
2005 BUDGET BRIEFING NOTE: Capital Budget Issues – Definitions, Policies and Guidelines

Issue/Background:

This briefing note summarizes the major issues and recommendations contained in the “Capital Budget Issues – Definitions, Policies and Guidelines” report adopted by Council at its meeting of July 20-22, 2004. The report recommended moving toward the approval of a 5-year Capital Plan for 2006, with 2005 being a transition year. It also provided an overview of the process, policies, guidelines, key terms and concepts used in the City of Toronto capital budgeting and planning process.

The current City of Toronto Capital Budget process is in line with best practices outlined by the (North American) Government Financial Officers Association (GFOA), however, there is still a need for the City to establish and approve capital plans beyond the current fiscal year. Council adopted that the City would transition towards the approval of a firm 5-year Capital Plan for 2006 and that, for 2005, City Programs and ABCs would prepare a detailed Capital Plan for the first 5 years and a capital forecast for years 6 to 10. Approval of a 5-year Capital Plan would provide predictability and stability in the capital planning process, which is critical to ensuring the cost-effective management of City assets.

Key Point(s):

- Council will consider 2005 to be a transition year for establishing the firm 5-year Capital Plan and that all the current and related policies and principles will apply.
- Report back on policies prior to 2006 Budget process.
- Council will approve a firm 5-year Capital Plan for the 2006 Budget that is based on the following:
 - a) Detailed projects for each year of the plan based on readiness;
 - b) Projects in years 1 and 2 must be preceded by feasibility studies and needs assessments while projects in years 3 to 5 may reflect the need for various planning work to be undertaken;
 - c) The 5-year Capital Plan must be developed within an approved fiscal affordability framework;
 - d) To ensure that the approved 5-year plan remains within the approved fiscal affordability framework, acceleration of any capital project in the plan must be offset through deferral of a project of equal value; and
 - e) Introduction of any new project must be approved by Council first, with the identification of a project deferral of equal value.

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- Future year operating budget impacts of the 5-year Capital Plan must be approved by Council.
 - Approval of a firm 5-year Capital Plan will result in projects being approved for a 5-year timeframe, but Capital Budgets will be approved annually.
 - The first quarter capital variance report of each year will be the primary reporting vehicle for capital project close-outs. The closing of capital projects supports two objectives – good financial control and the ability to apply any surplus funds to other corporate purposes. Reporting of capital project closings indicates that the authority provided by Council to perform capital work has been fulfilled and the specified asset provided. Once projects are closed, Accounting staff will return any unspent funds to source according to established priorities for any multi-sourced project and they will no longer be part of the capital variance reporting process. Any proposed application of remaining financing must first address the funding of other sub-projects within the project and other projects within the program, respect the purposes of the funding source, and seek Council approval for any new initiative beyond the scope of the original project.
 - Appendix A lists capital budget definitions.
 - Appendix B summarizes the current City of Toronto major Capital Financial Policies and Guidelines.

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Attachments:

Appendix A – Capital Budget Definitions

Appendix B – Current City of Toronto Major Capital Financial Policies and Guidelines

Date: January 17, 2005

Appendix A: Capital Budget Definitions

Capital Assets are real or personal property that are acquired at values equal to or greater than \$50,000 and have an estimated useful life greater than one year. Capital assets include land and

land improvements, buildings and building improvements, infrastructure, leasehold improvements, furniture and equipment, vehicles, computers and computer software, and works of art.

For the City of Toronto, capital assets generally include any asset, which has been acquired, constructed or developed with the intention of being used on a continuous basis, and are not intended to be resold in the ordinary course of business. Capital assets also include improvements, the purpose of which is to alter or modernize an asset in order to appreciably prolong the useful life or improve functionality.

Capital Expenditures are incurred to develop, acquire, or improve land, buildings, engineering structures, machinery and equipment. Capital expenditures are included in the capital budget and funded from the capital fund.

For the City of Toronto, capital expenditures generally include any expenditure on an asset, which has been acquired, constructed or developed with the intention of being used on a continuous basis beyond the current budget year, and where the assets are not intended for sale in the ordinary course of business. Capital expenditures also include improvements, the purpose of which is to alter or modernize an asset in order to appreciably prolong its useful life or improve its physical output or service capacity. Capital expenditures are included in the capital budget and are financed from various sources of capital funds.

Capital from Current (CFC) represents funds allocated from current year revenues through a charge to the Operating Budget for the funding of capital projects in the Capital Budget.

Cash Flow for purposes of the capital budget, is a projection of cash inflows and outflows (receipts and disbursements) planned during the budget year.

Capital Project is comprised of expenditures for major rehabilitation, replacement and/or expansion of existing assets and infrastructure, and acquisition or creation of new capital assets. A capital project is a one-time activity with desired outcomes or end results and must bring benefit to the organization for one year or longer.

Carry-forward - A capital carry-forward project is a previously approved project where the planned capital work was not completed and its associated cash flow budget was not fully spent and / or committed in the year of approval and the total unspent amount, or a portion thereof, is required in future years in order to complete the project. In the context of cash flow commitments, carry-forward refers to the unspent amount that was approved in a preceding year and is required in the current year in order to proceed with or to complete a capital project.

Eligible Capital Costs include:

External

- Professional and technical fees for preliminary and final design, inspection and certification services
- Professional, legal and technical fees for the acquisition of land, permits and approvals, contract development and enforcement activities
- Construction
- Equipment acquisition

Internal

- Professional and technical staff time with respect to preliminary and final design, inspection and certification;
- Professional, legal and technical staff time with respect to land acquisition, permits and approvals, contract development and enforcement;
- Construction contract management; and,
- Vehicles and equipment costs directly used in construction activities.

Eligible capital cost does not include corporate and program administrative overhead, a meeting expenses, carrying charges (interest) during construction period, vehicle and equipment costs indirectly used in construction activities (e.g. construction supervisor vehicles).

Development Charges (DCs) are charges against new development for capital infrastructure set aside in an obligatory reserve fund per the Development Charges By-law. The objective is to minimize the cost burden of additional growth on existing taxpayers in the form of higher taxes or user fees.

Debt Financing are funds borrowed through debentures or other loan agreements to be repaid through principal and interest charges from the Operating Budget, in future fiscal periods.

Debt Service Cost is the amount required to pay the interest cost plus the principal payments, interest payments plus contributions to a sinking fund for the term of debentures.

Future Year Commitment refers to the future year spending plan associated with capital projects that are approved by Council as part of the capital budget. An approved multi-year project will have current year budget or spending authority and future year commitments, which reflect the future year cashflows for the project. Future year commitments are not the same as future year estimates: a commitment refers to the cash flow funding required for future years spending to complete the project beyond the current year in a multi-year project approved by Council.

Future year estimates refer to the cash flow associated with project or sub-project proposals included in years 2 to 10 of the capital plan – that is, the project has no current year spending requirement and has not been previously approved for spending.

Major Maintenance and Repair - Maintenance expenses are incurred to repair or maintain the pre-determined service potential of a tangible capital asset to the end of its original useful life. These expenses do not enhance the functionality, capacity, usability, and efficiency of the tangible capital asset. Such costs should be accounted for as an expense in the fiscal year in which they are incurred. However, given the nature of the City's infrastructure with its need for periodic large-

scale maintenance expenditures (such as the Gardiner Expressway), major maintenance projects are deemed to be capital expenditures. This allows for the funding of these significant maintenance projects to be allocated over several years.

Other Funding includes any available funding sources (that is not CFC, Reserve / Reserve Funds, Provincial and Federal Grants, Development Charges or Debt Financing), such as funding from Business Improvement Areas (BIAs), development contributions that are not included in development charges, donations, et cetera.

Reserve / Reserve Fund is an account comprising legally restricted fund equity set aside for a specific purpose and therefore is not available for general appropriation.

Appendix B: Current City of Toronto Major Capital Financial Policies and Guidelines

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Debt Affordability Targets	<p>The CFO recommends <u>debt affordability limits</u> to Council and allocates affordable targets to programs and ABCs as part of the administrative directions to staff to guide the preparation of the capital budget. The report to Council includes assumptions made to arrive at the debt affordability limits and the impact such limits will have on the City's credit rating.</p> <p>Annually, the City undertakes an affordability analysis to determine the amount of capital funds available for the capital budget and program. This review assesses the amount of non-debt funds available, and the amount of debt that the City can afford based on its long-term fiscal plan and numerous credit criteria as part of the capital financing strategy. Factors influencing the debt affordability determination include the cost of borrowing, policies on debenture / long term borrowing, the outstanding debt, the impact of borrowing on credit ratings and on the current account or operating budget.</p>
Capital from Current	<p>Capital from Current refers to the transfer of funds from the Current / Operating Fund to the Capital Fund in order to finance capital projects on a <i>pay as you go</i> basis. This financing option reduces reliance on debt issuance and provides a financing mechanism for ongoing capital needs.</p> <p>The Finance Department allocates CFC funding for capital projects based on eligibility criteria described below. To qualify, projects must satisfy one or more of the following:</p> <ul style="list-style-type: none"> ▪ Studies, structure audits and planning related to capital projects; ▪ One year stand alone state of good repair projects ▪ IT projects including equipment and software any ▪ Capital projects to acquire or develop capital assets that are not directly owned by the City. This includes capital projects under certain community development arrangements including BIA projects. <p>Capital projects funded from CFC must be scheduled for completion within the budget year in which they are approved.</p>
Carry Forward Policy	<p>Funds that are not committed in the year in which they were approved are automatically re-approved in the next year as <u>carry-forward funding</u>. The request is reported to Council as part of the capital budget (cash flow). In effect, the cash flow funding approval continues to exist for one fiscal year following the year in which the capital project was approved. If the carry-forward funding is not spent by the end of the second fiscal year, then the capital project funding request is treated as a new budget request and will for part of the affordability target.</p> <p>Carry-forward funding requests included in the capital budget submissions are normally based on projected actual expenditures. Therefore, during the EMT review, Programs and ABCs, in conjunction with the Financial Planning Division, is provided with an opportunity to update their carry-forward estimates. A final opportunity to adjust the carry-forward is provided prior to the conclusion of the Budget Advisory Committee Review of the Capital Budget.</p>
Financing of Capital Projects	<p>The City relies on a number of sources to fund its capital projects, capital budget and capital program. These include Reserves and Reserve Funds, Provincial and Federal Grants, Development Charges, Capital from Current (or pay-as-you-go) and Other (third party) Funding sources not listed above.</p> <p>Guiding principles that influence the selection of funding sources for specific capital projects include the <i>Equity</i> principle, which is aimed at ensuring that</p>

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	<p>beneficiaries or consumers of a capital project or service pay for it. In effect, if a project provides benefits to a specific group, then that group is made to pay for development of the capital asset through user fees. Projects that benefit the entire community are appropriately funded from property tax revenues.</p> <p>The <i>effective financing</i> principle focuses on ensuring that sufficient funds are available when needed to proceed with a capital project. This principle recognizes that required funds are not always available from the current account or (operating budget) to pay for capital projects. Therefore, the City must rely on other funding sources to generate the benefits required by its constituents.</p> <p>In selecting amongst available funding sources, the City imputes the cost of borrowing along with other administrative costs associated with competing funding options. It also examines the impact of funding options on the operating budget with a view toward ensuring, in accordance with the <i>efficiency</i> principle, that the most efficient funding source is used.</p>
Capital Project Costing and Expenditure Reporting	<p>The cost of capital project/sub-project will be budgeted in the Capital Budget and will include all costs directly attributable or incurred to acquire, manage, construct, develop and/or improve the capital asset.</p> <p>Salary and benefit costs incurred to produce a capital asset will be charged to an operating account. These salaries and benefits costs should be recovered from the appropriate capital project account on a monthly basis.</p> <p>All City employees will be accounted for in the approved staffing complement total in the annual operating budget.</p> <p>Project management costs must not exceed 10% of the gross cost of the capital project/sub-project to which they relate.</p>
Budgeting for Land Acquisition Costs	<p>Every proposed Capital sub-project requiring the acquisition of land will be accompanied by a separate cost estimate for the real estate acquisition portion of the sub-project.</p> <p>Every proposed Capital sub-project requiring the assignment of City owned land will be accompanied by a valuation of the opportunity cost of that land according to the procedures of the Property Management Committee.</p>
Budgeting for Information Technology Projects	<p>All capital projects for information and technology acquisitions must be submitted to the Contract Management Office of the Corporate Information and Technology Division for review. This is to ensure that technology acquisitions are properly justified and approved, tailored to user needs, meet corporate standards, and are purchased through a competitive process, and are subject to a corporate asset management process.</p> <p>Capital projects with City-wide information technology implications will be budgeted, justified and managed by the Corporate Information & Technology Division. Program-specific information technology projects will be budgeted, justified and managed by the appropriate Program staff, in consultation with and concurrence by the Corporate I&T Office to ensure consistency to corporate standards.</p>
Budget for Fleet & Equipment	<p>Program fleet replacement requirements will be submitted, as per a prescribed schedule, and evaluated during the annual budget process to determine whether they meet specific criteria for inclusion in the Capital Budget. Fleet Services will ensure that corporate standards and objectives are met; and Financial Planning and Corporate Finance will evaluate program fleet replacement requirement as part of the capital budget review process.</p>

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In-Year Changes	In-year changes to the published, Council approved capital budget will be coordinated through the Financial Planning Division. This coordination will consist of receipt of change documents, change data verification, data input and maintenance of change document master files.
Urgent Pre-approvals	<p>Programs / ABCs that have urgent requirements for funding may apply for pre-approval of a specific capital sub-project. A summary listing of sub-projects requiring pre-approval must be submitted including the CAPTOR Project name/number, Sub-Project name/number and amount requested for pre-approval. A business case justification is also required. The program area must demonstrate a proven need and provide a thorough justification to receive a Pre-Approval.</p> <p>In reviewing pre-approvals, priority will be given first to Health and Safety, and critical, on-going State of Good Repair projects. This process is not applicable to new projects, particularly those categorized as service enhancement and growth. Special consideration will be given on a case by case basis to projects which are urgent in nature and which require or take advantage of the following:</p> <ul style="list-style-type: none"> • Funding partnerships and cost sharing opportunities • Run the risk of missed financial opportunities
Closing Completed Projects	<p>Any capital project approved in a previous year for which cash flow forecast is not included in a subsequent capital budget will be considered to be completed and should be closed as soon as all outstanding payments are processed, commitments cleared and all funding is recorded.</p> <p>One calendar year after the completion of a project will be considered sufficient time to settle all outstanding payments and close the project. Any certain, documented liability, arising from litigation or claims, must be accrued and funded and the project locked pending finalization of the settlement.</p> <p>If additional liabilities, beyond what was accrued, are expected to occur as a result of litigation or claims, it may not be appropriate to reflect those expenditures in the capital forecasts. In such cases the Program Head must advise the Treasurer of the possibility of additional costs to the capital project, as outlined in the Financial Control By-law.</p> <p>The Treasurer, after consultation with the Program Heads / Agency, shall close any capital project / sub-project that is considered to be complete and fully funded and shall submit a report to Council during the quarterly variance report or during the budget process detailing all capital projects to be closed.</p>

