PORT LANDS ACCELERATION INITIATIVE

Appendix 4
Port Lands Business Plan Peer Review

Photo of Ship Channel by loozryloy (Flickr)

TORONTO

WATERFRONToronto

TORONTO AND REGION Conservation for The Living City

PORT LANDS BUSINESS PLAN
PEER REVIEW

HEMSON Consulting Ltd.

August 27, 2012

TABLE OF CONTENTS

I BACKGROUND AND INTRODUCTION

The City of Toronto, Waterfront Toronto, and Toronto Region and Conservation Authority are in the process of developing a Business Plan for the development of the Port Lands which is an underutilized mainly industrial area. The area represents a substantial opportunity. It is extremely large and could accommodate a significant share of the City's growth for several decades. It has an attractive location close to the core with frontage onto the port and has nearby access to the expressway road system. Balanced against these advantages are a number of factors that will make development very challenging. The area was formed by filling a former marshy area at the mouth of the Don River. As a result the area (as well as land north of the Port Lands) is at risk from flooding and has less than ideal soil conditions. Existing infrastructure is inadequate to support intensive use of the Port Lands and a very substantial investment in water, sewer, roads and bridge facilities will be needed. A flood protection system is essential. Public transit service is currently very limited and will need to be improved to make the area appealing to new users.

Planning for the area of the Lower Don Lands has been underway for some time. A substantial amount of work has been undertaken in connection with the flood protection requirements and ways in which they could be phased. Analysis of the development capacity, mix, and market demand has been undertaken at a precinct level. More recently the City, Waterfront Toronto, and Toronto Region and Conservation Authority have embarked on the preparation of a business plan. It is intended to serve as the basis for a decision to move forward into the implementation phase.

In preparing the Plan a number of supporting studies have been undertaken. They have examined various aspects including stakeholder opinions and potential ways of financing infrastructure including Local Area Development Charges. Waterfront Toronto undertook the preparation of an overall estimate of the costs and potential timing of the general and local infrastructure requirements to support the proposed development. A key component of the business planning work is the preparation by Cushman and Wakefield (C&W) of a development demand and revenue forecast. This forecast is used in a long-term Revenue and Expenditure model that was also prepared by C&W. The model evaluates the development potential of the Port Lands from the perspective of a Master Developer with the results being expressed in terms of Net Present Value and calculated using Discounted Cash Flow.

The report that follows has been prepared in response to Council's request that a peer review be incorporated into the business planning process. The executive style report focuses on the Master Developer financial model and the inputs and assumptions that underlie it. As part of the review, additional analysis of alternative approaches to the use of Development Charges for funding infrastructure requirements was also undertaken. It is to be noted that the review did not involve additional investigations of market absorption rates or land values as these factors are addressed in a separate report by N. Barry Lyon and Associates Ltd.

II REVIEW OF THE FINANCIAL MODEL APPROACH, INPUTS AND ASSUMPTIONS

This section starts with a discussion of the approach to the financial model prepared by C&W. This is followed by a review of the revenue and expenditure inputs that were used in the model and then by a commentary regarding the assumptions.

A. APPROACH TO THE MODEL

- The financial model examines the Port Lands development from the perspective of a master developer of the lands. Under this approach it is implied that all revenues and expenses associated with servicing the area to enable development to occur and for sites to be sold are pooled. It does not consider financial aspects of developments that will be built on individual serviced parcels.

- The approach, while practical given the scale, complexity and timeframe of the overall development, does not reflect the actual situation.

- The City has the largest role to play in terms of servicing responsibilities and land ownership but it does not have full control of the development. As such the model is based on an idealized situation which may not occur as projected if other landowners choose to follow different routes than is anticipated under the master developer model.

- For example, some existing users may decide to remain in place for an extended period. Such decisions could alter the rate of development which in turn would affect the cost recovery assumptions built into the model.

- At the same time, it is inevitable that over the 30 year plus time horizon of the model many changes, both external and internal to the Port Lands, will occur and which will necessitate revisions to the overall plan. Accordingly, a key requirement for the business plan is that in addition to a long term perspective, it incorporate shorter term elements that can be adjusted to suit changing circumstances especially shifts in market demands but also in response to plans and decisions of other stakeholders.

- Given the nature of the proposed Port Lands development, overall, the approach that has been taken is reasonable.

B. INPUTS

1. Expenditures

- The expenditures that are considered in the model relate to the cost of constructing the infrastructure that is necessary to enable the Port Lands to be developed with the uses contemplated by the master land use plan for the area.

- The bulk of the expenditures ($1.33 billion) relate to major infrastructure that is regarded as the responsibility of the City. The remaining expenditures ($504 million) are for local infrastructure. These costs are assumed to be the responsibility of the developers of the individual blocks of land under the terms of their development agreements.

- The magnitude of the costs is such that few private development companies would be willing or financially capable of undertaking the project particularly given its very long term nature. Financial support from the government would be required to spark interest from the private sector.

- The cost estimates were provided by Waterfront Toronto. The costs were estimated by utilizing benchmark costs, rather than any level of design detailing. The costs are considered to be high level.

- We are not able to comment on the estimates themselves. However the approach to preparing them is in keeping with that usually employed in financial planning exercises undertaken at this stage in the process.

- The detailed level of understanding of the flood protection needs and phasing potential is beneficial in terms of risk as this element represents a particularly significant share of the overall costs for infrastructure.

- It is recommended that frequent testing of cost estimates for all elements be undertaken as the project progresses given that the fill conditions of the Port Lands area make cost estimation more difficult than usual.

- Overall it cannot be overstated how important the need for and cost of infrastructure are to the Port Lands development. Without the level of municipal services that the new infrastructure will provide the development cannot be undertaken. However unless costs are carefully monitored and, ideally, kept below current estimates the financial feasibility of the project could be seriously affected.

2. Revenues

- For the purposes of the main long-term cash flow projection and Present Value calculation the C&W model takes account of revenues from two sources: sales of development sites and development charges.

- The model also provides supplemental estimates of revenues from property taxes and land transfer taxes. These revenues are not considered as part of the main analysis but are discussed in C&W's accompanying report.

- This section discusses the basis for C&W's estimate of revenues from land sales. Development Charges are addressed in Section III.

- Land sales revenues are considered according to four land use categories: Residential, Office, Retail and Hotel. For each land use C&W provided low, medium and high estimates of potential absorption. An accelerated forecast taking account of the effect of a "catalytic" project was also provided. Land sales revenue estimates were based on C&W's assessment of what developers of the various uses would be prepared to pay for sites in the Port Lands taking account of current land prices elsewhere.

a) Residential

- C&W anticipate that the Port Lands will be a strong draw for residential condominium development particularly as other large scale sites (Liberty Village and the new Canary District) become fully absorbed.

- The case for residential development in the Port Lands is compelling:

  - It has a central location; and

  - The waterfront will become increasingly desirable as other sites, particularly the East Bayfront become developed. There is no other area in the city that has the scale to provide sites for several decades.

- The Stakeholder sounding work undertaken by Price Waterhouse Coopers (PWC) which included input from developers was very supportive of residential uses.

- The key factors that could detract from the positive outlook or at least slow down absorption are:

  - A major reversal in the condominium market;

  - Failure to provide the level of transit that the market anticipates; and

  - Loss of confidence on part of the development industry in the City's commitment to delivery of the required infrastructure.

- The land price assumptions in our view are reasonable given the sale price information that was relied upon and the rationale provided. As noted previously no additional research was undertaken regarding this aspect.

b) Office

- C&W provided a detailed projection and rationale for office demand in the Port Lands. It was based on the expectation that the area could attract a share of the office market that is currently being served by sites in the "905" region. It also anticipates that the area could attract office users from less central locations in Toronto.

- The C&W modelling was premised on the assumption that sufficient transit to support the office market would be constructed in the initial phases of the Port Lands development. Because of the importance of transit to the potential success of office development it will be crucial that the City demonstrate a clear and sustained commitment to the investment that will be required.

- In our view the rationale for the Port Lands becoming a significant location for auto-oriented office users is speculative in nature. The long established trend of auto-oriented office users continuing to move outwards from the centre has shown no signs of reversal.

- The developers consulted by PWC were of the view that offices to support other Port Lands land uses would have a market. They did not however suggest that there would be demand for offices aimed at a broader market.

- In our view, if the area is to succeed as an office location it must provide a sufficiently high level of transit service to become attractive as a hybrid office location that appeals to organizations with both employees who are City residents and those who live in the suburbs and who commute by automobile.

- Assuming that demand is manifested, the land price for office sites used by C&W appears reasonable. It is to be noted that the rate per square foot of development density used in the C&W model is lower than for residential uses ($25 psf vs $40 psf). Should uses be changed in the future and the price difference persist a positive financial outcome would likely result.

c) Retail

- In our view the potential for retail uses in the Port Lands is likely greater than is contemplated in the land use plan for the Port Lands. There has been developer interest in undertaking retail projects in the area for a long time. As well, as development occurs in the Port Lands area retail spending by new residents and employees will drive demand for retail space.

- C&W's land price estimate for retail uses is reasonable.

d) Hotel

- Proposed hotel uses represent a small component of the overall plan for the Port Lands. While currently not a viable location as and when the area "takes off" there is reason to expect that demand would develop for hotel rooms, particularly if sites have good views of the harbour and the downtown skyline.

- While the C&W projections of demand and land price are probably reasonable, the use is nevertheless speculative since the Port Lands area is not an obvious location for hotels. Accordingly achievement of the projected result depends to a large degree on the success of other Port Lands developments.

C. GENERAL ASSUMPTIONS

- The C&W financial model incorporates a number of important general assumptions in addition to those discussed previously. We consider they are generally reasonable and appropriate. Some however warrant specific comment.

- Land owned by the City but leased on a long-term basis is assumed to generate land sale revenues at a rate of 50% of the price of freehold land. The assumption is that because tenants would require lease amendments in order to develop, the City would be able to obtain 50% of the development value as payment for granting amendments. While this approach appears to be a reasonably logical amount, no specific evidence that it would occur in practice was provided. This is not an unimportant issue since a significant component of the City's land holdings fall into this category.

- While the C&W report explicitly cautions that the Port Lands may be subject to extraordinary costs (relating to geotechnical soil conditions or environment contamination), no information was given relating to the quantum of the costs, as insufficient information was available at the time of the release of the report. As such, no adjustment was made to the land prices. We would recommend that because of the nature of the area and the previous uses investigations should be undertaken to attempt to quantify the costs relating to the environment conditions of the land. If adverse conditions are prevalent the revenue projection of land sale revenues would likely be affected.

- Inflation and discount rates have a significant effect on the results of discounted cash flow projections. In the C&W model, a basic revenue and cost inflation factor of 3% has been adopted. We agree with this choice but would note that it reflects current conditions which are atypical compared to long term experience. Over the projection period it is to be expected that inflation rates will rise. By the same token, rates of return expected by developers should also be expected to rise.

- The land sales revenue forecast incorporates additional 10 % price rises beyond the inflation gain at years 7, 10, 13, and 15 to reflect the anticipated overall improvement in the appeal of the area as it gains market traction. In our view, while it is difficult to estimate how large this effect would be, the allowance is reasonable.

- C&W adopted a discount rate of 10% for calculating the present value of the projected cash flows. This rate is intended to represent the return that an investor in the project would expect to earn. Given the nature of the project, the purpose for which the projection is being prepared and its long term nature this rate is considered appropriate.

III DEVELOPMENT CHARGES

Development Charges (DCs) are a key source of revenue for the City to pay for the cost of infrastructure required to service growth. The City's current DCs are calculated and applied on a City-wide basis.

In the financial planning work for the Port Lands development that has been conducted to date DCs have been identified as a crucial source of revenue. However rather than treating the required Port Lands infrastructure in the same way as other growth related projects and incorporating them into the City -wide DCs, the model employs a Port Lands Area Specific Development Charge (ASDC). Under this approach the costs of eligible Port Lands infrastructure would be paid for by ASDCs applied only to development in the Port Lands area. The ASDC rates that the C&W model applies to the projected development were developed by Watson and Associates. The report that discusses the approach and the calculations is reviewed in this section.

As part of our Peer Review work we were requested to examine the feasibility and implications of adopting the City-wide approach rather than an ASDC to fund the infrastructure. This approach is also discussed in this section.

A. COMMENTS REGARDING WATSON AND ASSOCIATES REPORT

- While generally the report adopts a reasonable approach to the calculation of ASDCs, there are a number of comments that we would make regarding the estimate of ASDC revenue that could be generated by the City.

  - The cost summary on page 2 and detailed on Table 1 appear to be the infrastructure costs for years 0 to 20. This is inconsistent with the C&W Business Case Report and the Scotiabank Report which includes costs for year 20 and beyond.

  - Financing costs have not been included in the analysis which could be significant given the planning horizons.

  - The analysis includes infrastructure projects for precincts A, E1, E3, and F. The calculations use the development capacity of these precincts, and also precinct G in determining the DC rates. We find this approach agreeable since Precinct G will benefit from the works constructed in precincts A, E1, E3, and F.

- The Watson report comments upon the City's DC policy with respective to non-statutory exemptions, whereby the charge is only applied against the area of the ground floor of commercial development. The analysis assumes that this policy would not apply to an area-specific DC for the Port Lands.

- The analysis applies a 25% deduction to the "hard" services to account for the benefit to existing share. We would agree that a share needs to removed from the calculations to account for existing development.

- The report summarizes the City's current policy regarding the allocation of DC revenues to development-related projects. It explains that DC funding for projects is assigned on a "first come first serve" basis, and that there is no direct link between the location of where the DCs are collected, and where the DC revenues are spent. Given this approach the report suggests by using the alternative ASDC approach the flow of DC revenues to fund infrastructure projects for the Port Lands area would be more secure.

- While this argument is logical it does not take account of the likelihood that the flow of development in the Port Lands will be more irregular than in the City as a whole and that ASDC revenues would be affected in the same way. As well it does not consider the financial implications of the comparatively high cost of servicing the Port Lands. Because of the high costs ASDC rates are also high.

B. COMMENTS REGARDING USE OF CITY-WIDE VS. AREA SPECIFIC APPROACH

- While current financial planning for the Port Lands development has been undertaken on the basis that an ASDC approach will be used, in our opinion there is no reason why the City-wide approach could not be used for most elements of the infrastructure.

- There are however some of the infrastructure projects particularly relating to flood protection for which there is a strong argument that the benefit will be limited to properties located within the flood protection zone. For these projects an ASDC is arguably more appropriate.

- In accordance with the request to examine the implications of using a City-wide rather than a Port Lands area specific approach a high-level analysis was undertaken. The results of this are reflected in the City's staff report.

- In undertaking the analysis, flood protection infrastructure projects that would be inappropriate to include in City-wide charges were identified. It was determined that $52.8 million of flood protection works should be recovered through an area-specific basis.

- It should be noted that in our analysis, we included the flood protection works, which differs from the approach in the Watson and Associates report. These projects were deemed to be eligible for recovery through development charges, on a City-wide basis.

- Another notable difference in our analysis includes the deduction for service level increases relating to the general services of Transit. The Watson report does take a deduction to account for a service level increase with respect to Public Realm projects.

- Of the remaining infrastructure projects that could be funded by City-wide charges, $247.7 million was judged ineligible for DC recovery. This included:

    - $222.3 million in service level increase for Transit and Public Realm works;

    - $7.7 million for the statutory 10% discount for the "soft services" of Transit and Public Realm; and

    - $18.7 million to account for benefit to existing for some flood protection works.

- Of the $654.3 million in Port Lands major infrastructure projects addressed in the financial plan, a maximum of $406.6 million could be recovered through DCs after deducting the non-eligible components.

- The amount noted above does not include the works slated for precinct A, as they were subsequently removed in the development scenario. As such, the corresponding growth for precinct A has also been removed.

- The infrastructure costs for precincts E2 and E4 have been removed as these areas will be built out after year 30.This is consistent with the Watson and Associates analysis and the C&W model.

- The DC eligible component was analyzed under three cash flow scenarios, all over a 60-year build out time horizon:

    1. Scenario 1 — Recover the maximum DC eligible amount ($406.6 million)

2. Scenario 2 — The maximum DC eligible amount, less the non-residential exemptions ($308.5 million)

3. Scenario 3 — The maximum DC eligible amount, less the non-residential exemptions, less the 10% "basic discount" ($267.8 million)

- In each scenario, the cash flow analysis shows that strictly in relation to the Port Lands related infrastructure projects there would be a positive closing cash balance position up until year 13. This is due to the fact that the large expenditures are projected to occur between years 10 and 20. This results in a negative fiscal position until the last year of the cash flow analysis, year 60. As a consequence ways would need to be found to finance this long term shortfall recognizing the City's debt capacity constraints.

IV BROAD IMPACTS OF THE PORT LANDS DEVELOPMENT

This section addresses two issues which have been raised regarding the potential financial impact on the City of the proposed Port Lands development:

- The degree to which development in the Port Lands would represent growth that "but for" the investment in infrastructure would not occur in Toronto.

- To what extent could it be anticipated that property taxes generated from development in the Port Lands would exceed the cost of providing services to the new development.

A. AMOUNT REPRESENTING "ADDITIONAL" GROWTH WOULD VARY BY USE

- There is no clear way to identify how much of the potential Port Lands development would be a displacement of growth from other parts of the City or how much would be as a result of it being attracted from elsewhere. In our opinion the likely outcome will vary depending upon the use. This view is in keeping the opinion of C&W contained in their Memorandum "Port Lands Development Impacts on Existing and Future Development Elsewhere in the City of Toronto".

- Residential

  We are of the view that for the most part the residential component would be a displacement of development from elsewhere in the City. However because of the exceptional quality of the sites with direct harbour views it is reasonable to assume that some additional growth would be drawn in. While no specific amount is estimated we would suggest that it would not exceed 10%.

- Office

  Given the very different character of the proposed office areas in the Port Lands compared to existing office locations elsewhere in the City, in our view it reasonable to assume that the Port Lands would, to a substantial degree, have to attract development that would otherwise locate elsewhere in the GTA. It is an assumption of business plan for the Port Lands that the area will compete successfully for a share of the regional auto-oriented office market. If as successful as C&W assumes the additional growth would likely be in the order of 50%. If however this scenario is not achieved displaced City growth would be the prime source of office uses.

- Retail

  Retail development in the Port Lands would, we anticipate, largely be the result of displacement from elsewhere in the City. However to the extent that additional residential and office growth is achieved the retail space built to serve its residents and employees would also be "additional" growth that would not otherwise occur in the City.

B. POTENTIAL SURPLUS FROM PROPERTY TAX REVENUES IS LIKELY TO BE LIMITED

- As a basic assumption it is our view that given the scale of the Port Lands development, the ongoing annual costs of providing municipal services to the area, use by use, are unlikely to be lower than the City's average cost. The area does not possess any obvious advantages in terms of its ability to be serviced more efficiently than other parts of the City. Accordingly no "surplus" could be anticipated from the development that is displaced from elsewhere in the City.

- With regard to "additional" development that is attracted to the City, non-residential uses could be expected to generate a revenue surplus. However the surplus would be offset by the amount by which the costs of providing services to "additional" residential units exceeds the revenues the units generate. These units will likely have high assessed values than other more typical units thus generating higher than average taxes.

V CONCLUSIONS

This report provides a peer review of the financial planning aspects of the overall business plan for the proposed Port Lands development. It focusses on the financial model and supporting report prepared by Cushman and Wakefield. As requested additional analysis was undertaken with respect to the possible use of City-wide Development Charges to fund infrastructure project costs rather than area-specific charges that are contemplated in the financial model. Following are the main conclusions that have drawn from the review and analysis.

- Overall Approach

  The overall approach to the financial analysis undertaken by C&W is in our opinion appropriate given the purpose for which it has been prepared. With some qualifications, we consider the inputs and assumptions reasonable.

- Financial Model Perspective

  The financial model has been undertaken which emphasizes the perspective of a Master Developer. This does not reflect the reality that the City does not have full control of the development and is dependent to a significant extent on the decisions of other landowners.

- Expenditure Estimates

  We are not qualified to comment on the estimates of project costs. We would note that since the costs of infrastructure specific to the Port Lands have a high bearing on the outcome, the estimates should be reviewed and refined frequently as the project proceeds through the planning and implementation process.

- Land Absorption and Sales Revenue Estimates

  The rationales on which the estimates of absorption are based upon are considered reasonable with the exception of that for office development. In our view the location of the Port Lands has limited appeal for City office space users. The provision of reliable and frequent transit service will be important if this perception is to be changed. Attracting a share of the auto-oriented suburban office market, which is a key assumption in the C&W model, will be a significant challenge.

- General Assumptions

  While most of the general assumptions used in the model are reasonable and appropriate to warrant comment. The model assumes that for lands owned by the City but leased on a long term basis the City will be able to obtain payment from tenants equivalent to 50% of the land value in exchange for permitting tenants to develop. As revenues of this type are an important component of the model this assumption warrants further validation.

- Development Charges

  With some qualifications the ASDC estimates used in the C&W model are considered reasonable. Alternatively we are of the view that a City-wide DC approach could be used to fund most infrastructure projects in the Port Lands. Some components of the required flood protection works would arguably be better dealt with through an ASDC applied across the whole flood protection zone.

- Net Impacts of the Port Lands Development

  With respect the impacts on overall growth in the City we agree with the estimates made by C&W with the qualification that the estimate for office development is, in our view, speculative.

From an annual operating perspective there is no evident reason to expect that, on a use by use basis, development of the Port Lands would generate a fiscal surplus.