



Financing of Capital Assets in the Public Sector

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Introduction

This paper provides an overview of financing methods available for funding of capital assets in the BC public sector. It is intended to assist provincial public sector agencies (Agencies) including government ministries, Crown corporations and agencies, school districts, post secondary educational institutions and health care organizations, in the process of procurement and management of their capital assets. The purpose is to encourage the use of financing methods which minimise lifecycle costs of capital projects, and their impact on provincial taxpayer-supported debt while advancing the public interest.

1. Traditional Financing

The traditional methods of capital financing by the Province include the following:

- Direct funding for procurement of tangible capital assets by the Agencies.
- Prepaid Capital Advances (PCA) provided by government to eligible agencies primarily in the education, health care and transportation sectors.
- The Fiscal Agency Loan program for funding all other capital requirements of the Agencies.

These financing methods are discussed in greater detail below.

1.1. Direct Capital Funding

Direct funding includes government transfers, grants and contributions for the acquisition of tangible capital assets by the Agencies (e.g. Rapid Transit Project and the Vancouver Convention Centre Expansion Project). The cost of these acquisitions is not included in the operating budgets of the related organizations but is instead voted as one amount in the *Supply Act*. Capital appropriations and advances are financed through direct government borrowing in the capital markets.

Tangible capital assets are capitalized on the Province's financial statements and the cost is amortized over the useful life of the related asset. The annual amortization cost of tangible capital assets is included in the annual operating budgets of the related organizations. Tangible capital assets not related to a capitalized class of assets are expensed in the year incurred.

1.2 Prepaid Capital Advances (PCA)

PCA are provided to eligible agencies (as defined in section 56.1 of the *Financial Administration Act*) including school districts, universities, colleges and institutes, health care organizations (SUCH sector) and other designated government organizations for the acquisition of tangible capital assets. The Province has an on-going claim on the assets of these organizations to ensure their continued use for provincially funded public programs.

PCA are processed through an Electronic Fund Transfer. As part of the PCA process, agencies may be issued Certificates of Approval (COA) for specific projects, giving them the authority they need to receive funds and to draw down those funds to an established project limit.

Agencies that use the COA system should establish internal policies and procedures for its administration. These policies and procedures should accommodate local agencies' approval requirements, if applicable, particularly in

cases where legislation requires the agencies to pass bylaws before undertaking capital expenditures.

PCA are recorded on the Province's Consolidated Revenue Fund (CRF) as non-financial assets and amortized over the useful life of the underlying assets funded. PCA are financed through direct government debt.

The SUCH sector has been fully consolidated in the Province's financial statements, commencing in fiscal year 2004/05. As a result, PCA are under review to determine if they are still required for accounting, reporting and monitoring purposes.

1.3 Fiscal Agency Loan Program

Most public sector agency borrowing for capital needs is done through the Fiscal Agency Loan program, under which the Province borrows directly in the financial markets and re-lends the funds to agencies on matching terms. Examples include fiscal agency loans to British Columbia Hydro and Power Authority, and British Columbia Transportation Financing Authority. The program generally provides the most attractive financing terms because of the Province's strong credit rating and its ability to borrow at lower interest rates.

Under the program, responsibility for debt service payments rests with the borrowing agency. Fiscal agency loans, recoverable from sources other than government appropriations, are treated as financial assets on the Province's financial statements.

Given competing program demands for a limited capital budget, extending fiscal agency loans may not always be an appropriate use of the Province's credit for projects which can be financed through alternative sources. As a result, agencies undertaking such capital projects may be directed to obtain alternative financing for their projects.

2. Alternative Financing

Alternative financing refers to the use of innovative, non-traditional funding methods that may or may not add to the Province's debt and are structured with or without recourse to, or guarantees from, the Province.

Alternative financing is one component of alternative capital procurement (as discussed in detail in Section 8.4 of the Capital Asset Management Framework) which may deliver benefits such as:

- Mitigating and transferring project financial risks;
- Matching financing with capital requirements of the project;

- Asserting discipline imposed by the capital markets;
- Reducing demand for government funding and debt;
- Reducing fiscal pressures and supporting the Province's credit rating; and
- Supporting accelerated delivery of capital projects.

There is a broad range of alternative financing models with different corporate structures available to the provincial agencies or the private sector partners for funding of capital projects. These models vary with respect to the type and degree of financial control and risk transfer, resulting in various implications for financial accounting and debt reporting. Nevertheless, the selection of an appropriate financing model should not be based on desirable accounting outcomes, but rather on economic and business considerations including:

- Availability and reliability of separate identifiable revenue sources such as user fees, tolls and other non-taxpayer supported revenues sufficient to maintain the project on a self-supporting basis (Self-Supporting Projects).
- Availability and reliability of sufficient savings generated by the project (e.g. energy retrofit) to fully recover any incremental operating costs and debt service payments (Internal Payback Projects).
- Availability and reliability of other external, non-project related revenue sources such as endowments, donations, lotteries and other non-taxpayer supported revenues sufficient to support financing of the project.
- Ownership and control over revenues (collateral value, governance, price and demand risks).
- Ownership and type of assets (collateralization, specialized or multi-purpose, green field or mature).
- Potential sources of capital and the financial requirements of the project (capital structure).
- The business and financial risk profile of the project (competition, stability of cash flows, interest rate and currency risks).

The most common alternative financing models can be classified as follows:

2.1 Capital and Operating Leases

These transactions allow the public sector as the lessee to use an asset for a period of time in exchange for periodical or lump sum lease payments. The lease types differ primarily in their allocation of risk. In an operating lease, the lessor retains most of the risks and rewards of ownership. In a capital lease, the preponderance of the risks and rewards of ownership are transferred to the lessee. Under both capital and operating lease arrangements, the lessor has full recourse to the lessee for lease payments.

2.2 Financing through BC Immigrant Investment Fund

Since February 2006, a new capital financing program has been available to eligible provincial agencies through British Columbia Immigrant Investment Fund (BCIIF). Under this program, provincial agencies, including Crown corporations and the SUCH sector organizations may, subject to appropriate authorizations, finance eligible capital projects at competitive terms. In general, non-taxpayer supported capital projects with incremental regional economic development impact and job creation are eligible for funding through the program.

The BCIIF program is funded through provincial allocations under the federal Immigrant Investor Program (IPP) with repayments fully guaranteed by the Province. BCIIF is fully consolidated on the provincial financial statements. As a result, financing by the eligible institutions under the program will not have an impact on provincial tax-supported debt.

2.3 Borrowing by the Agencies in the Financial Markets

Provincial agencies may, subject to appropriate government authorization, finance their capital projects through private sources. The financing may be arranged through financial institutions or the capital markets for Self-Supporting and Internal Payback Projects or any other capital project, which is supported, at least in part, by external (non taxpayer-supported) revenues.

Self-Supporting Projects rely on identifiable non-tax-supported revenue sources (user fees, tolls) to cover their operating expenditures, capital maintenance costs and debt service payments (e.g. student residences, parking lots and toll roads). At minimum, these projects should demonstrate a sustainable positive net income (after deducting depreciation) and a debt service coverage ratio (free cash flow/debt service) of one-to-one for the past three consecutive fiscal years and/or the life of the project on a pro-forma basis.

Internal Payback Projects generate sufficient cost savings to fully cover debt service payments and any incremental operating costs without any increase in annual government grant or subsidy payments (e.g. energy efficiency retrofit projects for institutional buildings). These projects should demonstrate a positive net present value for cost savings generated over the useful life of the project, on a pro-forma basis.

A listing of the most common financing models includes:

- Project financing where investors' recourse is limited to the cash flows and assets of the project only;

- Securitization, a sub-set of the project financing model where the lender's recourse is limited to a dedicated revenue stream (e.g. tolls, levies, fares, tariffs, rentals, charges) generated by the project;
- Direct Borrowing by the provincial agency on its own credit where the lender's recourse extends to the borrowing agency as its general obligations.
- Pooled Financing where the financing requirements of several projects are pooled together and financed through a special purpose vehicle. This may deliver lower borrowing and transaction costs, greater liquidity and more cost effective access to the capital markets; and
- Any combination of the above models with provincial guarantee supporting the debt.

2.4 Private Financing by the Private Sector Partners

Capital projects may be financed by the private sector partner under certain types of alternative capital assets procurement contracts, whereby a provincial agency enters into an agreement with the private sector "project company" for the design, construction, financing and/or the operation of the project typically under a long term concession contract. The contractual arrangements include partnerships and joint ventures, public-private partnerships (PPP) with a broad range of corporate structures from special-purpose project companies that issue limited recourse debt (according to contractual arrangements under a public-private partnership) to stand-alone corporate entities that incur general obligation debt in their own names. A listing of the most common financing models is summarized below:

- Project financing whereby the project company, operating in a single line of business, issues a finite amount of financing on inception, in the form of equity and debt, and provides the lenders a security over the specific assets that generate cash flows as the sole source of debt service payments. Project financing is usually arranged through Special Purpose Vehicles (SPV) with the following corporate and governance structures:
 1. Single purpose corporations;
 2. Bankruptcy remote corporations including non-share capital corporations and non-profit organizations (Authorities);
 3. Income Trusts; and
 4. Partnerships and joint ventures.
- Securitization is a project financing instrument for funding of income producing projects, whereby the lender security is limited to the net revenues

of the project. When revenues are generated through the sale of goods or services to public buyers outside the government reporting entity (e.g. tolls), financing may be arranged by securitizing the revenue stream in the capital markets with no recourse to the sponsoring provincial agency.

When the provincial agency is the main purchaser of goods and services generated by the project, payments made by the government under purchase agreements or service payments are used to securitize financing.

The government may also provide loan guarantees, thereby reducing the financing risk to the private sector partner, or guarantee minimum payments, thereby reducing demand or performance risks of the project to the creditors.

Some of the key incentives for provincial agencies in using private financing models include:

1. No requirement for significant up-front capital outlays to fund the project;
2. Transfer of risks to the private sector via the project company, most notably the risks of cost and time overruns in completion of public facilities and lifecycle costing risks (operating and capital maintenance); and
3. Potential off-balance-sheet financing for the government, given the limited recourse of debt to the project company.

It should be noted that due to the single purpose of the projects, private financing arranged by SPVs may not achieve the same level of credit rating as the sponsoring provincial agency. This typically reflects construction risk (in most cases), the highly leveraged capital structure, thin senior debt service coverage ratios, and uncertainty respecting future capital maintenance and lifecycle costs of the project. As a result, there is a premium in the cost of financing for a project bearing the above noted risks when it carries no explicit government guarantee or direct recourse to government financial support.

Agencies are required to consult with Provincial Treasury, Ministry of Finance, prior to embarking on alternative financing initiatives.

Agencies are required to consult with Provincial Treasury, Ministry of Finance, prior to embarking on alternative financing initiatives. Provincial Treasury can provide:

- financial advisory services (support in developing business cases, deal structures, financial projections, discount rates, debt and funding models); and
- financing transaction services (support in engaging financial advisors, placement agents, credit rating agencies, borrowing in the capital markets and from financial institutions).

These services support a co-ordinated, streamlined approach that allows competitive engagement, and effective liaison among financial service providers,

investors, government and clients. Furthermore, Provincial Treasury can help to ensure lowest cost service delivery by leveraging the Province's relationship with the financial community.

3 Classification of Debt under the Fiscal Plan

For the purpose of the Province's Fiscal Plan, the debt of capital projects is classified into three categories:

- taxpayer-supported
- self-supported, and
- off-credit.

Each of these categories is discussed below, along with the criteria Treasury Board uses to determine the different classifications. These criteria parallel those applied by a major U.S. credit rating agency.

3.1 Taxpayer-Supported Debt

Taxpayer-supported debt includes direct debt incurred for government operating and capital purposes (direct capital funding and PCA); government guaranteed loans to individuals and entities outside the government reporting entity (GRE); debt of tax-supported Crown corporations and agencies and the SUCH sector (recourse or non-recourse); and guaranteed debt of tax-supported Crown corporations and agencies and the SUCH sector. These entities require an operating or debt service subsidy from the provincial government and are fully consolidated in the Summary Financial Statements.

3.2 Self-Supported Debt

Self-supporting debt includes the debt of commercial Crown corporations and agencies (including fiscal agency loans and guaranteed debt). These entities are owned and controlled by the Province but fully fund their operations and debt from revenues generated through the sale of goods and/or services to buyers that are outside the GRE. Commercial Crown corporations and agencies are consolidated in the Summary Financial Statements on the modified equity basis. Self-supported debt also includes debt incurred under the warehouse program, which takes advantage of borrowing opportunities in advance of requirements.

3.3 Off-Credit Financing

Off-credit financing refers to the borrowing and other types of alternative financing which do not create a legal obligation for debt service payments on behalf of the Province. As a result these types of debt are recorded as neither taxpayer-supported nor self-supporting debt. Examples include:

- operating leases as designated by the lessee's auditor, whether or not they are government guaranteed;
- alternative financing and debt of capital projects provided that:
 - a) the project is owned and controlled by an organization which is outside the GRE;
 - b) the debt recourse is limited to the project and/or the non-government reporting entity sponsoring the project;
 - c) there are no dedicated grants or subsidy payments from the government to the project or the non-government entity sponsoring the project for debt service payments; and
 - d) The Office of Controller General confirm that the substance of the business relationship between the Province and the project support off-credit treatment.