St. Catharines

Corporate Report
Budget Standing Committee

Report from Financial Management Services, Accounting

Date of Report: July 31, 2017 **Date of Meeting:** August 28, 2017

Report Number: FMS-B035-2017 **File:** 10.57.99

Subject: Debt Management Strategy

Recommendation

That the Budget Standing Committee receive this report for information and consideration.

Background

The City's current infrastructure funding gap is estimated to be approximately $140 million. There are only a limited number of options available for Municipalities to fund infrastructure including government grants, funds from the operating budget and reserves, user fees and issuance of debt.

Council has adopted the following strategies to address this issue:

1. Approved the creation of the following reserves:
    a. Tax Rate Stabilization Reserve
    b. Winter Control Program Reserve
    c. FirstOntario PAC Capital Reserve
    d. Litigation/Insurance Reserve
    e. Election Reserve
    f. Meridian Centre Capital Fund Reserve
    g. Meridian Centre Event Fund Reserve

2. Introduced a 1% Tax levy dedicated to fund infrastructure asset replacements and upgrades

With the implementation of the aforementioned strategies, debt financing currently funds 56% to 63% of the City's 2017-2021 estimated annual capital budget. To evaluate this debt management approach the following eight factors must be considered:

1. Definition of Debt Management Strategy - What does debt management mean?
2. Provincial and City Debt Regulations- Is City currently in compliance?
3. Key Financial Debt Indicators - Comparing City with its municipal comparators using 2015 data

4. Federal Gas Tax - A requirement for the City to receive the maximum fund level 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 allocate adequate budget dollars toward its linear assets either through operating budget contributions or capital dollars funded by reserves or debt.
5. Infrastructure Projects - There are currently no new major infrastructure projects identified for the next five years.
6. Impact of Interest Rates - Interest rates have been at historically low levels for a number of years, and this has enabled City to optimize its capital investment strategy. The Bank of Canada raised interest rates by 0.25% in July 2017, which was the first increase in over seven years.
7. Current Debt Repayment Strategy - 2017 to 2022
8. Alternative Options - Alternatives to issuance of debt and the impact on the operating and capital budgets - 2017 to 2022

Debt Management

Debt management is the process of providing for the payment of interest and principal on existing debt. It also includes the planning for the incurrence of new debt at a level which will optimize borrowing costs without negatively impacting the municipality's financial position.

For a municipality it means the blending of capital and operating budgets. Debt management on an annual basis reflects the impact of the capital budget on the operating budget. The issuance of debt and corresponding repayment timeline spreads the cost of unusually high capital budgets over a number of periods avoiding large short-term increases and matches over the life of the asset the cost to the benefit received.

Regulations and Restrictions - Provincial and City

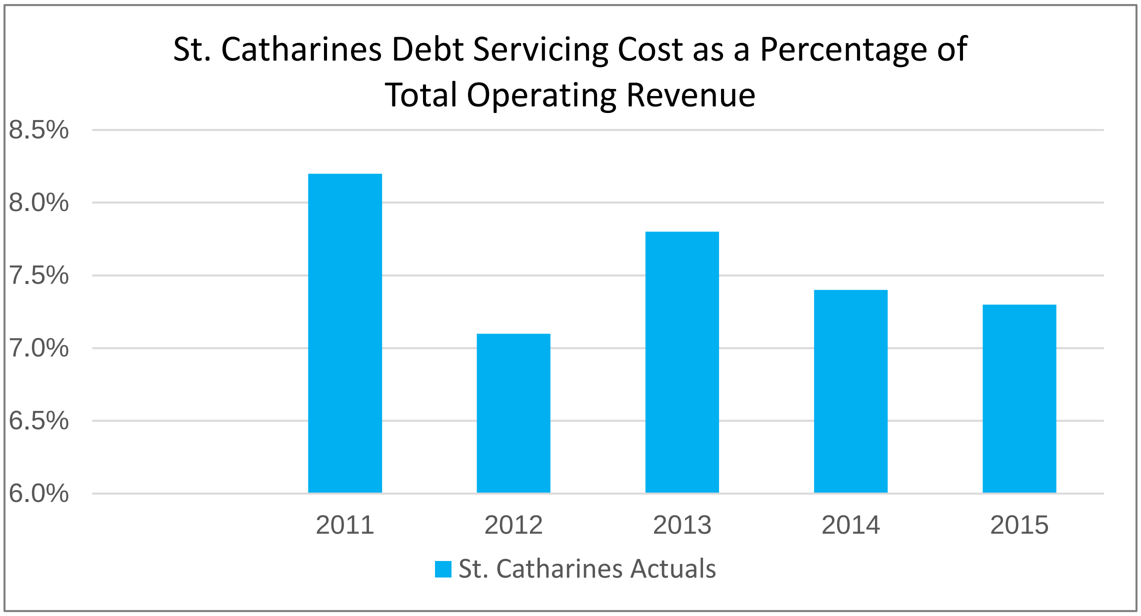
The Ontario Ministry of Municipal Affairs (MMAH) monitors municipal debt levels. MMAH mandates that a Municipality's debt service costs and other long-term obligations can be no more than twenty-five percent (25%) of total own purpose revenue.

In 2015, the City's debt servicing cost was 7.4% of the City's total operating revenue. 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%

Figure 1 demonstrates this particular financial indicator for the past five years.

Figure 1 – 2011-2015 Debt Servicing Cost



The City of St. Catharines has maintained a moderate indicator for the past five years, and over the last two years the percentage is trending positively downward.

In 2017, the City's Budget Standing Committee (BSC) continued to endorse the existing policy that debt charges, which include principal and interest payments are capped at ten percent (10%) of the City's total own expenditures. The 2017 budget was prepared based on those guidelines and is in compliance with existing debt policy.

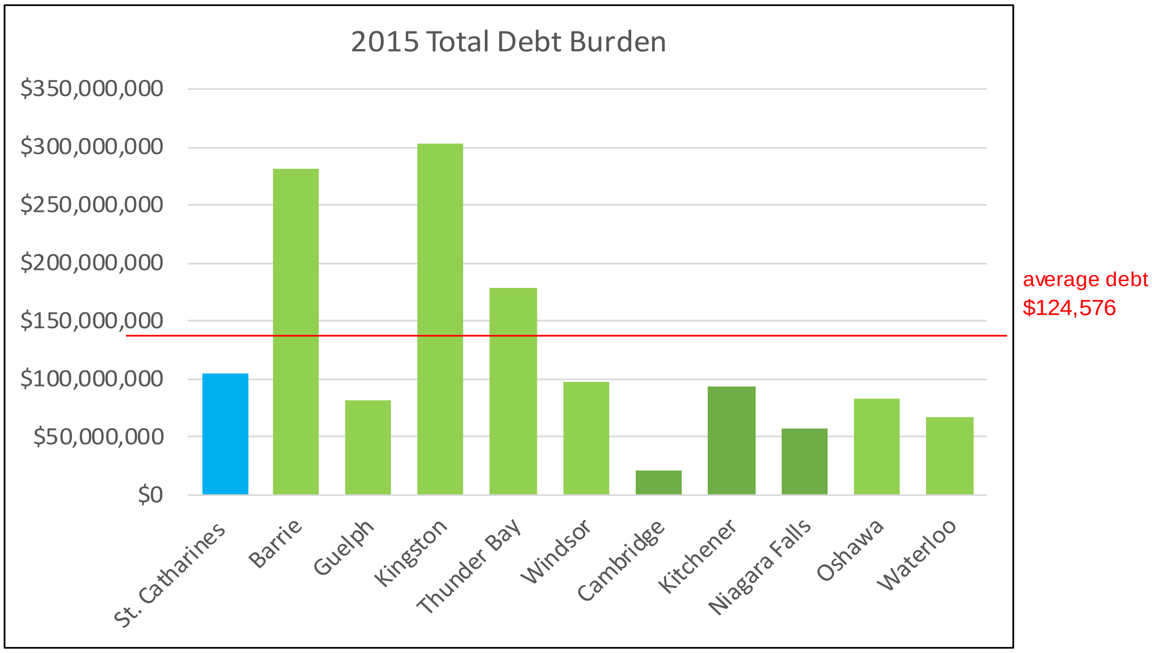
Key Financial Debt Indicator

Detailed below are best practice financial debt indicators. These will provide a better understanding of the City's overall debt outstanding, debt servicing costs and provide a comparison to our comparator municipalities' debt indicators.

Total Debt Level

For 2015, the City's comparator municipalities had debt levels from a low of $16 million in Cambridge to a high of $303 million in Kingston. The average debt level was $124 million.

Figure 2 – 2015 Total Debt Burden with Comparator Municipalities



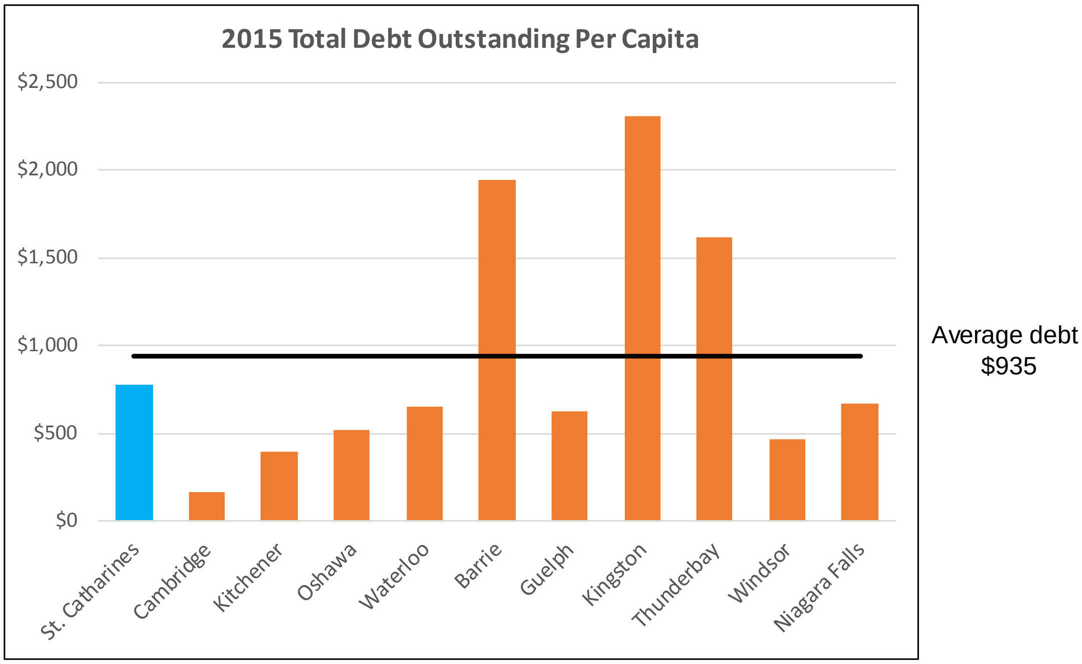
The City of St. Catharines debt level for 2015 is $104.3 million which is below the 2015 comparator municipalities' average. This graph indicates the City's debt is in a relatively stable position compared to its municipal comparators.

The City's debt level for 2016 is $111.3 million which is below the 2015 comparator municipalities' average. The City's debt level forecasted for the end of 2017 is $114.6 million which is below our municipal comparator average in 2015.

Other Debt Measures per BMA Study
(The information in this section was obtained from the BMA Management Consulting Inc. Municipal Study 2016)

For 2015, our comparator municipalities' debt outstanding per capita ranges from $161 in Cambridge to $2,303 in Kingston. The municipality comparator average is $935, whereas St. Catharines total debt per capita is $776, which is 20% below comparator average. Please see Figure 3

Figure 3 - Total Debt Outstanding Per Capita



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 2015 has a debt to reserve ratio of 2.1:1.

Overall, the 2015 ratio has weakened due to completion of major infrastructure projects, namely Meridian Centre and First Ontario Performing Arts Centre.

In 2016, three new reserves were created and a 1% Infrastructure Levy was introduced. In 2017, the City approved four additional reserves: Election Reserve, Litigation/Insurance Reserve, Meridian Centre Capital Fund Reserve and Meridian Centre Event Fund Reserve. The City is currently focused on reserve building, and this is further enhanced by the proposed recommendations in the recently issued Hydro Revenue report. Therefore, effective 2016 and beyond it is anticipated that the ratio will strengthen as these reserves continue to grow.

Report

Current Debt Management Strategy

The objective of the City's current Debt Management Strategy is to minimize the annual impact of debt on the annual 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 the capital projects that are eligible for debt financing, identifies a sustainable level of borrowing and details debt repayment timelines.

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

2. **Sustainable level of borrowing**: For debt management purposes, the City has adopted a policy which limits debt charges to a maximum of 10% of the City's total own expenditures. The policy ensures that debt service costs are sustainable within the operating budget.

3. **Debt repayment**: The City has adopted a 10% down payment strategy which reduces the amount to be borrowed and, matches the approximate costs of one year's debt service to the year in which project is approved. As a result, Council will raise, through property taxes, an amount which will be equivalent of one year's debt charges for each particular project. Debentures are taken for shorter timeframes, 5 to 10 years versus longer timeframe which are typically 20 to 30 years.

The City's current debt outstanding for the year ended 2016 is $111.3 million. The pie chart below (Figure 4) shows the debt break down by functional area.

Figure 4 - 2016 Long Term Debt By Function

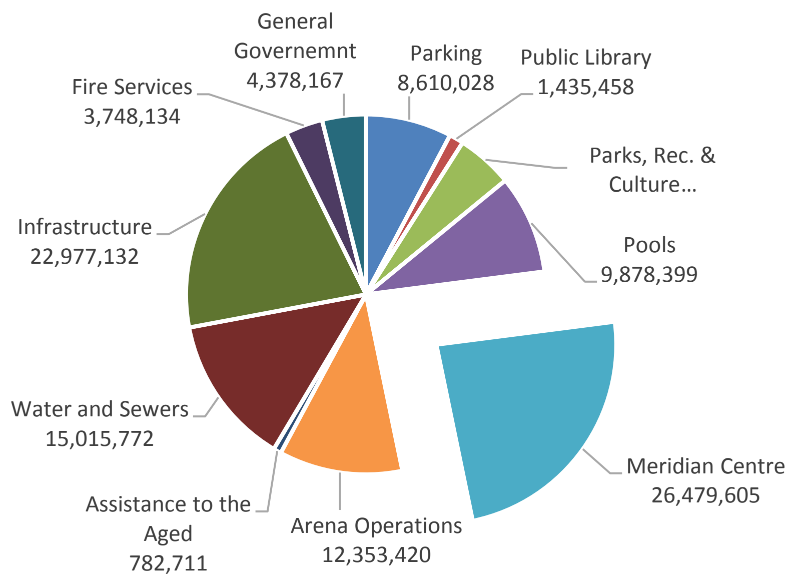
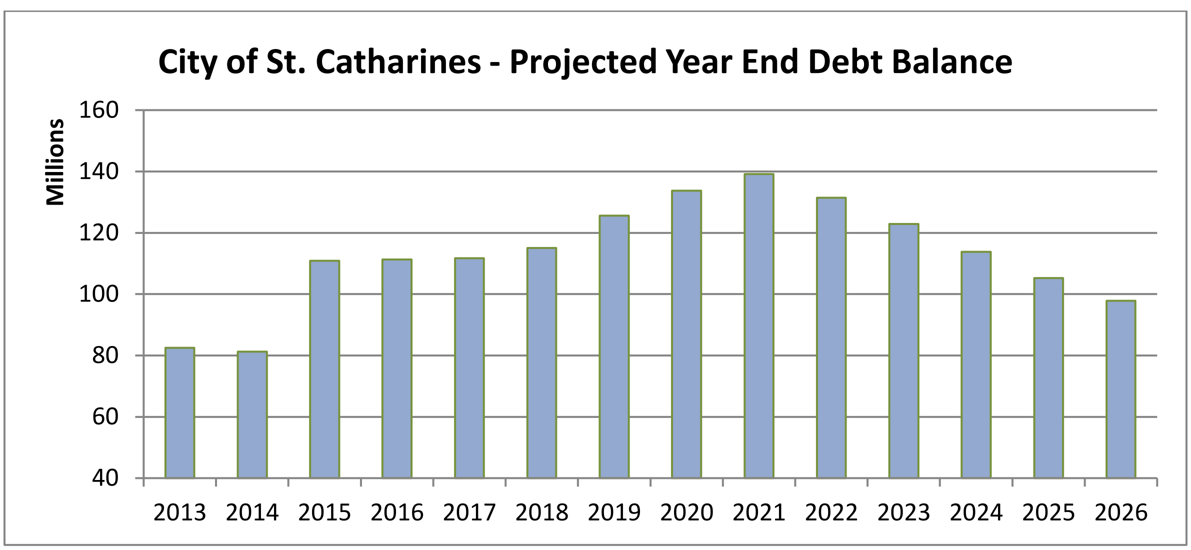


Figure 5 details the projected debt balances to year ended 2026. Based on the current projected capital and related debt activity the total year end debt will peak in 2021 at approximately $140 million, and then by 2026 will decrease to $98 million.

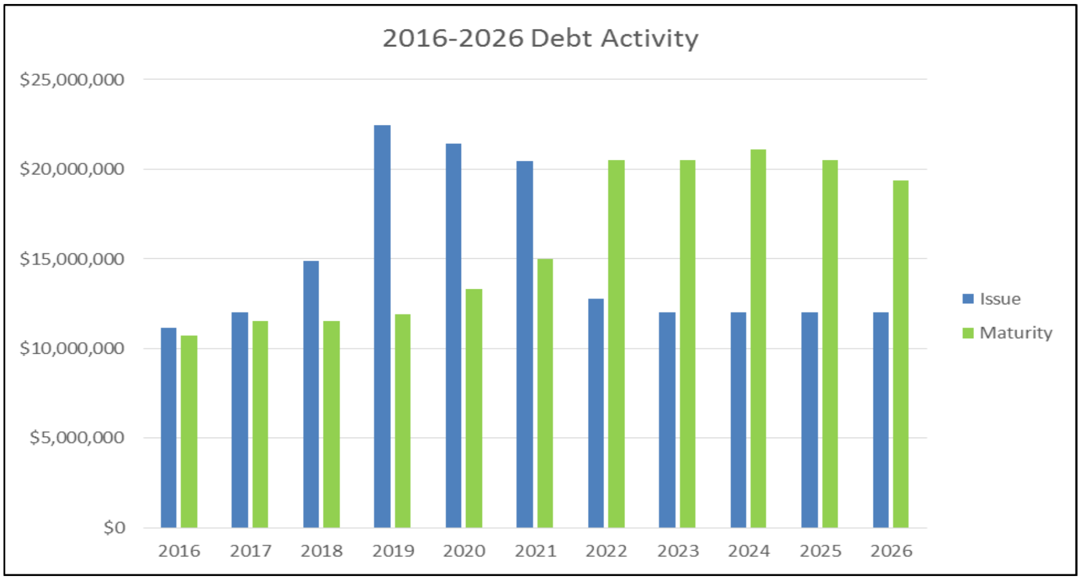
Figure 5 – Projected Debt Balances to 2026



Options to Consider to Minimize Debt Issuance

The following chart (Figure 6) demonstrates that based on the current debt management strategy the amount of debt issued will exceed amount matured during the period 2017-2021, by $28 million.

Figure 6 – Debt Activity



From 2022-2026, based on current projected activity the debt maturity will exceed debt issued by $41 million. Therefore, by 2026 there will be an overall net reduction in debt to a balance of $13 million.

There are four options available for the City to consider to minimize debt issuance:

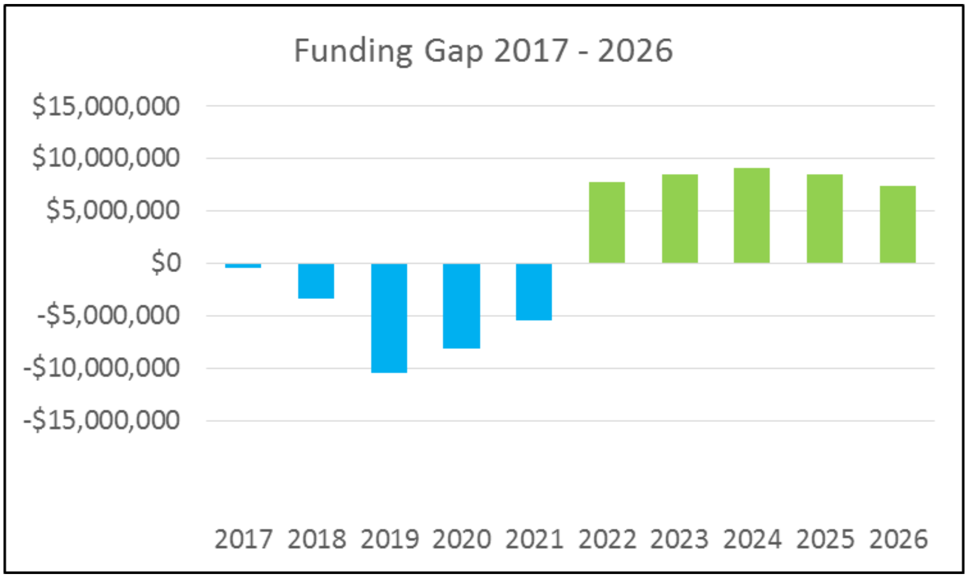
1. Current Year debt Issuance Limited to Amount of Annual Projected Debt Maturing
2. Increase infrastructure levy percentage
3. Increase Capital out of Revenue amount
4. Continue with Current Debt Management Strategy

Options – Explained

1. Current Year Debt Issuance Limited to Amount of Annual Projected Debt Maturities

This option would maintain the annual debt issuance at or below the amount of principal repaid in the current year. Currently, the City pays between $10 and $11 million of principal annually. The City's annual capital program has debt requirements between $14 and $16 million. Figure 7 demonstrates that based on current policy there is a funding gap for years 2017-2021.

Figure 7 – Funding Gap



There are a limited number of available options to address this funding gap and maintain the current spending level for capital improvements, replacements and upgrades. The current options available would be an increase in the capital out of revenue amount or an increase in the infrastructure levy to equal the funding gap. Both of these options result in a direct increase in the amount received from the taxpayer. The table below (Figure 8) shows the impact on the average residential household based on the 2017 tax rates.

Figure 8

Year	**2018**	**2019**	**2020**	**2021**
Funding Gap Amount – Increase Capital Out of Revenue or Infrastructure Levy equal to the gap amount	$3.334 M	$10.515 M	$8.104 M	$5.455 M
Annual Impact on Average Residential Household	**$48.43**	**$104.31**	**($35.02)**	**($38.48)**

Addressing the shortfall in this manner creates peaks and valleys in the annual operating budget which are directly related to capital infrastructure needs. An alternative is to slowly phase in the increases to the Capital out of Revenue and/or Infrastructure Levy over a number of years to reduce the spikes and to achieve the objective of debt issuance equaling debt maturities. These options are further explored below.

Staff will also review the 2019-2021 capital budgets and determine if any items can be funded through alternative sources or if expenditures can be deferred to 2022 and beyond.

2. Increase Infrastructure Levy to 5% over the next four years

An increase in the infrastructure levy would generate additional revenues that could be used to fund capital projects. Based on the current tax levy 1% infrastructure levy equates to $1 million. The funds would be allocated to appropriate capital projects with the intent to reduce reliance on debt.

Figure 9

Year	**2018**	**2019**	**2020**	**2021**
Funding Gap Amount	$3.334 M	$10.515M	$8.104 M	$5.455M
Less: additional Infrastructure Levy amount	($1.0M)	($2.0M)	($3.0M)	($4.0M)
Net Funding Gap	$2.334M	$8.515M	$5.104M	$1.455M
Annual Impact on Average Residential Household of increase Infrastructure Levy	**$14.53**	**$14.53**	**$14.53**	**$14.53**

As shown above, an increase in the infrastructure levy would have an impact on the taxes paid. This increase in property taxes needs to be balanced with the goal of reducing the City's debt burden.

3. Increase the Capital out of Revenue amount increments of $500,000 over four years

In 2017, the Capital out of Revenue amount was $1,529,000. An increase in the amount of support from the operating budget for capital projects reduces the amount of reliance on debt issuance. One approach to increase the amount of Capital out of Revenue is to increase the amount by $500,000 over the next four years. This increase would be used to reduce the amount of debt required to fund the same amount of capital works. Figure 10 below shows the annual impact on the average residential household of increasing the capital out of revenue.

Figure 10

Year	**2018**	**2019**	**2020**	**2021**
Funding Gap Amount	$3.334 M	$10.515M	$8.104 M	$5.455M
Less: additional Capital out of Revenue amount	($0.5M)	($1.5M)	($2.5M)	($3.0M)
Net Funding Gap	$2.834M	$9.015M	$5.604M	$3.455M
Annual Impact on Average Residential Household of Capital out of Revenue Increase	**$7.27**	**$14.53**	**$14.53**	**$7.27**

4. Remain with the Current Debt Management Strategy until 2022 when the debt maturities exceed issuances

Based on the capital program forecast for the next four years and existing and forecasted debt requirements, the City's debt maturities will exceed debt issued until 2022. Another option to consider related to debt management would be to continue with the City's current debt management strategy of the following:

- 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

Then add to the current debt management strategy that in 2022 when the amount of debt maturing exceeds the debt issuance that this be included as an additional and main component to the City's debt management strategy. In addition consideration could be made for maximizing debt issuance at 80% of debt maturity beginning in 2022. This provides the next four years as a transition period for the implementation of this part of the debt management strategy.

Current Challenges

1. An increase in the infrastructure levy and capital out of revenue would require an increase to the tax base.
2. Until 2022 debt issuance needs exceed debt maturities.
3. There is a lack of provincial or federal funding opportunities available to fund large infrastructure initiatives and often include matching dollars from the local municipality.
4. The City has a considerable infrastructure gap that will increase if the City's debt management strategy is altered significantly.
5. Choosing to be debt-free could mean tradeoff of an underfunded stock of infrastructure.

Conclusion

As this report indicates there are a limited 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, however, as identified above there are other options available which could reduce the amount of annual debt issuance.

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