46,000,000	16.3%
■ Sewer[1]	Tax Support & Utility Fees	58,750,000	20.6%
Capital from Revenue	Tax Support	47,900,000	16.9%
Development Cost Levies	Development	14,500,000	5.1%
Total[2]		$283,950,000	100.0%

1. *Sewer debt charges are recovered 90% from property taxes and 10% from user fees*
2. *Excluding outside funding of up to $90 million.*

The following sections review the three main components of the Capital Envelope and provide recommended funding levels for the 2006 – 2008 Capital Plan.

1. Tax Supported Funding

i. Funding Policy

The largest component of the Capital Envelope is the tax supported funding provided from the Operating Budget in three ways:

- debt charges (principal and interest) on the City's elector approved (general) debt;
- debt charges (principal and interest) on Council approved sewer debt which are 90% recovered from the taxes; and
- capital from revenue, reflected in the annual transfer from the operating budget to fund the pay-as-you-go portion of the Capital Plan.

In recent plans, approximately 80% of the Capital Envelope has been provided through tax supported funding.

The financial limits on the tax supported component of the capital program are generally defined by the ability of the Operating Budget to support the cost of the program over a longer planning horizon. The policy adopted by Council in developing the financial limits in recent capital plans is that:

- debt charges (principal and interest) for City and GVS&DD debt should not exceed 15% of revenues in the operating budget. This ensures that debt charges do not become a burden on the operating budget.

- the capital from revenue component of the plan should fall in the range of 2.5% to 5.0% of the revenue budget. This ensures an appropriate balance between operating and debt funding for the capital program.
- the cost of the tax supported capital program should not be a long term driver of general purpose taxes.

In practice, it is the last of these criteria that has constrained the financial limits of recent Capital Plans. While there has been room within the criteria to increase funding, doing so would have resulted in the capital program becoming a cost driver in the Operating Budget. As a result, Council has limited capital expenditures so as to ensure that they did not generate tax increases in excess of property tax objectives over the longer term.

The Director of Finance believes these are sound financial policies that ensure the capital program remains affordable and that the debt burden carried by the City is manageable in the long term. It is recommended that these form the basis for establishing the tax supported limits on the 2006-2008 Capital Plan.

ii. The 2006 – 2008 Funding Limit

Chart 1 below, provides information about the first two components of the funding limitation – tax supported debt charges and capital from revenue - in graphical form for the years 1998 to 2005. The chart indicates that for several years, debt charges as a percentage of operating revenues has been falling, from 16% in 1998 to the current level of 12.5% (once the full borrowing program for the 2003 – 2005 Capital Plan is completed). This decline is the result of a number of factors including lower interest rates and more rapid growth in operating revenues than anticipated when the projection for the 2003 – 2005 Capital Plan was done in 2002.

While Chart 1 illustrates that there is room within the limits established under Council policy to increase the debenture program and, therefore, the amount of capital funding, there is a significant cost to increasing toward the 15% limit. In 2002, Council established the limits outlined in Table 1 above based on the conclusion that a balance must be found for:

- the additional cost in terms of overall debt held by the City;
- the pressures that an increase in funding would have on property taxes; and
- the need to maintain a strong capital expenditure program within its policy limits.

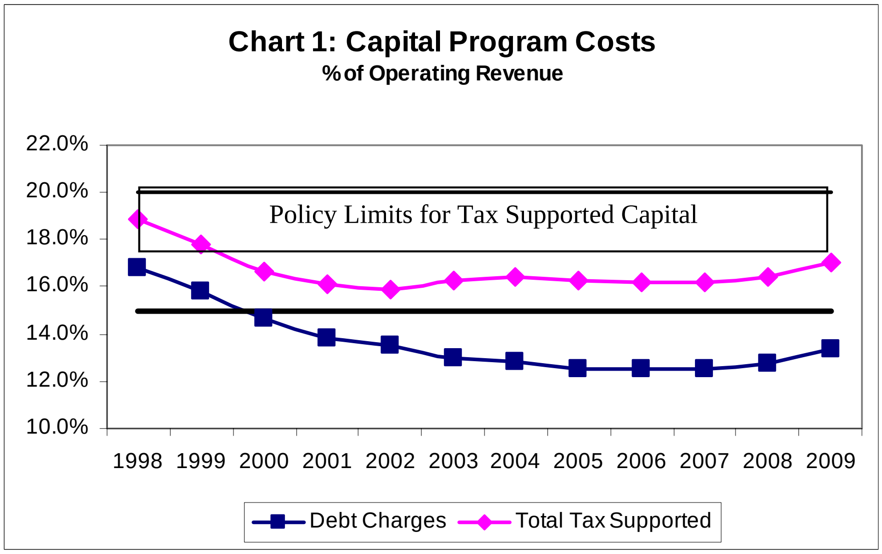
Council is faced with a similar problem for the 2006 – 2008 Capital Plan. There is room to increase the amount of debt and capital from revenue funding in the Capital Plan, however, to do so will have a negative impact on property taxes.

There are three steps to developing a **debt limit** for the 2006 – 2008 Capital Plan:

- **Replace retiring deb**t: Over the term of the plan, approximately $18.75 million in debt charges (approximately $12.75 million related to general debt and $6.0 million related to sewer debt) will mature. If this level of funding is maintained in the operating budget there is the capacity for approximately $130.0 million of replacement debt based on current interest rate expectations. This will have no impact on property taxes, however remaining at this level of debt charges will result in continued decline of the capital funding as a percent of revenues.

- **Increase the provision for debt charges by growth in the revenue budget.** As the budget grows, the capital funding limits policy anticipates that the capacity to support debenture costs also increases. At its extreme, the policy expects that up to 15% of each new dollar of revenue would be devoted to supporting the capital program. Since the 2003 – 2005 Capital Plan was established in 2002, operating revenues have grown by 14.5%. This additional revenue dedicated to the capital program would support an additional $60 million in debt for the 2006 – 2008 Capital Plan. The addition of $60 million in debt charges will impact on property taxes, resulting in a tax increase of approximately 2.0% over the course of the capital plan. However, this increase will allow the tax supported component of the plan to remain at the current 12.5% of revenues.

- **Continue to move debt costs toward the 15% target recognizing that this will impact on property taxes.** The first two steps ensure that the capital program does not lose ground to the policy targets but does not move the anticipated expenditures closer to those limits. Maintaining the current level of debenture funding in the Capital Plan leaves the City in a position where its capital program could be under funded. However, increasing funding will put pressure on property taxes. Reaching the full 15% target (equivalent to adding an additional $90 million in debt) would involve new funding in the budget equivalent to a further 3.0% tax increase over the course of the plan.



The projection in Chart 1 is based on the addition of $20 million in debt financing resulting in approximately $2.9 million in additional debt costs over the term of the plan. These additional costs represent a further property tax increase of approximately 0.6% over 2007 – 2009.

The Director of Finance recommends that Council establish a debt limit on the 2006 – 2008 Capital Plan that represent the total of these three strategies or $210.0 million to be allocated to general and sewer purposes. This compares with $175 million in the 2003 – 2005 Capital Plan. It is anticipated that approximately $75 million of this limit will be allocated to sewer capital work and the balance will be available for allocation to other projects. The projection in Chart 1 for 2006 through 2009 indicates that this recommendation will result in the share of operating revenues devoted to debt charges slowly increasing over the next capital plan, reaching 13.5% in 2009. While this is below the upper limit of Council's policy, the strategy does carry tax increase impacts of approximately 2.7% over the plan.

Capital from Revenue is the second component of tax supported funding. In 2005, capital from revenue is 3.6% of operating revenue compare to a policy target range of 2.5% to 5.0%. This represents an increase from the 2.8% of revenues that existed in 2002, before the 2003 – 2005 Capital Plan was approved and reflects the increase in funding provided by Council in that plan ($47.9 million compared to $38.0 million). In approaching the 2006 – 2008 Plan, the Director of Finance sought to maintain this level of funding, resulting in an increase to $55.6 million. As with the addition of debt charges recommended above, this increase will maintain the share of operating revenues devoted to the capital program at approximately 3.6% but will result in a tax increase of up to 0.5% over the plan.

Based on this strategy, the recommended funding limits for the tax supported component of the 2006 - 2008 Capital Plan would be as follows:

Source of Funding	Funding	Tax Impact
Debenture Borrowing	$210,000,000	2.7%
Capital from Revenue	$55,600,000	0.5%
	$265,600,000	3.2%

These limits will begin to move the City toward the policy limits for funding the capital plan, ensuring a funding level more closely reflective of Council's policy. However, they will also result in tax increases over the course of the plan of up to 3.2% beyond those currently projected. This will be in addition to the additional operating costs associated with the capital expenditure program.

2. Development Cost Levies

The City currently collects development cost levies (DCLs) in two ways. Beginning in the early 1990s, Council addressed growth related issues by approving a number of area-specific DCLs. DCL revenues collected in these areas must be spent within the area boundaries specified in the applicable bylaw. In 2000, Council extended the DCL mechanism on a City-wide basis by approving the recommendations of the *Financing Growth Study.* City-wide DCLs were implemented in June 2002.

The *Vancouver Charter* limits the application of DCL funds to the following purposes:

- constructing, altering, expanding or replacing sewage, water, drainage and highway facilities;
- providing and improving park land;
- establishing child care facilities in premises leased or owned, and acquiring property for such facilities; and

- assisting in providing replacement housing.

Area-specific and City-wide DCL bylaws are specific about the purposes to which DCL funds can be applied and, over the period in which growth occurs, it is a requirement that the funds be spent in these proportions.

A second limitation on the use of DCL funds is that in individual areas, or on a city-wide basis, there will never be sufficient DCLs to pay all of the capital costs identified with "growth". As a result, DCLs must be used in concert with existing City funding (in Financing Growth terms this is referred to as the "municipal assist"). This makes inclusion of DCL funding in the capital planning process critical to achieving the needs for infrastructure, parks, childcare care and replacement housing as the City grows.

These limits on the use of DCL funds suggest that their use must be meshed with other funding priorities identified in the capital planning process. In developing the capital plan, the Staff Review Group seeks to find opportunities to use DCL funding without otherwise jeopardizing the overall capital expenditure priorities.

In approving the 2003 – 2005 Capital Plan, Council adopted the Financing Growth policies for the use of DCLs:

- the allocation of City-wide DCL funding should not exceed the funds in reserve plus a partial allocation of DCL revenues anticipated over the next capital plan.
- the allocation of City-wide DCL funding should be based on the allocations established in the City Wide DCL By-Law.
- The total amount of funding available for allocation to capital expenditures should not exceed 100% of the funding available at the beginning of the plan and 50% of the funding anticipated to be available during the first two years of the plan.

This approach ensures that funds available for "growth-related" projects can be utilized over the planning period but that the allocation limit does not exceed the revenues that might reasonably be expected to be earned. This strategy will also ensure that should additional capital projects be identified during the plan, DCLs would be available to assist with their funding.

The Director of Finance recommends that Council confirm this policy for the allocation of DCL funds to the 2006 – 2008 Capital Plan.

At March, 31, 2005, the City wide DCL had generated $33.5 million of which approximately $23.5 million had been spent or committed leaving $10.0 million available. For planning purposes, it is anticipated that another $14.0 million will be generated before the end of 2005 and $24.0 million will be generated during 2006/07. This allocation methodology outlined above, will provide an allocation for DCL eligible projects of up to $36.0 million in the 2006 -2008 Capital Plan.

By-Law Allocation	**%**	**Funding Available**
Park Development	41%	16.7 million

Replacement Housing	32%	11.2 million
Childcare	5%	0.17 million
Transportation & Public Works	22%	7.74 million
Total		36.0 million

Using these targets, the Staff Review Group will search for opportunities to allocate City-wide DCL funds to individual projects or to program areas. However, it should be noted that, based on current expectations, this allocation will leave approximately $25.0 million available to deal with emerging opportunities during the 2006 – 2008 Capital Plan or for carry forward to the 2009 – 2011 Capital Plan.

3. User Fee Supported Expenditures – the Water Utility

The City's Water Utility is heavily capital intensive and is funded from consumption based water user fees which are levied separately from property taxes. As a result, credit rating agencies tend to treat water debenture debt separately from debt supported by property taxes.

The primary concern is that funding is provided at levels that ensure appropriate renewal and upgrading programs can be maintained, that is, that maintenance is not deferred. This is consistent with Council policy that in establishing the water capital program a "1% per year replacement" level be maintained over the long term. Based on an assessment of the water system and the impact of recent capital programs on the replacement program, a capital expenditure program for the Capital Plan is established.

The City Engineer has submitted a proposed waterworks capital plan at $54.3 million. While this represents an increase of 18% over the 2003 – 2005 Capital Plan, it should be noted the request includes full provision for inflationary increases to the end of the planning period. The Staff Review Group will review this request as part of the planning process and will comment on the adequacy of the estimate as part of the upcoming report on draft 2006 – 2008 Capital Plan.

Other Funding Sources

The foregoing sections focus on the limits to capital funding from City sources: The Operating Budget, Development Cost Levies and utility user fees. There are other sources that are important components of the overall funding plan associated with the Capital Plan. These could include:

- Translink funding for the Major Road Network;
- Community Amenity Contributions (CACs) available in a number of areas of the City;
- other negotiated contributions from developers, including the provision of non-market housing;
- senior government and government agency funding to support specific initiatives;
- contributions from community organizations;
- potential public-private partnerships for the development of civic facilities.

While these outside sources are important to completing the City's capital expenditure program, they are often uncertain at the time the plan is developed. It is therefore inappropriate to include them in the financial limits. However, where funding from these sources is available to complement City funding, it will be factored into the Capital Plan and reported to Council with final plan.

Risk Factors Associated with the Recommended Funding Levels

In developing these recommended funding levels, a number of assumptions have been made regarding the future. Council is urged to consider this funding level as a base level and to be prepared to consider changes should circumstances change during the course of the plan. There are a number of factors that might lead to reconsideration of the financing strategy:

i) Interest Rate Risk

The recommended financial plan includes assumptions about future borrowing. These assumptions include a steady borrowing schedule involving annual debenture issues in the range of $80 million and with interest rates rising above the current levels consistent with current industry projections. Should there be a significant increase in interest rates over the capital plan period, borrowing costs will be driven up, increasing tax supported costs and exerting pressure on the Operating Budget. During the course of the next plan, Council may have to make decisions about whether such increases should be reflected in changes to the Plan or to taxation targets.

ii) Operating Budget Challenges

In developing the Capital Envelope projections, assumptions were made about future Operating Budgets and general purpose property taxes. These include assumptions about relatively stable growth in the revenue budget of approximately 3.0% annually. However, past experience suggests that these budget targets may not be met and that Council will want to have a variety of potential actions available to respond to the Operating Budget challenges that may occur over the course of the next Capital Plan. One of those options is to reduce the level of capital expenditures, either by reprioritizing the projects funded from capital from revenue or by eliminating or reducing projects that are debt financed.

CONCLUSION

This report recommends that the financial limits for the 2006 - 2008 Capital Plan be established as follows (with current plan comparisons):

Funding Source	2003-2005 Capital Plan	2006 - 2008 Capital Plan	% Change
Debenture Program	$175.5 million	$210.0 million	18.5%
Capital from Revenue	47.9 million	55.6 million	14.8%

Waterworks Program	46.0 million	54.3 million	18.0%
	$269.4 million	319.9 million	17.6%
DCL Funding	14.5 million	36.0 million	248.2%
Total	$283.9 million	$355.9 million	25.5%

The recommended funding levels represent an overall increase of tax and utility fee supported capital expenditures of 25.5%. Although there is room within the financial guidelines to increase tax supported capital expenditures beyond this level, doing so will begin to put pressure on future property taxes. It is also recommended that City-wide development cost levy funding in the plan be increased consistent with the policies established by Council reflecting an increase of 2.5 times the allocation in the last plan.

Based on this allocation, the Capital Plan Staff Review Group will finalize the recommended draft Capital Plan. Once the draft plan is considered by Council and the public have had the opportunity to review it, final decisions on the overall level of funding will be made by Council. This final step will take place in September, 2005.

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