CITY OF **VANCOUVER**

RR-1

ADMINISTRATIVE REPORT

CITY OF VANCOUVER

Report Date:	April 21, 2008
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Meeting Date:	April 29, 2008

TO:	Vancouver City Council
FROM:	General Manager of Financial Services / Director of Finance In consultation with the General Manager of Business Planning & Services
SUBJECT:	2009 - 2011 Capital Plan Financial Limit

RECOMMENDATION

A. *THAT Council set the financial limit for the tax supported component of the 2009 - 2011 Capital Plan at $369.0 million as follows:*

- *$197.3 million from general borrowing authority;*
- *$97.7 million from sewer borrowing authority; and*
- *$75.0 million as Capital from Revenue.*

This limit to be used for planning purposes and subject to confirmation at the time Council approves the final Capital Plan in September 2008.

B. *THAT Council instruct the Capital Plan Staff Review Group to seek expenditure opportunities from City-Wide DCLs to a limit of $54.3 million.*

C. *THAT Council set the financial limit for the Water capital program at $61.0 million, this limit to be used for planning purposes and subject to confirmation at the time Council approves the final Capital Plan in September 2008.*

D. *THAT the Capital Plan Staff Review Group be instructed to report back with the Draft Capital Plan on the impact that anticipated cost inflation during the 2009 – 2011 Capital Plan could have on the capital expenditure program.*

CITY MANAGER'S 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 and growing. 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 2009 – 2011 Capital Plan will be a difficult one from both of these perspectives.

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 "financial 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 4.0% over the three year period. In addition, the inclusion of new physical assets in the Capital Plan will have both operating and renewal costs that will impact on future budgets beyond those already identified for Council. The proposed financial limits are supported by the Director of Finance and the City Manager because they balance the fiscal and asset management needs of the City.

Making decisions about how much funding to provide without knowing what is being requested might seem unusual. Addressing the issue of funding "capacity" separately 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 maintaining our credit rating. Finally, setting financial limits based on "financial 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. As a result of these factors the Director of Finance and City Manager caution against further expansion of the financial limits.

With these limits, the Capital Plan Staff Review Group will complete the task of developing the Draft 2009 – 2011 Capital Plan and will report that plan to Council on May 27, 2008. 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 therefore RECOMMENDS approval of A, B, C and D.

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 2009 - 2011 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 reflect the life-cycle of its assets. Sewer and water infrastructure capital expenditures 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 also planned on a multi-year cycle ensuring time for appropriate planning and property acquisition and for the identification of opportunities to co-locate civic operations 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 February 26, 2008.

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 an annual transfer from the 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;
- development cost levies or community amenity contributions provided by development that assist in dealing with the capital costs that growth imposes on the City;
- external funding including cost sharing from senior governments or their agencies; and funding from the City's many community partners.

Development of the 2009 – 2011 Capital Plan began in the fall of 2007. The process and issues to be addressed in the plan were reported to Council in a Report Reference in February, 2008. 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 are responsible for considering the requests from departments and recommending a capital plan allocation to Council. 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 on May 27, 2008. The draft plan will then go to the community for input, culminating in a public meeting scheduled for September 15, 2008. Final Council approval of the Plan and the associated financial plan will be required before the end of September and the questions to the electorate seeking the necessary borrowing authority will be put as part of the municipal election on November 15, 2008.

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 2009 – 2011 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 and credit profile of the City. While it could be tempting to spending more, the reality is that without appropriate limits, the capital expenditure program could place an undue burden on taxpayers through higher costs in the Operating Budget and could result in deterioration of 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 that civic infrastructure is renewed and replaced in a sustainable manner 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.
- use of borrowed funds allows the cost of capital expenditures to be financed over periods more related to the life of the asset.
- 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 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 2006-2008 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 the highest credit ratings and therefore benefit from easy and low-cost access to financial markets, both in Canada and internationally.

Establishing Financial Limits for the Capital Program

The Capital Plan Financial Limit has several funding sources:

- **Tax Supported Capital Expenditure Program** provides a sustainable approach to capital rehabilitation and renewal of the City's non-utility assets (streets, facilities, parks) as well as capital support for outside organizations that assist the City in delivering services to the public. This program is funded from debenture authority that must be approved by the electorate, debenture authority for sewer purposes that Council approves directly, and from capital from revenue. Debenture and capital from revenue costs are reflected in the annual Operating Budget and are supported by property taxes.

- **Development Cost Levies** provide funding for growth related, non-utility capital expenditures. DCLs are provided through development in the City and have no direct impact on the Operating Budget or property taxes.

- **Water Capital Expenditure Program** provides for capital maintenance, upgrading and replacement of the City's waterworks infrastructure. Funding for this program comes from debenture authority that Council may approve without reference to the electorate. As the costs associated with water debt are recovered through user fees, it has no impact on the Operating Budget or property taxes.

The City's capital program also benefits from a variety of outside sources of funding such as senior governments and their agencies and the City's community partners. 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 these funding opportunities. However, these are not considered as part of the City's financial limits.

For illustration, Table 1 summarizes the funding in the 2006 – 2008 Capital Envelope and the associated funding sources:

Table 1: 2006 – 2008 Capital Plan Envelope

Funding Tool	Funding Source	Amount	%
Tax Supported Funding			
■ General Debt (elector approved)[1]	Tax Support	$ 170,570,000	43.9%
■ Sewer Debt (Council approved)[2]	Tax Support	74,430,000	19.1%
■ Capital from Revenue	Tax Support	55,600,000	14.3%
Total	Tax Support	300,600,000	77.3%
City Wide Development Cost Levies	Development	33,575,000	8.6%
Council Approved Borrowing Authority			
■ Water	Utility Fees	54,870,000	14.1%
Total		$389,045,000	100.0%

1. *Including funding of $35.0 million for Percy Norman Pool, Killarney Ice Rink and Trout Lake Ice Rink advanced from future capital plans.*
2 *Sewer debt charges are recovered 90% from property taxes and 10% from user fees*

The following sections review the three main components of the Capital Envelope and provide recommended funding levels for the 2009 – 2011 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; 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.

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 capital plans is that:

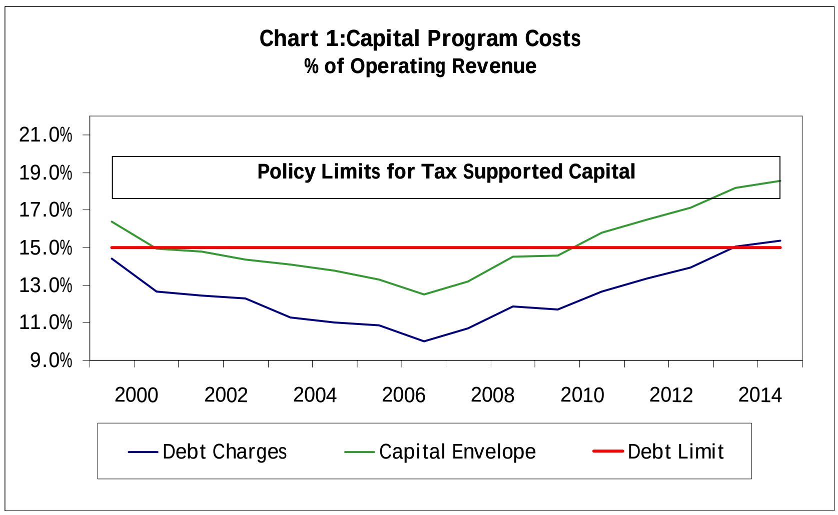
- debt charges (principal and interest) for City and GVS&DD debt should not exceed 15% of revenues in the operating budget. This ensures a balance between an adequate capital program and the impact that debt charges have on the operating budget.
- the capital from revenue component of the plan should 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 Capital Plan financial limits in recent Capital Plans. While there has been room within the first two criteria to increase funding, doing so would have resulted in the capital program becoming a cost driver in the Operating Budget.

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 policies form the basis for establishing the tax-supported limits on the 2009-2011 Capital Plan.

Chart 1 below, provides information in respect of the first two funding policies - tax-supported debt charges and capital from revenue - in graphical form for the years 2000 to 2008. The chart indicates that for several years, debt charges and capital from revenue as a percentage of operating revenues have been declining because of more rapid growth in operating revenues and lower borrowing costs than anticipated when the projection for recent Capital Plans were developed.

This decline should be of concern as it demonstrates that the City's capital expenditure program is not keeping up with the growth in its "capacity" to fund as evidenced by the growth in operating revenues. At the upper limits of the policy ranges, for every hundred dollar increase in operating revenues, between $17.50 and $20.00 should be allocated to the Capital Program.



Council recognized this situation in developing the 2003 – 2005 and 2006 – 2008 Capital Plans by establishing financial limits intended to move the capital program toward the target ranges despite the pressure these increases were projected to have on the Operating Budget and on property taxes.

Council is faced with a similar situation for the 2009 – 2011 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 put upward pressure on property taxes. Further, decisions to increase the designated funding for the capital program must be made in recognition that they may have long term impacts on the City's credit profile.

ii. The 2009 – 2011 Funding Limit

The Director of Finance believes that funding increases beyond the current levels relative to operating revenues are important for both tax supported debt and capital from revenue.

- **Debenture funding in the Capital Plan should be increased such that the resulting**

debt charges are increased beyond the current level of 10.7% of operating revenues, recognizing that this will impact on property taxes. Maintaining the current level of debt funding in the Capital Plan suggests tax-supported debt of approximately $280.0 million. Funding at this level leaves the City in a position where its capital program is under-funded compared to its “financial capacity”. However, reaching the full 15% target (equivalent to adding an additional $90 million in debt) would involve new funding in the budget of about $14 million, equivalent to a further 2.75% tax increase over the course of the plan.

The Director of Finance recommends that Council establish a debt limit on the 2009 – 2011 Capital Plan of $295.0 million to be allocated to general and sewer purposes. This compares with $245.0 million in the 2006 – 2008 Capital Plan and growth in debt charges of about 20% compared to 15% for operating revenues beyond 2008. It is anticipated that approximately $98.0 million of this limit will be allocated to sewer capital work based on Councils’ 1% replacement policy. The balance will be available for allocation to other projects. The projection in Chart 1 indicates that this recommendation will result in the share of operating revenues devoted to debt charges slowly increasing over the next capital plan, reaching 13.3% once all of the borrowing authority is exercised by 2012. This remains below the upper limit of Council’s policy, however, the increase does carry incremental tax increase impacts of approximately 2.0% over the plan.

- **Capital from Revenue** is should be increased beyond the current 2.5% of operating revenues. In developing the 2006 -2008 Capital Plan, Council acknowledged the need keep an appropriate level of capital from revenue by approving an increase of 16% over the prior plan in order to hold the anticipated funding level at 3.6% of operating revenues. However, as noted in Chart 1, this ratio has declined to approximately 2.5% over the last three years. Holding this ratio through the 2009 – 2011 Capital Plan would suggest funding of approximately $68.0 million.

  As with debt charges, the Director of Finance believes funding at this level does not represent an appropriate level of funding from current taxes. However, increasing to the mid point of the 2.5% to 5.0% of revenue range would add an about $25 million to the allocation over the capital plan period and place a significant impact on property taxes. Moving more slowly to correct the ratio would be more affordable. As a result, the Director of Finance is recommending that Capital from Revenue be set at $75.0 million, about $2.3 million per year above the status quo level. This would leave capital from revenue funding at an estimated 3.1% of operating revenue by 2011. The property tax impact of this additional amount is estimated at 1.2% over three years.

The following table summarizes these recommendations and indicates the impact on property taxes.

Source of Funding	Funding	Tax Impact[1]
General Debt (elector approved)	$197,300,000	2.75%
Sewer Debt (Council approved)	97,700,000	
Capital from Revenue	$75,000,000	1.20%
Total	$370,000,000	3.95%

1. Incremental impact on property taxes beyond the status quo scenario over the three years of the 2009 – 2011 Capital Plan.

These limits will begin to move the City toward the policy limits for funding the capital plan (Chart 1), 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 4.0% beyond those indicated by funding the plan at current levels relative to operating revenues.

2. City Wide Development Cost Levies

Council has established policies for the use of City Wide DCLs in the capital expenditure planning process:

- the allocation of City-wide DCL funding should not exceed the funds already in hand plus a partial allocation of DCL revenues anticipated over the next capital plan. The total amount of funding available 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.
- the allocation of City-wide DCL funding should be based on the allocations established in the City Wide DCL By-Law:

  i. constructing, altering, expanding or replacing sewage, water, drainage and highway facilities;
  ii. providing and improving park land;
  iii. establishing child care facilities in premises leased or owned, and acquiring property for such facilities; and
  iv. assisting in providing replacement housing.

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, City Wide DCLs could be available to assist with their funding.

In addition, the Capital Plan Staff Review Group will consider the application of Area Specific DCLs and Community Amenity Contributions in situations where these geographically restricted funding sources can be accessed.

To date, the City-wide DCL has generated over $90 million. At the end of 2007 all but $13.5 million of this funding had been allocated to specific projects. It is anticipated that, based on Council policy, another $41.0 million will be available for allocation during the 2009 – 2011 Capital Plan. This brings the recommended allocation to $54.3 million as follows:

By-Law Allocation	%	Funding Available
Park Development	41%	$18.4 million
Replacement Housing	32%	22.1 million
Childcare	5%	1.2 million
Transportation & Public Works	22%	12.6 million
Total		$54.3 million

Based on current expectations, this allocation will leave approximately $45 million to $50.0 million available to deal with emerging opportunities during the 2009 – 2011 Capital Plan or for carry forward to the 2012 – 2014 Capital Plan.

3. User Fee Supported Expenditures – the Water Utility

The City's Water Utility is funded from consumption-based water user fees which are levied separately from property taxes. As a result, credit rating agencies treat water debenture debt separately from debt supported by property taxes when considering the City's credit profile. 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 approach 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.

Based on this policy, the City Engineer has submitted a proposed waterworks capital plan at $61.2 million (2009), an increase of 11% over the 2006 – 2008 Capital Plan. 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 Draft Capital Plan report.

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 $125 million and with interest rates rising above the current levels. While the envelope is not overly sensitive to small changes in interest rates, should borrowing costs increase substantially, the impact of the recommended limits on the operating budget will be greater than indicated in this report. 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 Risk

In developing the Capital Envelope projections, assumptions have been made about future Operating Budgets and general purpose property taxes using a combination of past experience and future expectations. These assumptions indicate that 2009 and 2010 will be particular challenges for Council. The additional impact of these recommendations for the capital expenditure program will add to this challenge and Council will want to have a variety of potential actions available to respond to the Operating Budget challenges that may result. 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.

iii. Inflation Risk

Over the course of the 2006 – 2008 Capital Plan, there have been inflationary increases in costs well beyond what were anticipated when the plan was developed and beyond the general inflationary provision built into the plan. For construction projects, these increases have been up to 12 – 15% annually while in the sewer and water programs increases have been in the 5% - 8% range annually. The submissions being considered by the Staff Review Group are provided in estimated 2009 dollars and some provision will have to be made in the plan for future inflation. The Capital Plan Staff Review Group is currently consulting with departments on potential inflation impacts over the 2009 – 2011 period and will include recommendations on the implications of accommodating these within the financial limits in this report when it reports on the Draft Capital Plan.

CONCLUSION

This report recommends that the financial limits for the 2009 - 2011 Capital Plan be established as follows (with current plan comparisons):

Funding Source	2006 - 2008 Capital Plan	2009 – 2011 Capital Plan	% Change
Debenture Program	$245.0 million	$295.0 million	20.0%
Capital from Revenue	55.6 million	75.0 million	34.8%
Waterworks Program	54.8 million	$61.6 million	12.4%
	$355.4 million	$431.6 million	21.2%
City Wide DCL Funding	33.6 million	54.3 million	60.7%
Total	$389.0 million	$485.9 million	24.8%

The recommended funding levels represent an overall increase of tax and utility fee supported capital expenditures of 24.8%. Although there is room within the financial guidelines to increase tax-supported capital expenditures beyond this level, doing so will begin to put further 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 allocation 60% higher than in the last plan as a result of increased development in the City.

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 provide comments, final decisions on the overall level of funding will be made by Council. This final step will take place in September, 2008.

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