Request for Recommendation

Finance and Administration Committee

Greater | Grand Sudbury
www.greatersudbury.ca

| Type of Decision | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Meeting Date | February 2, 2016 | | | | Report Date | January 28, 2016 | | |
| Decision Requested | | Yes | X | No | Priority | X | High | | Low |
| | | Direction Only | | | Type of Meeting | X | Open | | Closed |

| Report Title |
|---|
| Debt Financing |

| Budget Impact/Policy Implication | |
|---|---|
| X | This report has been reviewed by the Finance Division and the funding source has been identified. |
| X | **Background Attached** |

| Recommendation | |
|---|---|
| For Information Only | |
| | **Recommendation Continued** |

| Recommended by the Department | Recommended by the C.A.O. |
|---|---|
| Ed Stankiewicz<br>Acting Chief Financial Officer/Treasurer | Kevin Fowke<br>Acting Chief Administrative Officer |

## BACKGROUND

At the January 19, 2016 Finance and Administration Committee meeting a parking lot request was made to provide a report on debt financing identifying the City's debt capacity, the City's ability to access our current investment portfolio for internally debt financing, and provide comparison of the City's debt levels to other municipalities.

### Debt Management Policy

In October of 2013, City Council approved a debt management policy, which set out the parameters for securing debt, managing the outstanding debt, providing guidance regarding the timing of debt, type of instrument to be used, and the purpose for the use of debt.

The City's debt financing strategy should be coordinated with the City's long term plans. The policy also states that the debt should be affordable and sustainable and should be structured in an equitable manner to have those that benefit from the asset pay for the debt. The policy also sets out the principles of debt financing in accordance with the City's Long Term Financial Plan. The principles state that debt financing should only be considered for:

- New, non-reoccurring infrastructure requirements
- Programs and facilities which are self supporting
- Projects where the cost of deferring expenditures exceeds debt servicing costs
- Securing debt for terms no longer than the anticipated life of the funded asset

The policy addresses the debt categories, that being:

1) Tax Supported Debt - The debt repayment sources would be on the tax levy.

2) Self Supporting Debt - The debt repayment source would be outside the tax levy, such as user fees or development charges. Such projects would include, but not limited to, water/wastewater projects, parking lot improvements, growth related projects (such as arenas) where other revenues would provide for debt servicing costs.

A copy of the Debt Management Policy is attached.

### Debt Capacity

Each year the Ministry of Municipal Affairs and Housing provides the City with a document for the determination of its annual debt repayment limit. For 2015, based on the City's 2013 Financial Information Returns (FIR), which reflects the City's net revenues at $379 million, the Ministry uses 25% of net revenues for an annual repayment limit ceiling of $95 million. The Debt Management Policy restricts the City's maximum annual debt repayment at 5% of net revenues. Council has indicated that this policy may be revisited to modify this ceiling if more debt is required. The following chart reflects the amount of debt that can be secured at the current policy level, 10% of net revenue, and 25% of net revenue (Ministry of Municipal Affairs and Housing limit).

| ($ millions) | | Current Annual Debt Repayment | Available Debt Repayment | Debt Secured @ 3.2% | Debt Secured @ 3.5% |
|---|---|---|---|---|---|
| 2013 Net Revenues | $379 | | | | |
| Ministry of Municipal Affairs 25% | $95 | $9 | $86 | $1,256 | $1,222 |
| Current Policy 5% | $19 | $9 | $10 | $146 | $142 |
| Change Policy to 10% | $38 | $9 | $29 | $424 | $412 |

This chart reflects the amount of debt that can be secured/funded over a 20 year period.

As reflected under the current policy the City could secure an additional $142 million in debt for capital projects.

**How Does Sudbury Compare to Others**

The BMA study that the City participates in on an annual basis compares 104 municipalities across Ontario on a number of factors. There are a number of measures that deal with debt and the following chart reflects how Greater Sudbury compares to others in the 2015 survey.

| | Tax Debt Interest as % of Net Revenues | Tax Debt Charges as % of Net Revenues | Debt to Reserve Ratio |
|---|---|---|---|
| Greater Sudbury | 0.3% | 1.5% | 0.2 |
| Median | 1.3% | 3.2% | 0.7 |
| Average | 1.4% | 4.2% | 1.1 |

These figures are based on the 2014 Financial Information Returns (FIR). In all cases, the City is in a favourable position.

**Using Committed Reserve Funds for Capital Projects**

At the Finance and Administration Committee meeting of January 19, 2016, a request was made to evaluate the use of committed reserve funds to fund capital projects as these committed funds may not be required for their intended purposes until much later. As reflected in another report on this agenda, there are approximately $21 million of committed reserves, which could be used to fund projects. The largest amount is the allocation of $12.2 million for Maley Drive. The second largest committed amount is for the Whitson-Paquette Drain at $4.1 million. These amounts include allocations identified in the 2015 and previous budgets.

As well, there are also committed reserve funds that are required for the City's obligations. The following table identifies some of the larger committed reserve funds.

| Committed Reserve Fund | Description | Balance Forecast @ December 31, 2015 |
|---|---|---|
| Human Resources Management Reserve Fund | Used for claims fluctuation, succession planning, other potential liabilities and employee rewards and recognition programs | $6.1 Million |
| WSIB Reserve Fund | City is no longer able to secure insurance for catastrophic events, therefore must self insure | $3.6 Million |

| | | |
|---|---|---|
| Capital Financing Reserve Fund – General | Used for a number of one time projects, which include TDS elevator replacement, solar panel project, and funds for market development | $6.0 Million |
| Capital Financing Reserve Fund - Water | Contains funds committed from previous capital budgets; as well, it also includes the water stabilization allocation of 10% of revenues as per the Reserve Funds By-law | $8.6 Million |
| Capital Financing Reserve Fund – Wastewater | Contains funds committed from previous capital budgets as well it also includes the wastewater stabilization allocation of 10% of revenues as per the Reserve Funds By-law | $5.6 Million |
| Capital Financing Reserve Fund – Roads | Contains funds committed from previous capital budgets and funds which are currently deferred for a later date including Maley Drive and several bridge rehabilitations/replacements | $22.3 Million |

In addition to the committed reserve funds, there are a number of uncommitted reserves and reserve funds with significant balances that are required to fulfil obligations of the City. The following table provides a list of some of these reserves with larger balances.

| **Reserves & Reserve Funds** | **Description** | **Balance Forecast @ December 31, 2015** |
|---|---|---|
| Tax Rate Stabilization | This reserve provides for year-to-year variances in the operating budget | $2.6 Million |
| WSIB | The funds are used to pay for invoices from WSIB and to pay rehabilitation expenses | $4.1 Million |
| Industrial Reserve Fund | The funds are used for the expansion or creation of industrial parks | $2.3 Million |
| Roads – Winter Control Reserve Fund | The funds may be used to offset winter control over-expenditures | $3.1 Million |
| Capital Financing Reserve Fund – I.T. | The funds are used for Information Technology projects | $3.6 Million |
| Capital Financing Reserve Fund – EMS | The funds are used for ambulance capital projects including all vehicles, equipment, and stations | $2.3 Million |
| Capital Financing Reserve Funds – Roads | Funds to be used for capital roads projects | $11.2 Million |
| Capital Financing Reserve Funds – Water | Funds to be used for water projects including any projects necessitated by the Ministry of the Environment | $3.4 Million |
| Capital Financing Reserve Funds – Wastewater | Funds to be used for wastewater projects including any projects necessitated by the Ministry of the Environment | $9.5 Million |

Some of the balances noted above are committed as part of the 2016 Capital Budget.

None of the Police Services Reserve Funds have been identified in the above charts as the reserve funds are under the control of the Police Services Board.

As outlined in the BMA study, reserves and reserve funds are a critical component of a municipality's long-term financing plan. The purpose for maintaining reserves, as outlined in the report, is to:

- Provide stability of tax rates in the face of variable and uncontrollable factors (consumption, interest rates, unemployment rates, changes in subsidies)
- Provide financing for one-time or short term requirements without permanently impacting tax and utility rates
- Make provisions for replacements/acquisitions of assets/infrastructure that are currently being consumed and depreciated
- Avoid spikes in funding requirements of the capital budget by reducing their reliance on long-term debt borrowings
- Provide a source of internal financing
- Ensure adequate cash flows
- Provide flexibility to manage debt levels and protect the municipality's financial position
- Provide for future liabilities incurred in the current year but paid for in the future

**Internal vs External**

The City's rate of return on investments for 2015 was 1.97% when considering interest earned only. With the additional returns realized from the capital gains, the rate of return is 3.1%. For the last two months Infrastructure Ontario's lending rates (used as a benchmark) for 20 year borrowing has ranged from 3.1% to 3.3%. If reserve funds were used rather than external borrowing, the opportunity cost would be the 3.1% lost rate of return from the investment portfolio on the funds used for additional capital. As a result, monetarily there would be very little impact in the short term, however, the City would lose the ability to borrow at low rates that are currently being offered. If the City considers external debt financing, the City will be locked into a considerably low interest rate for 20 years in a potentially rising interest rate environment. In this case, the City will also benefit with higher future rates of return on our investment portfolio, ultimately benefitting the reserve funds.

For major capital projects, the debt should be identified for a specific project with a specific time line matching the anticipated life of the asset. Therefore, it would not be considered prudent to use reserve funds for internal long term debt financing. Internal debt should be utilized for smaller capital projects and a projected shorter repayment period. For larger projects, external debt financing should be pursued and the debt repayment period should match the life of the asset to ensure that those individuals consuming or benefiting from the asset pay for it.

**Implementation of a Capital Levy to Fund Capital Projects**

In an attempt to close the infrastructure gap Council may also consider implementing a capital levy. This could be used to enhance the annual capital program or to secure debt.

A capital levy of 1% ($2.3 million) could leverage $33 million of debt to be used for capital programs. The City's Long Term Financial Plan identified the use of a capital levy.

## Federal Infrastructure Stimulus

Minister Sohi recently announced the government's approach to the Infrastructure Stimulus Program. He reiterated the government's overall infrastructure commitment of $60 billion. He had stated the first approach is getting $10 billion working for the economy now, noting that he trusts municipal governments to set priorities. The government wants "shovel ready and shovel worthy" projects and the Minister spoke to the importance of investing in maintenance deferral to extend the life cycle of assets, using examples such as water and wastewater, housing, and upgrading bus fleets.

As a result the City should be ready with priorities and funding plan to secure our share of the funding requirements.

## Additional Resource Requirements

The delivery of a capital project involves costs that can be divided into two broad categories, namely direct and indirect costs. Direct costs include the construction costs and associated physical works such as utility relocations. Indirect costs include a number of non-construction related costs including preliminary investigations, testing, property acquisitions, professional design services, inspections, project management, contract administration, commissioning and record documentation, training and development of operating manuals.

The indirect costs of a project compared to the direct costs will vary with the complexity of the project and value of the project. Purchasing property and relocating expensive utilities such as natural gas lines can significantly affect the percentage of indirect costs. Experience has shown that indirect costs as a ratio of direct costs can vary between 10 and 20 percent of construction costs.

It is important in considering investments in large capital projects that existing staff resources are limited to the capacity of existing capital budgets. To ensure successful completion of the projects additional resources are required as a component of the project. Additional resources can be acquired as permanent staff appointments, temporary secondments, and consultant services. It is also important to note that all projects require a certain amount of time for City staff to ensure that the projects are administered and managed correctly. If specific staff are assigned to a capital project, then it is also possible that they have to be backfilled to ensure their normal work obligations are maintained.

## SUMMARY

As a result of the current low interest rate environment in Canada, it would be prudent to fund large capital projects with external debt. The City should be prepared to identify shovel ready projects to the Federal Government and consider appropriate funding sources.

**THE CITY OF GREATER SUDBURY**
**POLICIES AND PROCEDURES**

**DEPARTMENTS:** All Departments

**SECTION:** All Sections

**TITLE:** Debt Management Policy

**APPROVED BY:** City Council

**DATE:** October 8, 2013

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## Table of Contents

## Purpose

The purpose of the Debt Management Policy is to set out the parameters for securing debt, managing outstanding debt and provides guidance regarding the timing of debt, type of debt instrument and the purpose for which the debt will be used.

## Policy Statement

- Debt is an ongoing component of the City's capital financing structure and should be coordinated with the City's long-term plans and strategies
- Debt must be affordable and sustainable
- Debt should be structured in an equitable manner to those who pay should benefit from the asset
- Issuing or securing new debt should be only approved by Council
- Debt must be managed, monitored and reported upon

## 1.0 Principles of Debt Financing

The City's Capital Policy By-law 2012-119 states:

In accordance with the Long Term Financial Plan (L TFP), more specifically, Principle #7 "use debt financing where appropriate", any internal or external debt financing must be approved by Council, and should only be considered for:

- new, non-recurring infrastructure requirements
- programs and facilities which are self-supporting, and
- projects where the cost of deferring expenditures exceeds debt servicing costs

The LTFP also stated that Council should:

- Consider undertaking a short-term, managed program of debt financing to address the City's current infrastructure deficiency and to reduce further deterioration of the City's infrastructure
- Issue or secure debt for terms no longer than the anticipated life of the funded assets

### Reductions in External Debt Repayments

The LTFP also recommends: "As debt charges decline due to retirement of debt, apply savings to accelerate achievement of full life cycle costing for City infrastructure." When preparing the annual budget, any decrease in annual debt repayments shall be offset by a corresponding increase in the contribution to the respective Capital Envelope. This allows the envelopes to increase while having no impact on the operating budget.

## 2.0 Debt Approval

**2.1** The Capital Policy By-law #2012-119 also provides guidance regarding debt approval.

### Finance Approval for Debt Financing

If a capital project is identified that meets the above noted criteria for debt financing, an application should be made by the SMT member to the Chief Financial Officer.

The Financial Planning and Policy Section will determine if it is in the City's best interest to finance the project internally or externally.

Council approval is required for either internal or external debt financing.

### Internal Debt Financing

From time to time, a capital project may require internal debt financing, with repayments to come from future capital envelopes or other sources over time. If the term of the repayment exceeds two years, then interest will be charged.

Any internal financing recommended to Council will be in accordance with the City's Investment Policy, which states that interest will be charged at one percent above the average investment rate locked in at the time the internal financing is approved. Finance will provide interest rates and amortization schedules for each project with internal debt financing.

**2.2** A multi year debt service funding strategies consistent with the capital planning and budget cycle will be developed. Capital projects requiring debt financing should be identified during the budget process.

## 3.0 Debt Categories

To facilitate debt planning, management and reporting, debt is categorized into two groups based on the funding source for the debt servicing:

1. Tax Supported Debt – the debt repayment source would be the tax levy

2. Self Supporting Debt – the debt repayment source would be outside the tax levy – such as user fees or development charges. Such projects would include but not limited to water/wastewater projects, parking lot improvements, growth related projects, arena projects where other revenues would provide for all operating costs and debt servicing costs

## 4.0 Debt Limits

The municipal debt limits based on debt servicing costs are:

5% of Net Revenues or Own Purpose Revenues (as identified in the Ministry's Annual Repayment Limits). This refers to the total revenue the municipality receives and it is discounted for items such as the Ontario and Canada grants, deferred revenue earned and gain/loss on sale of land and capital assets.

## 5.0 Debt Instruments

The following are guidelines for the City:

- Issue an RFP to secure the best interest rates and terms available
- Obtain a credit rating from one of the rating services if it would assist in reducing the interest rate significantly, and the benefits outweigh the costs
- Make application and secure debt from Infrastructure Ontario if rates are lower than through the RFP process, and the terms are more favourable
- Use of debentures should be considered if bank rates or Infrastructure Ontario rates are not appealing
- Acquisition of financing through a Private Public Partnership (P3) must be approved by Council
- Before entering into a Capital Lease, it must be in accordance with Bylaw 2003-213
- Make use of Municipal Swaps when available to reduce interest costs

## 6.0 Debt Amortization Term

Debt term shall not exceed the probable life of the asset. If the debt term is less than the life of the asset and affordable, this would be recommended with the view of minimizing long term financing costs. (Municipal Act cannot exceed forty years).

Minimizing costs will be balanced against being fair and equitable to taxpayers that pay and benefit from the underlying assets over time.

## 7.0 Reporting and Monitoring

Staff will monitor this regularly and at a minimum report annually against the limits and guidelines identified in Section 4.0.

Staff will also periodically review benchmark data from other municipalities.