City of Richmond

Report to Committee

To:	Finance Select Committee	Date:	June 27, 2002
From:	Andrew Nazareth Manager - Budgets & Accounting	File:	0780-01
Re:	**RFP for Sale and Leaseback Agreement for vehicle fleet**		

To Finance Select - July 25/02

Staff Recommendation

That the Purchasing department be directed to issue a Request For Proposal for a sale and leaseback agreement for the vehicle fleet (as described in the report dated June 27, 2002 from the Fleet Management and Budgets & Accounting departments) and report back to Committee with a recommendation.

Andrew Nazareth
Manager - Budgets & Accounting

Ken Fryer
Manager – Fleet Management

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Staff Report

Origin

There is a potential crisis with the Equipment Replacement Statutory Reserve based on the current rate of depletion of this reserve. In particular, the Public Works Vehicle Reserve which is a part of the Equipment Replacement Statutory Reserve has been declining at the rate of $800,000 per year. This will result in complete exhaustion of the reserve by the year 2006. As a result of this impending crisis, TAG and the Finance department have been evaluating alternative strategies with a goal of bolstering the reserve, improving cash flow, minimizing tax impact and ensuring the timely renewal of the vehicle fleet in order to meet the demands of the City's operations.

Analysis

The City currently incurs approximately $2.0 million per year in vehicle acquisition costs for fleet renewal and this is financed by the Public Works Vehicle Reserve with an existing balance of $3.1 million. In turn, this reserve is funded by a $1.2 million annual contribution from the operating budget. At these levels of usage and funding it will only take another four years to completely deplete the reserve.

There are a number of options that we have analyzed in order to deal with this impending crisis:

OPTION 1 - Extend the useful life of the existing vehicles

The Fleet Management department is already doing this as we attempt to defer the replacements beyond a 10 year (trigger point) life cycle as opposed to the industry average of 7 years. With this initiative also comes the increased costs of maintenance and reliability, thus, attempting to extend well beyond a 10 year life will increase the risks and may result in costs that outweigh any potential benefits. Therefore, this is not an option we wish to pursue.

OPTION 2 – Improve fleet utilization

The Fleet Management department do this on an ongoing basis to ensure that we are optimally utilizing the fleet through less down time (parked vehicles) and more effective use. They are achieving some success through increasing the number of trailers for carrying of equipment and thus not tying up a motorized vehicle all day. However, there is a limit as you reach a point whereby the increased staffing requirement for drivers to keep repositioning vehicles and picking-up/dropping off crews outweighs the vehicle capital cost savings achieved. As this is an ongoing fleet management initiative we cannot solely rely on this option to resolve our dilemma.

OPTION 3 – MFA or Bank Loan to bridge the shortfall

This is only a stop gap measure. Our analysis has shown that while this option will initially provide some cash relief it will hurt us in the long-run resulting in a tax increase of 2.0% to keep up with the repayments of the principal and interest (see Appendix I). Therefore, this is not an option we wish to pursue.

OPTION 4 – Vehicle Purchase recorded as an Operating Expense

Rather than funding a reserve and then purchasing the vehicles with funds from the reserve we could charge the cost of purchasing the vehicles as an operating expense which would translate to a direct charge against the tax draw. Concurrently, we could retain a fixed $2 million in the reserve to earn interest revenue which can then be used toward keeping up with inflation and thus not having to raise taxes in future years. Our analysis shows that while this is a feasible option it does result in a tax increase of 0.7% (see Appendix II).

OPTION 5 – Sale and Leaseback Agreement

This option involves selling the vehicle fleet to a third party for cash and in turn leasing the fleet back from them over a 5 year term. The current market has sale/leaseback rates ranging from 3.25% to 5.50%. This means that we could leverage a rate of return greater than the lease interest cost based on the present return on our investment portfolio. If we were to sell our light vehicle fleet alone we would receive over $5.3 million in cash which could then be reinvested at over 5% or utilized for the acquisition of other assets. As well, this option results in no impact to taxes (see Appendix III).

Note: None of the options listed above impact the bi-weekly rates currently used in the Operating Budget to chargeback departments for the use of the vehicles. In addition to depreciation these rates are largely dependant upon labour rates, licensing fees, insurance, maintenance and fuel costs and will therefore adjust according to the market rates for the above mentioned items.

Financial Impact

The financial benefits of a sale and leaseback agreement for the vehicle fleet are as follows:

(i) Receive $5.3 million cash up front that can be either reinvested or utilized for the acquisition of other assets.

(ii) No tax impact.

(iii) Positive Net Present Value (NPV) cash flow of $6.5 million.

Conclusion

Based on the above analysis we recommend that the Purchasing department be directed to issue a Request For Proposal for a sale and leaseback agreement for the vehicle fleet and report back to Committee with a recommendation.

Andrew Nazareth
Manager - Budgets & Accounting

Ken Fryer
Manager - Fleet Management

APPENDIX I

Cash Flow & Internal Rate of Return Projections
MFA or Bank Loan - OPTION 3

Total Capital Investment:	$0
Contract Term:	5

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	Total
REVENUE (or SAVINGS)						
Loan (@6%)	$ 6,000,000	$ -	$ -	$ -	$ -	$ 6,000,000
Transfer to Reserves saving	$ 1,164,500	$ 1,164,500	$ 1,331,000	$ 1,597,000	$ 1,830,000	$ 7,087,000
Interest Revenue (@5%)	$ 150,000	$ 307,500	$ 322,875	$ 339,019	$ 355,970	$ 1,475,363
TOTAL REVENUE	$ 7,314,500	$ 1,472,000	$ 1,653,875	$ 1,936,019	$ 2,185,970	$ 14,562,363
EXPENSES (ADDITIONAL)						
Loan Repayments	$ (1,424,378)	$ (1,424,378)	$ (1,424,378)	$ (1,424,378)	$ (1,424,378)	$ (7,121,890)
Purchase of vehicles	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (10,000,000)
	$ -	$ -	$ -	$ -	$ -	$ -
TOTAL EXPENSES	$ (3,424,378)	$ (3,424,378)	$ (3,424,378)	$ (3,424,378)	$ (3,424,378)	$ (17,121,890)
Net Expenses	$ 3,890,122	$ (1,952,378)	$ (1,770,503)	$ (1,488,359)	$ (1,238,408)	$ (2,559,527)
Cash Flow (tax draw)	$ 3,890,122	$ (1,952,378)	$ (1,770,503)	$ (1,488,359)	$ (1,238,408)	$ (2,559,527)
Tax % over current rates	3.9%	-2.0%	-1.8%	-1.5%	-1.2%	

Internal Rate of Return	**0.0%**
NPV Cash Flow	**($1,658,562)**
Payback Years	**N/A**

APPENDIX II

Cash Flow & Internal Rate of Return Projections
Vehicle Purchase as an Operating Expense - OPTION 4

Total Capital Investment:	$0
Contract Term:	5

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	Total
REVENUE (or SAVINGS)							
Transfer to Reserves saving		$ 1,164,500	$ 1,164,500	$ 1,331,000	$ 1,597,000	$ 1,830,000	$ 7,087,000
Interest on $2 M. Reserves (@5%)		$ 100,000	$ 105,000	$ 110,250	$ 115,763	$ 121,551	$ 552,563
TOTAL REVENUE		$ 1,264,500	$ 1,269,500	$ 1,441,250	$ 1,712,763	$ 1,951,551	$ 7,639,563
EXPENSES (ADDITIONAL)							
Purchase of vehicles		$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (10,000,000)
TOTAL EXPENSES		$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (2,000,000)	$ (10,000,000)
Net Expenses		$ (735,500)	$ (730,500)	$ (558,750)	$ (287,238)	$ (48,449)	$ (2,360,437)
Cash Flow (tax draw)	$0	$ (735,500)	$ (730,500)	$ (558,750)	$ (287,238)	$ (48,449)	$ (2,360,437)
Tax % over current rates		-0.7%	-0.7%	-0.6%	-0.3%	0.0%	

Internal Rate of Return	**0.0%**
NPV Cash Flow	**($2,076,871)**
Payback Years	**N/A**

APPENDIX III

Cash Flow & Internal Rate of Return Projections
SALE AND LEASEBACK - OPTION 5

Total Capital Investment:	$0
Contract Term:	5

	YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	Total
REVENUE (or SAVINGS)						
Sale of Vehicles	$ 5,348,500	$ -	$ -	$ -	$ -	$ 5,348,500
Transfer to Reserves saving	$ 1,164,500	$ 1,164,500	$ 1,331,000	$ 1,597,000	$ 1,830,000	$ 7,087,000
Interest Revenue (@5%)	$ 133,713	$ 274,111	$ 287,816	$ 302,207	$ 317,317	$ 1,315,164
TOTAL REVENUE	$ 6,646,713	$ 1,438,611	$ 1,618,816	$ 1,899,207	$ 2,147,317	$ 13,750,664
EXPENSES (ADDITIONAL)						
Lease Payments	$ (1,176,218)	$ (1,176,218)	$ (1,176,218)	$ (1,176,218)	$ (1,176,218)	$ (5,881,090)
Acquisition/Origination Fees - one time	$ (58,725)	$ -	$ -	$ -	$ -	$ (58,725)
Non recoverable taxes	$ (123,503)	$ (123,503)	$ (123,503)	$ (123,503)	$ (123,503)	$ (617,514)
TOTAL EXPENSES	$ (1,358,446)	$ (1,299,721)	$ (1,299,721)	$ (1,299,721)	$ (1,299,721)	$ (6,557,329)
Net Expenses	$ 5,288,267	$ 138,890	$ 319,095	$ 599,486	$ 847,596	$ 7,193,334
Cash Flow (tax draw)	$ 5,288,267	$ 138,890	$ 319,095	$ 599,486	$ 847,596	$ 7,193,334
Tax % over current rates	5.3%	0.1%	0.3%	0.6%	0.8%	

Internal Rate of Return	**0.0%**
NPV Cash Flow	**$6,488,683**
Payback Years	**N/A**