Chatham-Kent

Chatham-Kent Debt Management Strategy

Executive Summary:

This draft policy is prepared for members of Council to review the recommended principles that may be employed in managing the financing of the asset management plan, new assets and more specifically debt management.

Unless otherwise stated, concentration has been placed on the tax supported asset management plan. The PUC Commission should also consider its financing strategy of water and wastewater rate supported asset management plans.

Council must give consideration to the increased debt servicing costs that will be included in the operating budget, based upon debt financing any component of the asset management plan or new initiatives (which translates to approximately 25-35% increase in project costs at today's interest rates). This is money that will either have to be found from other programs or from increased revenues (likely taxes) in the future.

Based on research from other municipalities, a debt management strategy should be considered as a long-term approach and carefully weighed against immediate infrastructure needs and tax rate increases.

Purpose of the Asset Management Plan:

The performance of a community's infrastructure provides the foundation for its economic development, competitiveness, prosperity, reputation and the overall quality of life for its residents. Reliable and well-maintained infrastructure assets are essential for the delivery of critical core services for the citizens of a municipality.

A technically precise and financially rigorous asset management plan, diligently implemented, will mean that sufficient investments are made to ensure delivery of sustainable infrastructure services to current and future residents. The plan will also indicate the respective financial obligations required to maintain this delivery at established levels of service.

The asset management plan is a very important planning tool for municipalities as it allows them to provide for the necessary infrastructure to maintain or enhance future service levels. Through asset management planning, municipalities can plan future operating budget expenses, debt repayment and potential reserve fund needs in order to manage the financial position of a municipality over a five to ten year period. Capital and infrastructure budgets provide the basis for the implementation of official plans, master plans and strategic plans and also provide the financial mechanism to implement Council's strategic plans and fiscal policies.

Guiding Principle:

Asset management investment in the community has always been important to maintaining or enhancing quality of life. In recent and future years, there will be increased demands to make strategic investments to attract new business or create vibrancy; whether related to infrastructure, cultural, community or economic, as well as to meet ongoing and new demands that have been downloaded from senior levels of government.

Council needs to determine a mix of pay-as-you go funding, reserve financing and debt financing to fulfill the requirements of both existing infrastructure requirements, but also any new initiatives to support the strategic directions that each Council sets as goals for their term.

With the Asset Management Plan, we are driving towards 100% pay-as-you go funding of the current infrastructure requirements. This allocates the expenses for a well maintained inventory to the current users in our community. Administration highly recommends continuing towards the 100% funding.

With longer term large infrastructure replacements, we can use reserves to smooth out the funding requirements and mitigate the need for debt financing for those large projects. By increasing the reserve requirements over time, when that large project is required to refurbish or replace the infrastructure, the funding is in place. This also helps to achieve expenses being allocated to the current users in the community.

With required new infrastructure that is related to growth in our community, we are recommending a review of our development charges, to assist in funding for these new assets. This allocates expenses for these items, specifically to the users that will benefit most, due to these users requiring this new infrastructure for their new properties or businesses. It is a long-standing principle that growth pays for growth and this should be considered moving forward in our review of development charges.

New initiatives that help support our strategic directions should be the areas that we consider issuing new debt for. These assets generally will have a long life span and follow the principle that the expenses for these will be paid out over a period of time (the term of the debt) and this allocates the expenses to the users in our community over the life of that asset.

Consideration should always be given to funding any project from existing funds, whether from an existing budget or from an existing reserve to minimize the additional debt servicing costs associated with issuing debt to pay for our assets.

Source of Funding for the Asset Management Plan:

All sources of funding, unless external to the municipality, affect the property tax, sewer or water rates. The question is one of timing of the impact on the respective rate.

Sources of funding for asset management projects result from four primary areas:
Internal Sources

- Debt – build now, pay later (lowest impact on short-term tax rates – highest overall cost and long-term impact on tax rate)
- Reserve Fund – save (pay) now and build when needed
- Annual Infrastructure Levy – build now, pay now (pay-as-you-go) (highest impact on short-term tax rates – lower overall cost than debt, smoothens long-term tax rates)

External Sources

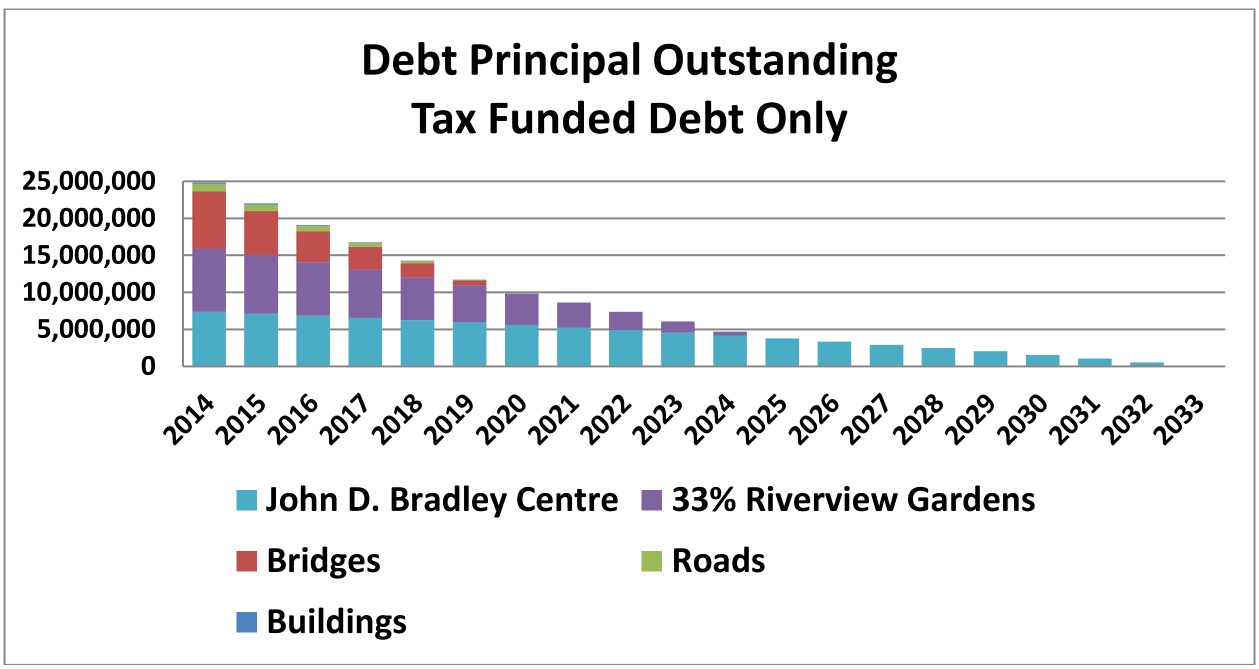
- Outside Sources – Provincial and Federal grants, donations, partnerships, development charges (currently restricted to specific formulae for water and wastewater growth projects)

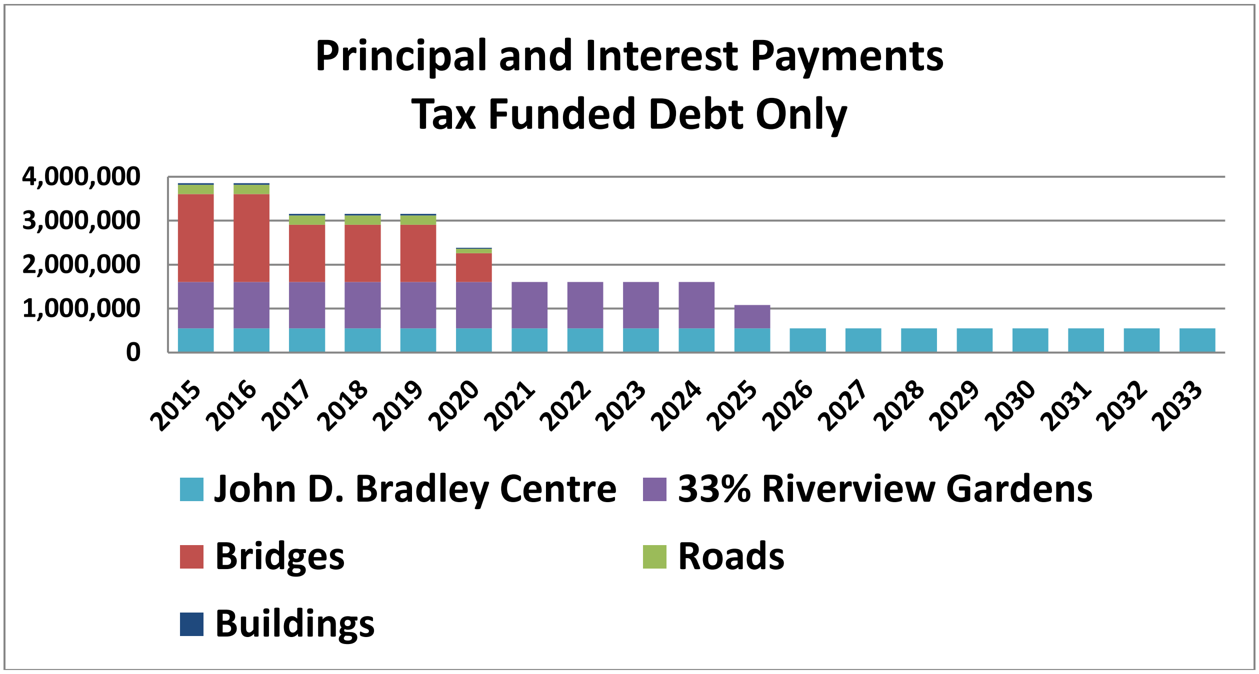
The mix of sources of funding can have a significant impact on the level of lifecycle maintenance spending today and the impact on tax rates (or service levels tomorrow). For example, significant lifecycle maintenance investment could take place today with no impact on **today's** tax levy, if debt were the source of financing. However, when the debt is issued (generally in the year following the completion of the project), the interest and principal have to be repaid in the form of debt servicing costs. This will require more money to be devoted to debt repayment, which will have to be taken from other lifecycle maintenance (do less today to pay for the past), cut other programs (less recreation, police, finance, etc.), or by raising funds (usually taxes, but could be other sources).

At the Municipality of Chatham-Kent, a concerted effort in recent years to limit debt issuance has reduced the outstanding debt to $115 million, of which more than half is PUC debt.

Debt Outstanding at December 31, 2014						
PUC		Municipality		Total		
Rates	Locals	Taxes	Locals	PUC	Municipality	Total
62,000,000	0	25,000,000	28,000,000	62,000,000	53,000,000	115,000,000

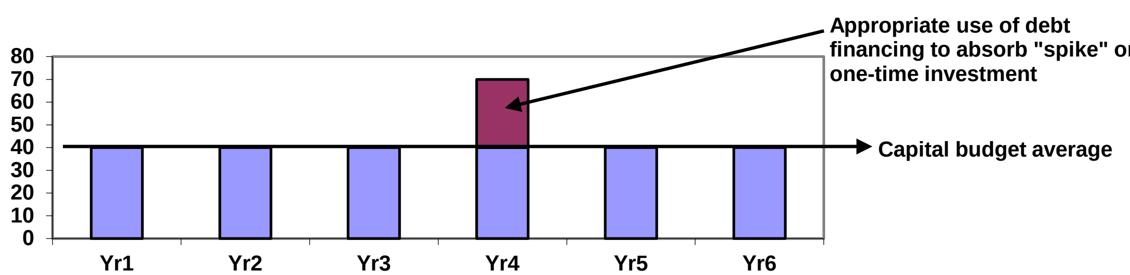
Existing Debt:
Our existing tax supported debt is made up of roads, bridges, buildings and the two most recent debt issuances for Riverview Gardens and the John D. Bradley Centre. The PUC debt is for water and wastewater infrastructure.



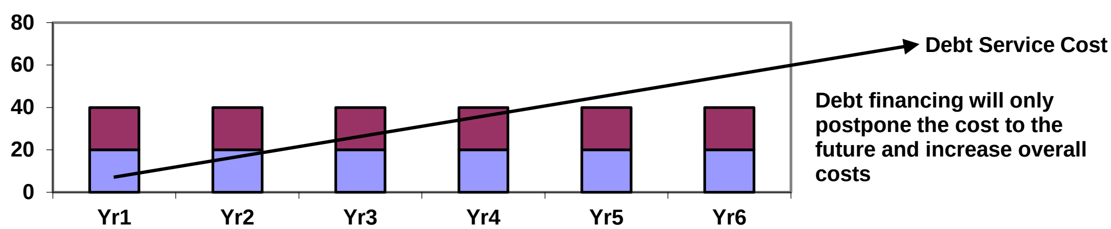


Debt Financing Principles:

Debt financing is best used to smooth the impact on the tax rate of “spikes” in capital spending. Debt spreads the cost of unusually high asset purchases over a number of periods, avoiding large short-term tax increases and matching the cost to the benefit received which, presumably, will last for a number of years over the life of the asset.

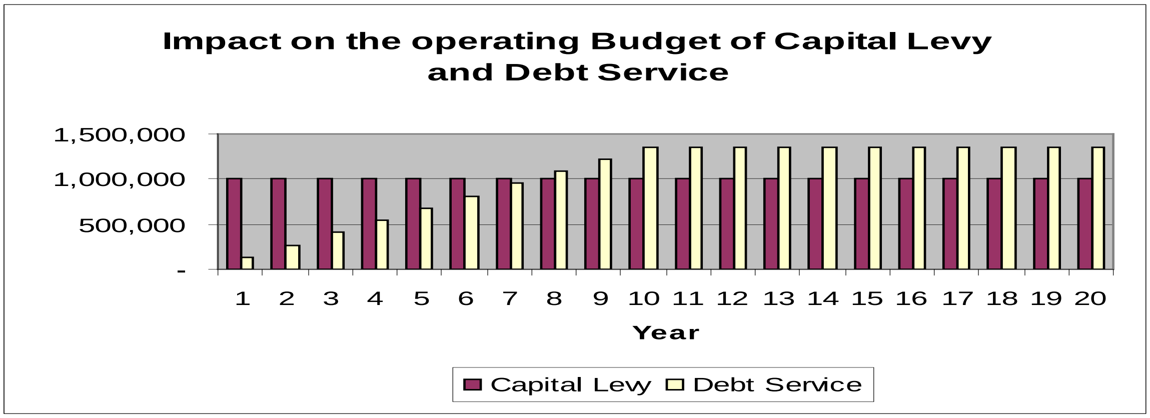


Using debt to fund the **average** lifecycle budget will not smooth the impact of the lifecycle budget; it will merely postpone the impact to future budgets and increase the overall costs of our assets.



Taking the example one step further, the impact of debt financing can be quite severe on a budget when one considers long term implications. The following comparison shows the impact:

$1 million dollars of capital works for each year in a twenty year period financed two ways; by annual infrastructure levy (pay-as-you-go) and debt. The assumption is, the $1 million is issued in the same year as the asset management expense and is paid in 10 years at a rate of 4% per annum.

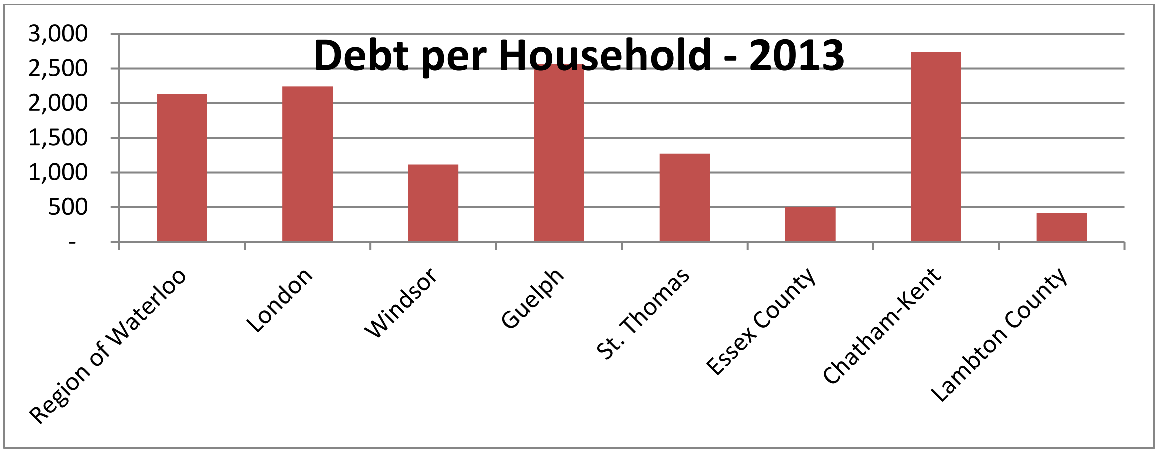


As time moves on, the payments build up until the payments on the old debt are completed and replaced by payments on the new debt (around year 10). If debt is the instrument funding the $1 million capital expense, it will cost approximately $1.3 million per year to finance the asset management program versus the $1 million per year to finance the pay-as-you go approach. If one looks over 20 years, in the early years more capital expenses are possible through debt financing; in the later years after year 7, pay-as-you-go is less costly. In addition, approximately $5 million in additional debt payments would continue after the twenty years, even if there was zero capital spending. In short, funding a $1 million annual asset management plan for a twenty year period on a pay-as-you-go basis will result in completing 30% more lifecycle maintenance projects than for the same capital plan funded by debt.

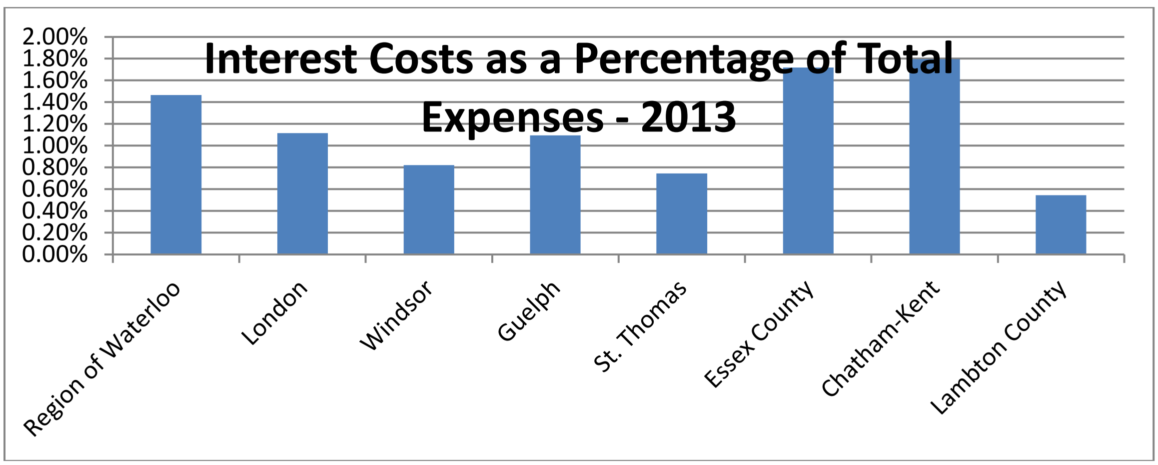
Municipality of Chatham-Kent Relative to Other Municipalities:

The following graphs are based on Municipal Financial Information Returns filed with the Province of Ontario in 2013. This information includes both property tax, water and sewer rate supported information.

It is very difficult to compare municipalities, since one must also take into consideration the state of infrastructure, the services that have to be provided (many Cities within regional governments provide fewer services than a single tier municipality such as Chatham-Kent) and overall asset management spending.



However, if one looks at the impact on a per-household basis, Chatham-Kent is at the upper range. Some of the municipalities represented in the graph above are in regional government areas and so the mix of services, as well as the state of the infrastructure may make the per-household debt less comparable. Also in Chatham-Kent in 2014, the per-household debt has decreased to just over $2,400, due to paying off $15 million in 2014. We will also be paying down additional debt in 2015, without issuing new debt.



The interest costs as a percentage of gross operating expenses are another factor that can be loosely compared between municipalities. Again, one has to respect differences in services that are provided, as well as total operating dollars dedicated to asset management spending. Chatham-Kent again appears in the upper range, but this figure will also drop when the 2014 and 2015 payments are figured in.

What Other Municipalities Have Done:

A number of other municipalities have recognized the need to target or manage their debt and asset management financing as a whole. This includes a review of all financing alternatives, including the mix of pay-as-you-go and reserve fund financing, as well as expense limits. A number of municipalities have published their policies with respect to debt and asset management financing. The following presents a hybrid of various policies employed at the different municipalities:

1. Annual requirements by asset class have been established for total asset management spending. These requirements establish what the total asset management spending will be in any given year and relate this impact to the operating budget. For example, how much will be allocated to debt service, annual infrastructure levy and lifecycle reserve contributions.

2. Determine the types of projects that are eligible for debt. There are basically three types of projects:
   a. lifecycle projects (rehabilitation and renewal of existing assets),
   b. growth projects (increasing capacity and growth of the Municipality),
   c. new programs and initiatives (projects that improve the level and/or quality of service)

3. Move to a more pay-as-you-go approach. At one extreme, some municipalities have the goal of eliminating debt financing completely, while others choose to reach the goal of using debt in only certain circumstances. This move appears to be accompanied by a strategy to reduce debt financing for any assets to provide some ability/room to get the debt balances under control.

4. Establishing limits on asset management reserves and not allowing them to be completely depleted, by establishing minimum balances.

5. Limiting debt service expenses in any given year by:
   a. not allowing principal and interest costs to exceed operating fund contributions to the lifecycle reserves.
   b. Holding debt service costs to a maximum ratio such as:
      i. % of operating expenses,
      ii. % of controllable revenues (usually limited to taxes, fines license fees and user fees/rates),
      iii. per-household debt limit.

6. Attempt to get new revenues (government grants, donations, partnerships, etc.). There is a general understanding that a shift in the funding is necessary to effect true change in the ability of municipalities to meet the demands of infrastructure needs and community investment. Many municipalities are taking multiple approaches to this:
   a. Review the revenue opportunities within the existing *Municipal Act* or equivalent. In Ontario, user and license fees are limited to cost recovery. Definition of cost is a factor; full cost recovery, including asset management, could make user fees prohibitive.
   b. Options to introduce new partnerships are complex and require significant effort and may be costly to undertake effectively. The key is in assuming an appropriate level of risk. Although recognized as an option, many municipalities appear to be cautious when it comes to partnerships.
   c. Many municipalities are making statements/requests to the Provincial and Federal governments to be given access to a share of existing taxation not currently available to municipalities, such as the HST or Land Transfer Taxes.
   d. Increasing the rates in certain sectors for development charges to fund growth.

7. Where a large new investment is required by the community, some municipalities have considered a temporary infrastructure surcharge on the tax rate. This in some cases has been accompanied by a split in the way the tax rate is presented, namely to designate an amount for operating and an amount for asset management.

8. Rationalizing and divesting of assets not providing maximum benefit to the public and using the funds to reduce debt, increase reserves or provide for immediate financing of asset management investment.

In all cases, municipalities recognized that managing debt and asset management needs is a long-term process. Attempting to adjust asset management financing too quickly could result in infrastructure gaps and/or a loss of economic growth. The debt has built up over time; to alter the course will take time and strong debt management policies that are supported / adopted by Council.

--- DRAFT PRINCIPLES ---

1. **The capital budget should be categorized and prioritized into three main categories.**
   a) **Priority 1 – Lifecycle Maintenance**
   b) **Priority 2 – Growth**
   c) **Priority 3 – New Program/Initiatives**

Implementation of the above recommendation would have the effect of developing a minimum level or a base lifecycle budget that allows the infrastructure to be maintained and replaced at the end of its useful life. In addition, sources of funding could be allocated according to the following chart.

		IDEAL SOURCE OF FUNDING			
		Infrastructure Levy (pay-as-you-go)	Reserve Fund	Debt	External Sources (1)
Lifecycle Maintenance	rehabilitation and renewal of existing assets	YES	YES	NO	YES
Growth	increasing capacity and growth of the municipality	NO	YES	YES	YES
New Initiatives/Programs	increasing the level and/or quality of service	NO	YES	YES	YES

(1) Note: External sources include DC, grants, and donations

As a rule of thumb the financing should match the benefit received by the taxpayer and be paid for accordingly. For example:

One lifecycle maintenance project is the annual paved and surface treated roads program. This is an annual program that is budgeted at approximately $10 million per year and expenses are paid as incurred from the annual lifecycle budget. Who benefits from the roads that are being maintained? The people that drive on the road currently are the individuals who benefit and should therefore be paying today for the upkeep or use of the road.

If for example a new sports complex was built and debt was used to finance this asset, the payments would go out over time for that asset and it is being matched to the citizens that are using the facility. Similarly, if the ongoing maintenance is paid on a pay-as-you-go basis, it is also the citizens that are using the facility that will be paying for those expenses, through their taxes. The key is creating a match between those who benefit and those who pay.

2. **Move to pay-as-you go financing for Lifecycle Maintenance projects**

Since pay-as-you-go is the lower cost long-term method of paying for life-cycle maintenance programs and more closely matches beneficiary and payment, the next question becomes affordability.

--- DRAFT PRINCIPLES ---

The asset management plan as presented during the 2014 budget anticipates an increase of 1% in taxes in funding infrastructure requirements, plus additional allocations of eliminated debt payments and inflation each year to finance the requirements of the asset management plan. Based on the information presented, administration would recommend no debt be issued for the lifecycle maintenance category.

3. Review Lifecycle Reserves with a view to:
   a) rationalizing the number of reserves,
   b) setting minimum balances that provide for emergency funding and offset debt, along with providing flexibility to match funds for senior government grant programs
   c) establish targets on balances based on longer term horizons (20 years)

The outstanding debt is $115 million at December 31, 2014; Compare this with the operating and lifecycle reserve balances supported by the general tax, water and sewer funds, of under $100 million. The total balance after the commitments is a negative balance. Ideally a ratio of 1:1 or better in the reserve balance favour should be targeted.

Reserves, like debt financing are a tool to smooth impacts on the tax rate of asset management projects. Usually they are used to fund major planned expenses and are a savings vehicle over a period of time. For example, we know that in 10 -15 years we will have to replace certain bridges, if we put a little money aside now and each year, we will have sufficient funding in the future to replace the bridge when needed. The time horizon for replacement of a water treatment centre or pollution control plant is significantly longer.

Reserves can also be used to help finance emergency situations. This, however, means that reserve balances will increase accordingly. For example, if a minimum balance on a reserve to replace vehicles and equipment were to include replacement of an ambulance snow plough, fire vehicle, police car, the minimum balance would have to be over $1 million. This money could be invested in long-term investments and earn better rates of return and also help with respect to short-term cash flow.

The number of reserves has grown over the years. Administration annually reviews the number of reserves and will bring forward recommendations to rationalize the number.

4. Adopt various ratios to ensure that debt spending does not exceed certain tolerances

A number of factors could be used in conjunction with each other to determine the level of debt that is appropriate. However, all ratios should be used in conjunction with an assessment of the state of the infrastructure.

Ratios that could be used are:
- Debt service as a percentage of gross operating expenses
    - Shows how much in a given year will be dedicated to paying debt
- Debt service as a percentage of property tax levy, water or sewer rates

  - Shows how much controllable revenue is absorbed by the annual payment of debt
- Debt service as a percentage of operating expenses dedicated to asset management financing (debt service, asset management levy and contributions to asset management reserves)
  - Of total operating expenses dedicated to asset management financing, how much is dedicated to paying for past asset management projects
- Asset management debt as a percentage of the asset management category expenses (debt used to finance lifecycle maintenance projects)
  - Within each category, targets can be established (for example, 0% should be established as the long term goal for lifecycle maintenance projects)
- Outstanding debt per household
- Debt to Reserve Ratio (target should be 1:1 or under)

5. Mitigate the short-term debt risk by considering the following measures:

a) Divestment of existing assets and use proceeds to reduce requirements for lifecycle maintenance and reduce risk of requiring debt

b) Dedicate 50% of future surpluses (if any) to a contribution to reserves

c) Maximize use of Infrastructure Ontario (IO) or other low interest debt

Implementing these steps will have the effect of reducing the need for issuing debt for any assets in the lifecycle budget.

5a) can be achieved by administration developing a listing of facilities and infrastructure that could be divested. Council may wish to amend the list, but each add-back will increase the infrastructure requirements and increase the cost of lifecycle maintenance and the risk of debt financing.

5b) is a policy statement that could be adopted and cover the next five years to help in lowering the risk of requiring an issuance of new debt.

5c) has already been achieved by administration. The financing, while very attractive, is limited to specific projects. It should be recognized that this is still debt, and will only provide temporary relief in the form of lower debt service costs for certain projects.

6. When approving new initiatives or new asset projects, require business cases be presented that outline the total cost of the project, the cash flow of the project, the operating costs after the completion of the project, any cost avoidance, any resulting return on investment and capital pay back in years and the benefits to the community.

If Council were to require a full business case prior to approval of the project, there would be “no surprises” with respect to cost and benefits against which the success factors can be measured to determine if returns were achieved. This should be extended to commitments of outside boards and commissions.

7. Lobby higher levels of government to gain access to other revenue sources.

A number of municipal groups have been lobbying higher levels of government for a "new deal". These groups include Big City Mayors, FCM, AMO, MFOA, OGRA/ROMA, WOWC and operate at both the political and administrative levels. The basic premise is that municipalities are the drivers of the economy and part of the attraction they hold for businesses looking to relocate to Ontario is sound infrastructure, good pool of employees, low taxes (of which income tax is probably the most significant), good access to markets and "no hassle" turn-key development opportunities.

Similarly, as a result of local services restructuring, municipalities have become either wholly or partially responsible for services which have asset management costs, for example social and affordable housing. Without additional sources and even with the additional tax room, the demands on the property tax dollar are severe and the funding and responsibility for these services should continue to be addressed with the provincial government.

8. Where new initiatives or programs are required look for public-private or community partnerships and do not assume all the risk.

Partnerships generally involve legal agreements and some form of benefit sharing arrangement. These can be costly to implement and generally have more risk associated with them. When entering a public-private partnership the business plan should clearly outline the outcomes expected by the municipality (more service hours, community availability, maintenance standards, etc.), the risk that will be assumed by each party and what happens if something goes wrong.

Traditionally, municipalities when entering these arrangements have not been clear on what they want out of the arrangement and have assumed all the risk in the form of asset management costs and maintenance. The partnerships at the Municipality of Chatham-Kent should have shared risk, outlined expectations and legal agreements that outline what happens if something goes wrong.

9. New infrastructure programs introduced by the Federal and/or Provincial governments (such as Building Canada, Canada 150, OCIF) should be assessed relative to the asset management needs and priorities, compared with our ability to fund.

With introduction of the new Building Canada Fund, OCIF and most recently the Canada 150 funding, many changes were introduced and projects advanced in the asset management plan that may not have been in the current year plans. Each new program needs to be reviewed for comparing to the asset management plan over a five year period in order to maximize the benefit of receiving funding from the Federal and Provincial Government, weighing it against the use of reserves or issuance of debt to cover our share.

In the past, the Municipality of Chatham-Kent has benefited from various projects undertaken by the recent infrastructure stimulus program that assisted with sanitary and storm systems, roads, bridges, parks and recreation facilities.

The municipality has also put in requests with the Province to allow for changes in the process of allocation of the Provincial Gas Tax, including longer time horizons and broader criteria on how the grants can be spent. (rather than prescribed areas and specific cost eligibility)

10. Place a moratorium on contributions to non-mandated programs and projects and lobby the Province to cease the practice of requiring municipalities to participate in order for these entities to secure provincial funding.

The municipality has provided over the years many grants, including asset development grants, to community organizations that provide benefit to the citizens of Chatham-Kent. These grants include large amounts provided and committed to St. Clair College, the YMCA and most recently the Hospice. Hospital and college rebuilds often require a large share of municipal contributions.

Much of the Provincial assistance provided to these sectors for building campaigns and/or asset management projects requires some matching dollars from the municipality. This places an added burden on the municipality and usually causes asset management projects to be reprioritized.

Most existing commitments should/must be fulfilled, but new requests should be placed on hold unless proven to be a strategic investment by Council. Municipalities should lobby the Province to cease the practice of requiring municipalities to participate in capital rebuilds of facilities falling under their mandate.

--- DRAFT PRINCIPLES ---

Summary of Recommendations for the Municipality of Chatham-Kent:

1. The capital budget should be categorized and prioritized into three main categories.
   a) Priority 1 – Lifecycle Maintenance
   b) Priority 2 – Growth
   c) Priority 3 – New Program/Initiatives

2. Move to pay-as-you go financing for all Lifecycle Maintenance projects

3. Review Lifecycle Reserves with a view to:
   a) rationalizing the number of reserve funds,
   b) setting minimum balances that provide for emergency funding and offset debt, and establishing financial flexibility to match funds for senior levels of government grant programs
   c) establish targets on balances based on longer term horizons (20 years)

4. Adopt various ratios to ensure that debt spending does not exceed certain tolerances

5. Mitigate the short-term debt risk by considering the following measures:
   a) Divestment of existing assets and use proceeds to reduce requirements for lifecycle maintenance and to reduce risk of requiring debt.
   b) Dedicate minimum of 50% of future surpluses (if any) to contribution to reserves
   c) Maximize use of Infrastructure Ontario (IO) or other low interest debt

6. When approving new initiatives or asset projects, require business cases be presented that outline the total cost of the project, the cash flow of the project, the operating costs after the completion of the project, any cost avoidance, any resulting return on investment and capital pay back, in years and the benefits to the community.

7. Lobby higher levels of government to gain access to other revenue sources.

8. Where new initiatives or programs are required look for public-private or community partnerships and do not assume all the risk.

9. New infrastructure programs introduced by the federal and/or provincial governments (such as Building Canada, Canada 150, and OCIF) should be assessed relative to the asset management needs and priorities compared with our ability to fund.

10. Place a moratorium on contributions to non-mandated programs and projects and lobby the Province to cease the practice of requiring municipalities to participate in order for these entities to secure provincial funding.