Report from Financial Management Services

Date of Report: June 14, 2016 **Date of Meeting:** June 20, 2016

Report Number: FMS-B002-2016 **File:** 10.57.99

Subject: Debt Management Strategy

Recommendation

That the Budget Standing Committee confirm the City's debt management strategy:

- Debt charges be capped at ten percent (10%) of the City's total own expenditures
- Annual contribution of ten percent (10%) from the operating budget for debt-funded portion of capital project
- Debt financing be used for infrastructure related projects

Summary

Currently the City's infrastructure funding gap is estimated to be approximately $140 million. The City has a limited number of options available to fund its infrastructure. They include funds from reserves and operating budget, government grants and debt. The City is working to increase reserve and operating budget contributions; however debt financing is a significant portion of the City's annual capital budget. It ranges from 50% to 66% of the funding sources.

When we look at our municipal comparators, the City's total debt outstanding, based on 2014 and 2015, is lower than the average of our comparators. The City's debt per capita is also below the study 2015 BMA Study average. The City is also focusing on increasing its reserves and approved three new reserves during the 2016 budget process.

One of the criteria for the City to continue to receive the maximum fund level of Federal Gas Tax is that the City's annual contribution towards its linear infrastructure assets must remain at or above the baseline funding. Therefore it is important that the City continue to contribute adequate budget dollars toward its linear assets either through operating budget contributions or capital dollars funded by reserves or debt.

In recent years, there has been a lot of attention focused on the City's debt level with the construction and completion of the Meridian Centre. The Meridian Centre debt was fully incurred in 2015. Going forward, there are no new major infrastructure projects on the horizon.

In this time of low interest rates it creates the ability to get more done at a lower cost. As interest rates increase, the City's debt management strategy can be revisited. Presently, when interest rates are at an all-time low, it is a good time to borrow.

Background

Council's Strategic Plan identified a number of action items related to the budget for the City that encourages multi-year budgeting, a target to keep taxes at or below the rate of inflation, as well as the direction to conduct a review of financial controls and our debt management strategy.

In creating its work plan, the Budget Standing Committee (BSC) included the review of the City's debt management strategy and best practices.

Report

This report will review the following items related to debt management.

- Debt Management defined
- Regulations and Restrictions
- Advantages of Financing options
- How we measure up with our comparator municipalities
- Current debt management strategy
- Debt Management Options to Consider
- Current Challenges
- Key Factors to Consider in Debt Management Strategy

Debt Management

Debt management is the process of providing for the payment of interest and principal on existing debt and the planning of incurrence of new debt at a level which will optimize borrowing costs and not impair the financial position of the municipality.

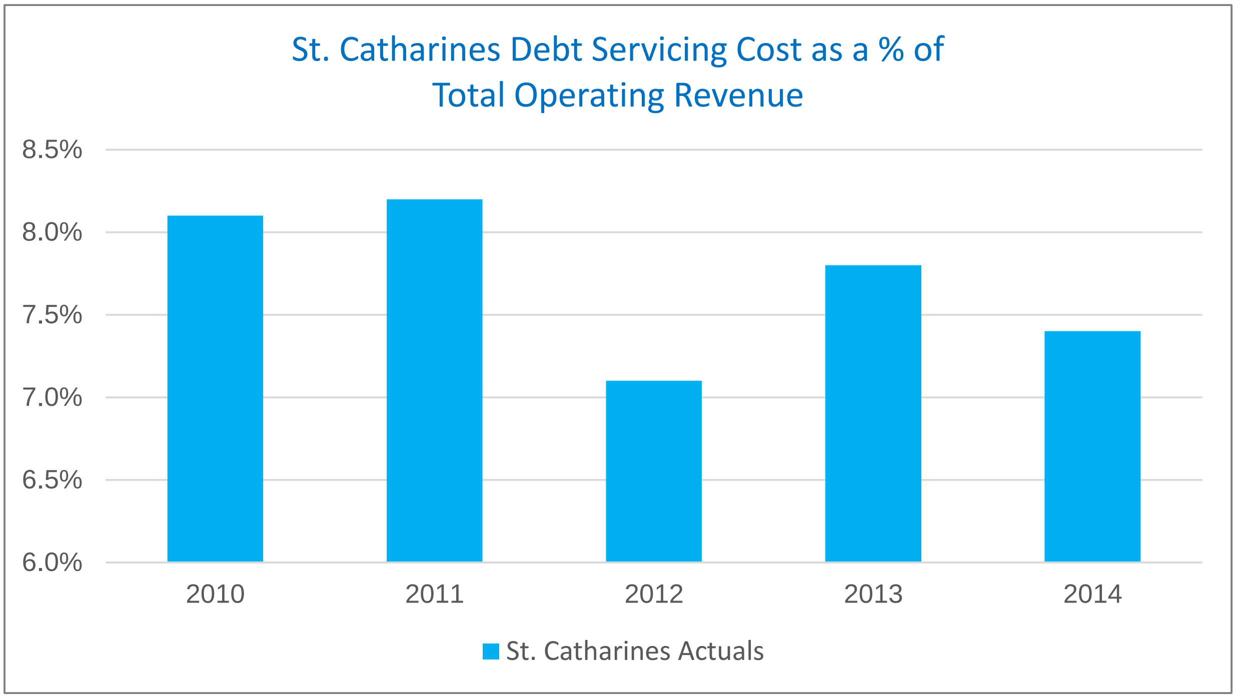
For a municipality it means the blending of the capital and operating budgets. It is also the projecting of the capital budget's impact on the operating budget. Debt spreads the cost of unusually high capital budgets over a number of periods, avoiding large short-term increases and matching the cost to the benefit received that presumably will last for a number of years. Using debt to fund the annual capital budget will not reduce the impact of the capital budget; it will merely postpone the impact to future budgets.

Regulations and Restrictions

Ministry of Municipal Affairs (MMAH) monitors municipal debt levels. A Municipality's debt service costs and other long-term obligations can be no more than twenty-five percent (25%) of total own purpose revenue.

Each fall MMAH provides municipalities with their financial indicators based on their annual Financial Information Return (FIR). One of the financial indicators is debt servicing cost as a percentage of total operating revenue.

The graph below shows this particular financial indicator for the past five years (2010 to 2014).



In 2014 the City's debt charges were 7.05% of the City's total estimated expenditures. MMAH considers debt servicing costs as a percentage of total operating revenues and has established the following indicators:

- Low - less the 5%
- Moderate - between 5% and 10%
- High - over 10%

The City of St. Catharines has had a moderate indicator for the past five years, as shown in the graph above. The City will receive its 2015 financial indicators from the MMAH in the fall of 2016.

Advantages of Financing Options

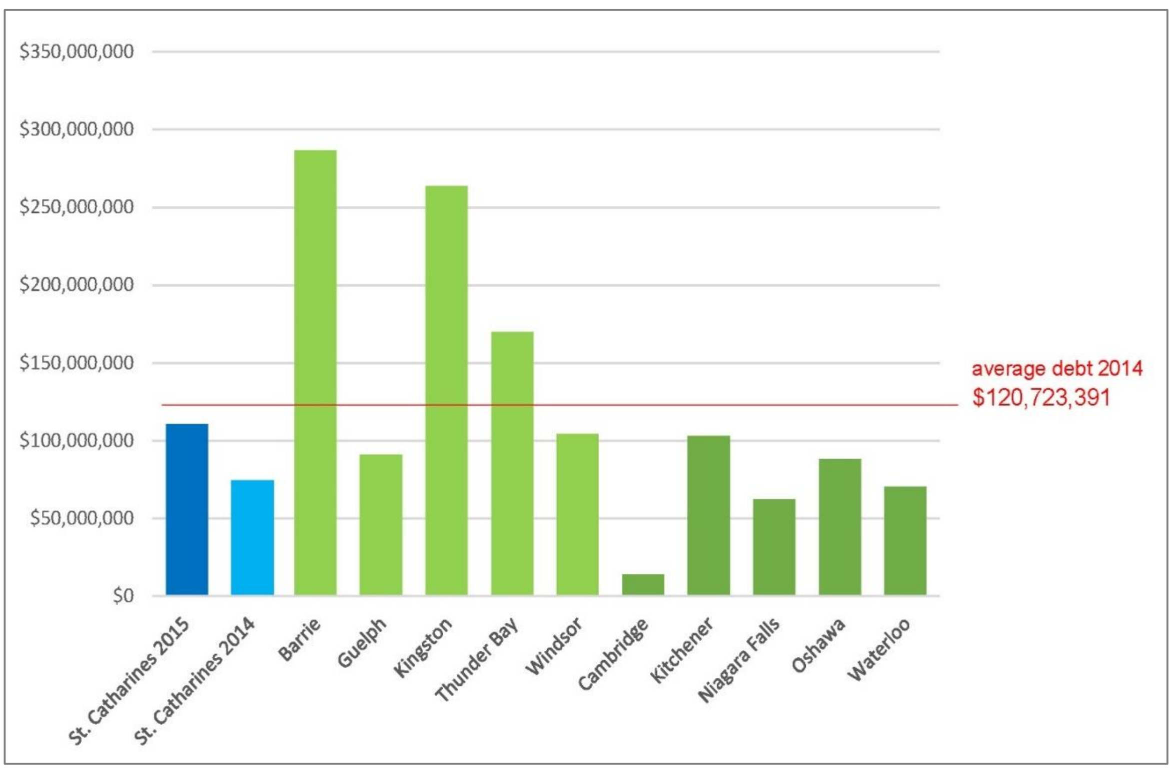
At present most major municipalities use a combination of financing options. Capital financing options for municipalities are limited. The options available are grants, reserves and operating fund contributions and debt.

Advantages of Long-term Debt Financing
Debt financing should be used for assets with a longer life expectancy to spread the payment over a longer term. The use of debt financing reduces large spikes and major impacts on operating budget. It also allows for more projects to be constructed simultaneously. In time of increasing inflation, the use of debt can reduce the real cost of a project. Debt can also be a tool for handling emergency situations.

Advantages of Pay-As-You-Go Financing
The use of Pay-As-You-Go financing requires that the financial consequences of capital spending be faced as spending decisions are made. Paying up-front encourages realistic level of spending. Pay-As-You-Go increases financial strength. Pay-As-You-Go allows future generations to received paid-up facilities. It also avoids interest payments, fiscal agent fees and debt issuance costs.

How do we measure up to our Comparators

Comparator Municipalities Debt Levels
Staff have reviewed our comparator municipalities' debt levels. For 2014, our comparator municipalities had debt levels from a low of $14.2 million to a high of $263.6 million with an average of $120.7 million. All comparator municipalities' 2014 debt level is shown in the graph below.



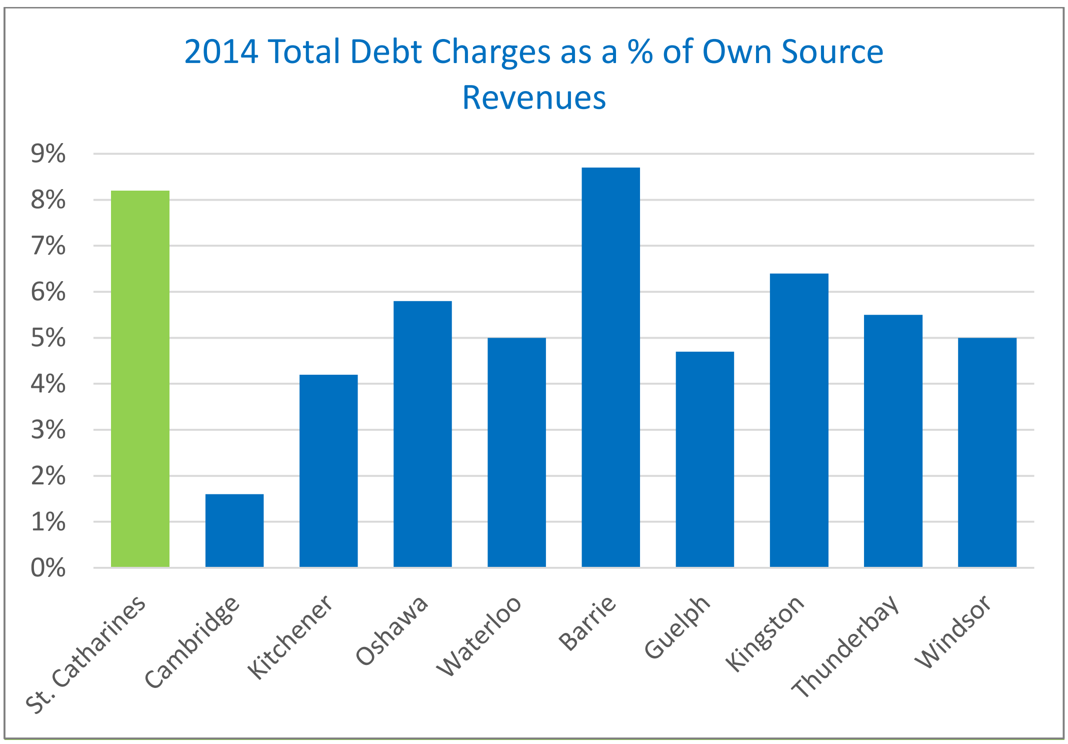
The City of St. Catharines debt level for 2014 and 2015 is below the 2014 comparator municipalities' average. In addition, the City's 2015 debt is below three of its comparators, Barrie, Kingston and Thunder Bay and it is very close to two others, Windsor and Kitchener. The City's 2015 debt level is above five of its comparators. This graph indicates the City is in a relatively stable position with its current level of debt.

Other Debt Measures per BMA Study

(The information in this section was obtained from the BMA Management Consulting Inc. Municipal Study 2015)

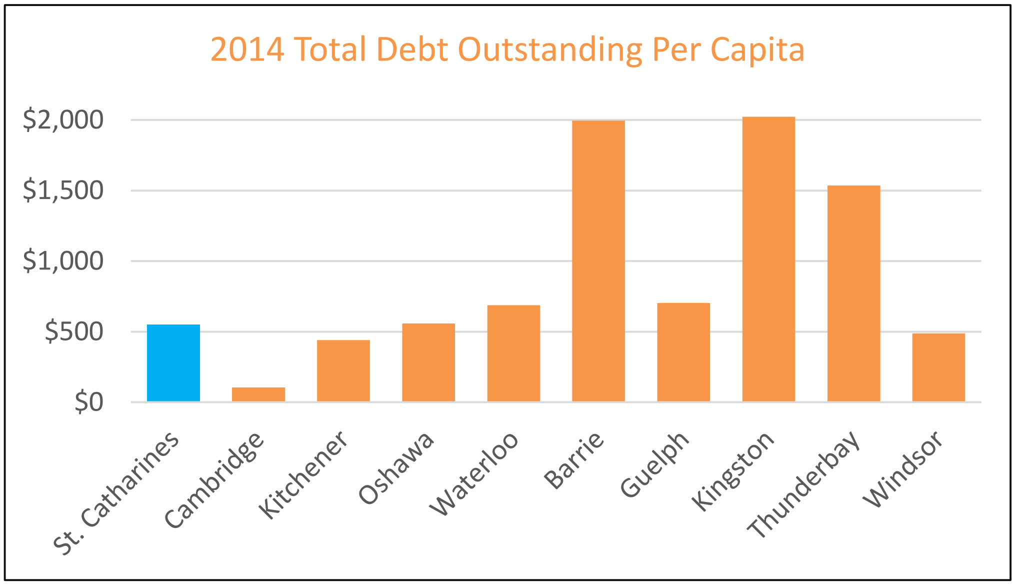
Annual Repayment Limit (ARL)

MMAH regulates the level of debt that may be incurred by municipalities, such that no more than 25% of the total own source revenue can be used to service debt and other long-term obligations without receiving OMB approval. This is also referred to as the City's Annual Debt Repayment Limit (ARL).

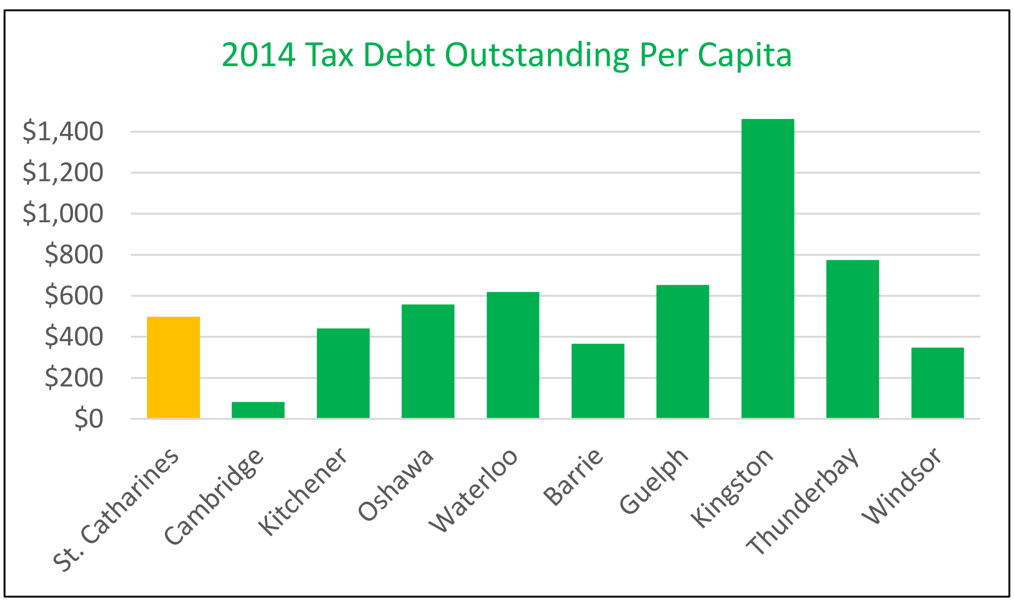


This graphs shows that the City's annual debt charges for 2014 are just above 8% of its own source revenues. The City is still well within the ARL as 8% is less than one-third of 25%, which is the provincially set maximum. This is another indicator that the City's debt is in a relatively stable position.

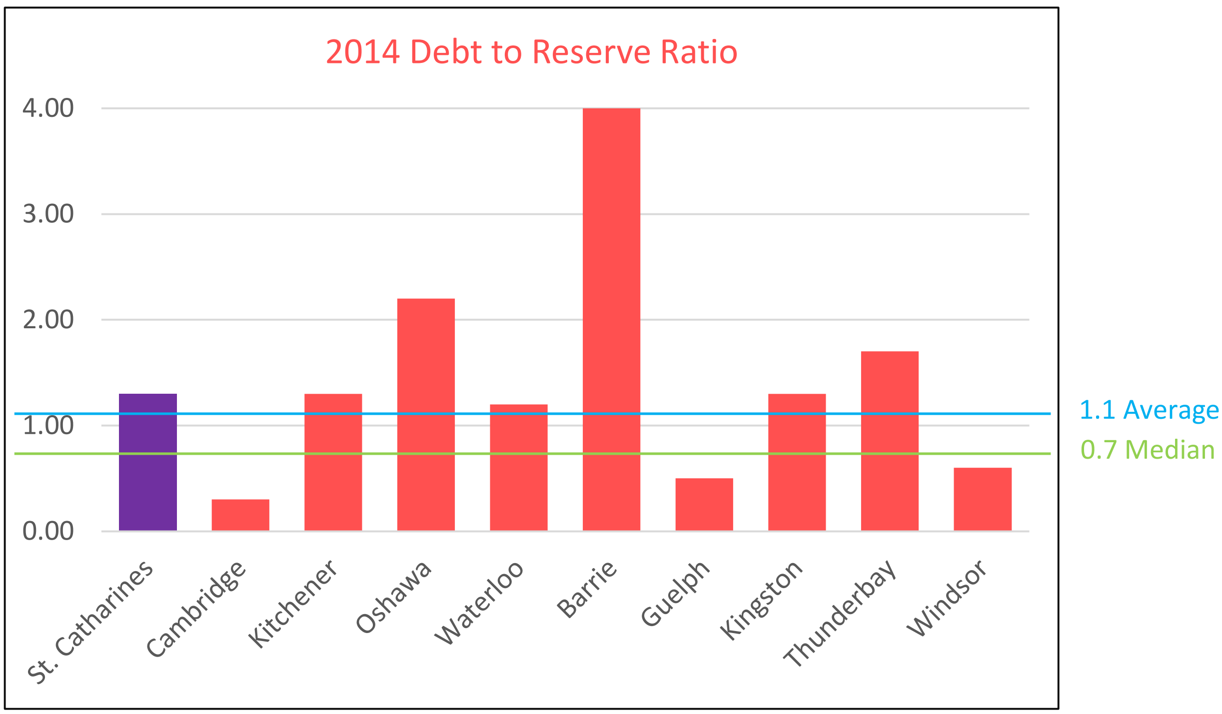
Total Debt Outstanding Per Capita
The average for municipalities reviewed in the 2015 Municipal Study for 2014 Total Debt Outstanding per Capita is $674 and the median is $493. The City of St. Catharines is at $553 for 2014. This is below the study average.



Tax Debt Outstanding Per Capita
The average for municipalities reviewed in the 2015 Municipal Study for 2014 Tax Debt Outstanding per Capita is $478 and the median is $366. The City of St. Catharines has an amount of $498 tax debt per capita for 2014. This is above the average and median of the study.



Debt to Reserve Ratio
This indicator provides a measure for financial prudence by comparing total debt to the total reserve balances. In general, the benchmark recommended by credit rating agencies is a ratio of 1:1. In other words, debt should not exceed total reserve fund balances. Therefore for each dollar of debt there should be a dollar of reserves. The City of St. Catharines for 2014 has a debt to reserve ratio of 1.3:1. The average per the 2015 BMA Study for 2014 is 1.1 and the median is 0.7. St. Catharines is above the average and the median for 2014. In recent years, St. Catharines was not focused on building reserves. Instead it was revitalizing this downtown. Now with the Meridian Centre and the First Ontario Performing Arts Centre (FOPAC) complete, Council is able to shift its focus. This shift began during 2016 budget process where Council approved three new reserve funds (Tax Rate Stabilization Reserve, Winter Control Program Reserve and FOPAC Capital Reserve) and the introduction of a one-percent tax levy for infrastructure.



Overall the City's total debt level is reasonable compared to other municipalities. Our overall debt level and total debt is below the average. This is positive for the City. Our current debt management strategy has established a sustainable level of debt.

Current Debt Management Strategy
Under the City's current Debt Management Strategy the objective is to minimize the annual impact on the operating budget, while continuing to sustain and improve its infrastructure assets over the long term. The City has established its own Debt

Management Strategy which determines capital projects that are eligible for debt financing, identifies a sustainable level of borrowing and deals with debt repayment.

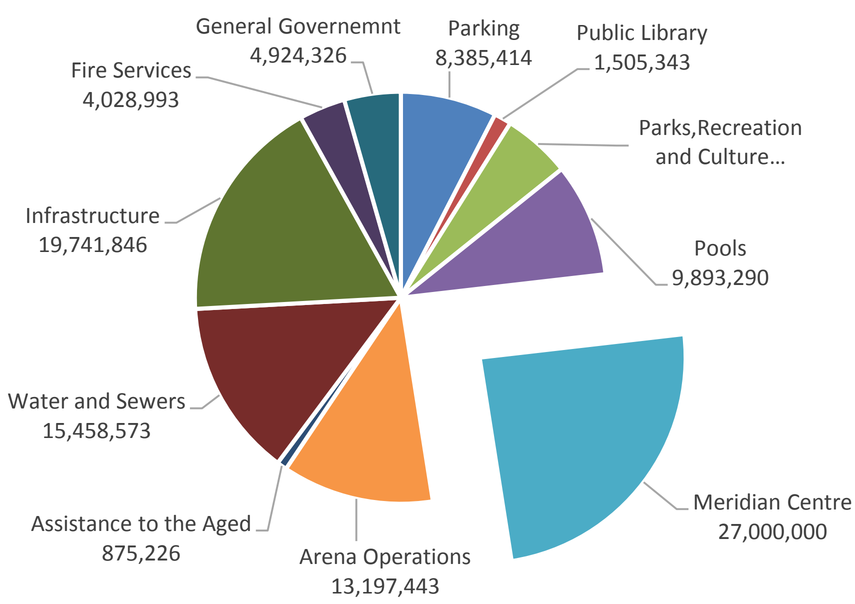
1) **Eligibility**: Not all capital projects are suited for debt financing. The City's policy is to recommend debt financing only for infrastructure purposes. Specifically, for large projects that provide well-defined benefits to the community, have long asset lives and the ability to leverage additional financing elsewhere.

2) **Sustainable level of borrowing**: For debt management purposes, the City has adopted a policy aimed at containing debt charges at approximately 10% of the City's total own expenditures. This will ensure that the debt service costs will not become an increasing burden and a larger portion of the City's budget, as it is essential the City ensure debt levels are sustainable within the operating budget.

3) **Debt repayment**: The City has a 10% down payment strategy which reduces the amount to be borrowed and at the same time, brings the approximate costs of one year's debt service to the year of decision. As a result, Council will raise, through property taxes, an amount which will be equivalent of future annual debt charges for each particular project. Debentures are taken for shorter timeframes versus longer timeframe which are typically 5 or 10 year.

The City's current debt outstanding for the year ended 2015 is $110.9 million. The pie chart below shows the debt break down by functional area.

2015 Long Term Debt By Function



Options to Consider

1. Move to Pay-As-You-Go Strategy
2. Current Year debt maxed at debt maturing
3. Increase Debt servicing amount to support debt financing
4. Continue with Current Debt Management Strategy

1. Move to Pay-As-You-Go

This option would mean that no debt would be issued for capital projects and each project would be funded by the tax base. This would require the increasing of the amount of capital-out-of-revenue in the operating budget. This option would create significant spikes in the annual operating budget. Pay-as-you-go capital financing results in more capital funding over the long term.

If this option were selected there would be a transition period over a number of years to increase the amount of capital-out-of-revenue in the operating budget.

Phase One

- Gradually increase the contribution to capital from operating
- Gradual establishment of reserve funds
- Annual debt requirements and resulting charges would be on the decline

Phase Two

- Once reserves are at sustainable level
- Capital expenditures made from reserve funds
- Basically internal debt financing using a revolving reserve fund
- Annual contributions to reserve similar to annual repayment of external debt, multi-year operating budgets

Phase Three

- When amount budgeted for repayment to reserve equals or exceed net capital budget requirement

This option has the potential to result in a backlog of projects and a larger infrastructure deficit. Also, as the FGT is incremental to existing infrastructure programs the commitment to linear infrastructure cannot be reduced below the City's baseline or the maximum funding amount would be jeopardized.

2. Current Year Debt Maxed at Debt Maturing

This option would keep the current level of debt at or below the amount of principal paid in the current year. Currently, the City pays off between $8 and $10 million of principal annually. The City's annual capital program has debt requirements between $13 and $16

million. This debt management strategy option would increase the City's infrastructure gap as the annual capital program would need to be reduce to meet this debt financing limits.

3. **Increase Debt charges as percentage of Total own Expenditures**

Given the City's large infrastructure funding gap, one option would be to increase the percentage of debt charges of the City's total own expenditures from 10% to another amount. Although, Staff is not recommending this option, some consideration could be given to increasing debt financing to address the City's infrastructure gap. If this option is considered the additional debt room should be phased in over a few years.

4. **Continue with Current Debt Management Strategy**

Continue with the Current Debt Management Strategy for the City for future years. As indicated above the current Debt Management Strategy caps debt charges at 10% of the City's total own expenditures.

This strategy has served the municipality well and could continue to be used as the guideline for debt. At this time, the City is becoming very close to its debt maximum level as defined by Council. The City is well below the 25% threshold set by the Province.

Current Challenges

1. Currently the City has approximately $45.1 million in approved projects that are not yet complete and would require debt financing.
2. Any significant decrease to the City's current debt management strategy at 10% of total expenditures would require a phased approach.
3. Choosing to be debt-free would mean tradeoff of an underfunded stock of infrastructure

Factors to consider in Debt Management Strategy

- Borrowing for capital projects that provide economic benefits in the future
- Moving to pay-as-you-go may not contribute to the overall health of the City
- Ensure that debt levels are sustainable within operating budget
- Borrowing is a valid form of infrastructure financing

Conclusion

As this report indicates there are a number of options available to the City to manage its debt. The challenge is to find the balance between minimizing the impact on the annual operating budget and addressing the City's infrastructure funding gap of approximately $140 million. Debt financing is a needed funding source for the City. The city is also committed to a minimal level of funding in order to maximum the amount of annual FGT funds.

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