Subject: Capital Financing Policy

Report to: Committee of the Whole

Report date: Thursday, October 3, 2019

Recommendations

1. That the Capital Financing Policy, Appendix 1 to Report CSD 51-2019, **BE APPROVED**; and

2. That the Capital Asset Management Policy, C-F-024, Appendix 2 to Report CSD 51-2019, **BE AMENDED** to remove section 3.0 and 4.0.

Key Facts

- The purpose of this report is to approve a Capital Financing Policy that establishes guiding principles for Council and staff to effectively plan for the appropriate financial resources to deliver the growing needs of the Region’s Capital Program.
- Policy principles will be implemented over time to manage affordability associated with the transition period to financial sustainability. Risks of maintaining the status quo could result in continued project deferral, potential asset failure and reduced level of service.
- The policy incorporates regulatory requirements including those outlined in the Asset Management policy, maintenance of a strong credit rating and best practices relative to our municipal peers.
- This policy will require an amendment to remove sections 3.0 and 4.0 from the Capital Asset Management Policy (C-F-003) attached in Appendix 2 to avoid duplication between the two policies.
- A separate procedure document to carry out this policy is developed and will be presented for approval by the Corporate Leadership Team as is corporate practice for all policy procedures.

Financial Considerations

There are no direct financial impacts to the 2019 operations of the Region as a result of this report. However without implementation of a formalized policy, there are risks to the sustainability of the Region’s capital assets. Consequences include continued deferral of projects, potential asset failure and reduced level of service. The policy will implement the guiding principles of a fiscal plan that will lead the Region towards sustainability.

Niagara Region maintains assets with an estimated replacement value in excess of $7.4 billion (as per the 2016 Asset Management Plan (“AMP”)). The principles in this policy were applied to the Water and Wastewater assets totalling $4.7 billion and resulted in the financial sustainability plan being approved by Council (PW 4-2019 *Financial Plan for O.Reg. 453/07)* which included an annual increase of 5.15% for 10 years. Of that amount, 3.15% is to be utilized for the Water and Wastewater capital funding gap. This Policy formalizes these principles for levy assets.

The financial strategy when applied to the Levy supported assets totalling $2.7 billion would require an annual separate levy increase of 2.16% over the 2019 10-year forecast period in order to eliminate the funding gap.

Table 1 provides the variance in levy funding based on the principles of the Capital Financing Policy (“Policy”) being applied according to project types i.e. AMP, growth and strategic investment. The 2019 10-year capital forecast for Levy, excluding Rate supported programs and ABCs is $1.27 billion. The result is a gap in reserves (pay as you go) of $426 million over 10 years. Applying this policy allows for a reduction of the $131 million of debt that would otherwise have been required.

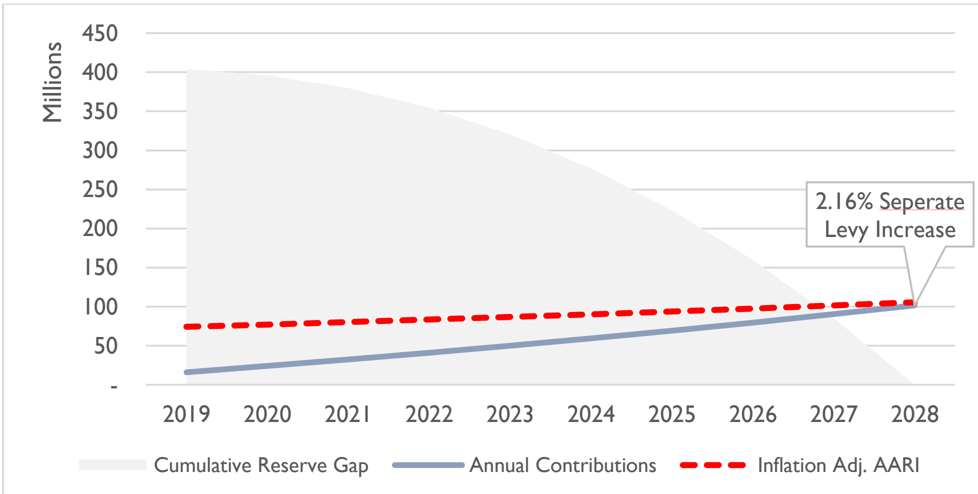
Table 1: Proposed Expenditure vs Current Funding ($millions)

Funding Source	Proposed Expenditure based on Policy				Current Funding available	Funding Strategy realignment
	AMP	Growth	Strategic Investment	Total		
Reserves	668			668	242	426
Debt			271	271	402	(131)
DCs		203		203	203	
Other			23	23	23	
Gas Tax	80		32	112	112	
Total	748	203	326	1,277	982	295

The annual current contribution to Levy Capital reserves is $17 million. This is not sufficient when compared to either the annual amortization (annual consumption of assets based on useful life and historical cost) of $37 million or the Average Annual Renewal Investment (“AARI”) (annual investment needed to sustain existing assets based on replacement value) of $66 million.

Chart 1 shows the elimination of the $426 million reserve (pay as you go) gap over 10 years when we apply an annual 2.16% increase. Using this strategy the annual incremental capital levy contribution at the end of 10 years is $85 million, which increases the annual contribution to $102 million for asset sustainment. When compared to the 2016 Asset Management Plan 10-year Levy AARI of $66 million indexed to 2028 using the Non-Residential Building Construction Index, the AARI required to sustain existing infrastructure is $106 million; which aligns to the capital reserve contribution at the end of the 10-year plan.

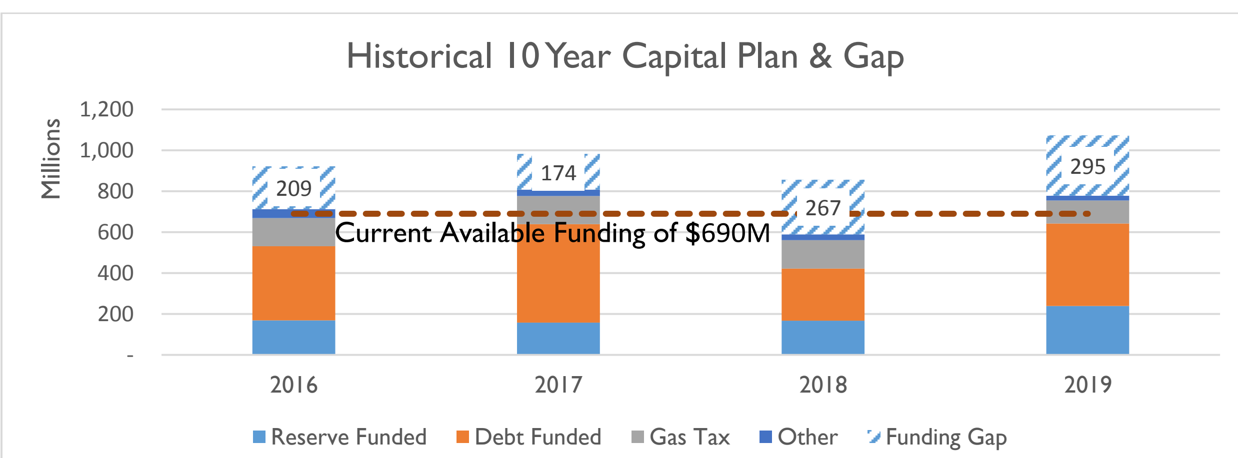
Chart 1: Funding Gap and AARI vs Separate Levy Increase



Analysis

As referenced within CSD 40-2019 “2020 Budget Planning”, staff noted a capital funding gap. This policy was developed as a strategy to close the gap. The required annual levy increase to close the 10-year capital funding gap was identified as 1% in 2012. Due to increasing capital costs and minimal increases in sustainable funding, the levy increase required had grown to 2.16% for the 2019 10-year forecast. As a result of past deferrals of projects and new assets since the 2016 Asset Management Plan, the Region’s 10-year capital forecast along with the funding gap continues to increase as seen in the Chart 2.

Chart 2: Historical 10 Year Levy Capital Plan & Gap (excluding DC's)



A Capital Financing Strategy is identified in Council's Strategic Priorities as per CAO 9-2019 and the implementation plan acknowledged a long-term commitment by Council. Staff are proposing the following principles to ensure a Capital Financing Policy with a flexible implementation strategy to address the funding gap that ensures the capital program provides the required level of service.

It is important to establish a clear link between revenue and expenditure decisions for sustainability. Different financing sources are appropriate to pay for different types of infrastructure. The four main sources of capital financing to fund the 10-year Capital program are as follows:

A. Debt
B. Reserves (pay as you go)
C. Development Charges
D. External Sources

An analysis of the funding sources and the proposed best use recommendation / project types are summarized below.

A. Debt

Definition: Funds raised through long-term borrowing from a creditor.
Who Pays: The cost to borrow is spread and paid over the useful life of the capital asset. This cost is funded by the current and future tax base.

Pros and Cons of Debt

Pro

- Ability to afford large project costs by spreading the cost of capital over time.
- Cost of capital paid by future beneficiaries.
- Interest rates are low.
- Timing of certain grants and subsidies are structured to align to use of debt. (Eg. Provincial per diems)
- Provincial imposed limit of total annual financing charges cannot exceed the 25% of own source revenues (ARL). The Region is currently at 7.09%.

Con

- Debt has incremental operating budget impacts and may not be sustainable in the long run.
- Debt will impact future taxpayers. Therefore when used for replacement of existing infrastructure, current and past taxpayers did not pay for use.
- Expensive relative to reserves due to debt servicing costs.
- May constrict future financial decisions.
- Too much debt may lower the Regions credit rating resulting in an increase in future borrowing costs.

Definition: Funds raised through long-term borrowing from a creditor.	
	Using debt exclusively to fund the gap would breach the S&P ratio by 2022.
Example of impact of tax base • $1,000,000 debt financed requires $1,740,000 tax dollars • $58,000 annual operating cost is 0.02% of the levy • $1,000,000 project with 30-year 4% debt will require $58,000 annually from the tax base for 30 years resulting in gross cost of $1,740,000 (interest of $740,000).	
Conclusion: The best use of debt funding is for Strategic Investment projects. Assets that provide a new or enhanced level of service should be funded by future beneficiaries as the asset is consumed and the debt paid through future operating budgets.	

B. Reserves (Pay as you go)

Definition: Previous and current operating budget contributions to Capital Reserves.	
Who Pays: These funds come from the taxation levy on the current tax base and any funds set aside from the historical tax base.	
Pros and Cons of Reserves (Pay as you go)	
Pro	**Con**
• Users of the asset are funding for the replacement of the asset as it is being consumed. • Interest savings from debt avoidance can be put towards other projects. • Greater flexibility relative to debt which are tied up in long repayment terms. • Establishing an appropriate reserve allows the Region to smooth tax impacts of significant one-time "spikes" in the capital program	• Investment rate of return on reserves may not match inflation risk on project expenditure. • Establishing the appropriate reserve contribution level from current tax payers to match their use of the assets. • Contributions to Capital Reserves in the operating budget does not buy as much capital acquisitions as does the same operating budget funding for debt.
Example of impact of tax base • $1,000,000 reserve financed requires $1,000,000 tax dollars.	

Definition: Previous and current operating budget contributions to Capital Reserves.
• $1,000,000 annual pay as you go contribution to the capital reserves is 0.3% of the levy
Conclusion: The best use of reserves (pay as you go) funding is for Asset Management (State of Good repair) projects Assets that are currently in use should be funded from the current and past operating budgets as the asset is being consumed.

C. Development Charges

Definition: Fees collected by the Region for the purpose of financing the construction of new capital infrastructure to support growth.
Who Pays: These funds are collected from developers upon issuance of a building permit for new developments.

Pros and Cons of Development Charges

Pro	Con
• Development charges are past on to property owners therefore new taxpayers are paying for the cost of growth capital. • No financial impact to the existing tax base.	• Collection of receipts may not match the timing of capital projects. • All of the DCs are not being collected due to Grant programs (2018 - $13M) • The current taxpayers are funding for shortfalls in development charges due to grant programs. • Growth may not materialize as expected.

Example of impact of tax base • $1,000,000 development charge financed requires $0 tax dollars.
Conclusion: Growth projects should be funded by Development Charges In the event that DC collections are insufficient or timing is delayed, debt could be utilized to finance growth assets and have DCs fund the debt servicing costs.

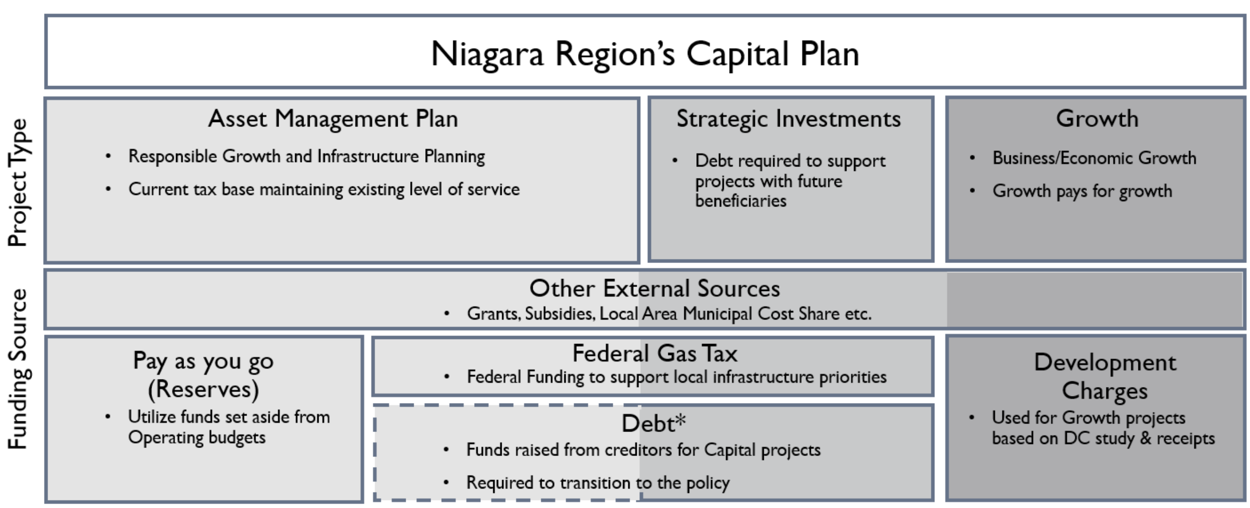
D. External Sources

Definition: Gas Tax and 3rd party contributions, subsidies and recoveries.
Who Pays: These funds are collected from 3rd parties.

Definition: Gas Tax and 3rd party contributions, subsidies and recoveries.
Pros and Cons of External Sources **Pro** • No financial impact to the existing tax base. • Allows for coordination with funding partners. **Con** • Funding may be restricted to specific projects. • Difficult to forecast and dependant on 3rd parties.
Example of impact of tax base • $1,000,000 externally financed requires $0 tax dollars.
Conclusion: The use of external funding will be project specific based on ownership of assets being constructed and compliance with the funding agreement. Gas tax should be prioritized for state of good repair projects until appropriate levels of funding are established.

Based on the analysis above the following is a summary of the link between revenue and project expenditure type. Chart 3 illustrates Capital Financing Strategy based on the types of projects.

Chart 3: Capital Financing Strategy



As identified in the Financial Considerations section, upon applying the strategies to the 2019 10-year forecast, an annual separate levy increase of 2.16% is required over a 10 year period to eliminate the gap. Recognizing this will delay availability of funding to the appropriate level required; in the interim debt may be considered to bridge the gap but only with consideration of all Policy principles.

Other municipalities have faced similar fiscal challenges as the Region and have adopted similar funding strategies. Niagara Region currently has the lowest contribution to the capital reserves in dollars and as a percentage of tax supported assets relative to our comparator upper-tier municipalities below. Other municipal implementation strategies ranging from 0.5% - 2.0% annually are provided in Table 2.

Table 2: Comparable Municipal Peers (Levy Capital Program)

Upper Tier	Niagara	Halton	Peel	Waterloo	York	Durham (Roads /Bridge)
% Levy Increase for AMP	0%[4]	0.5%	1.0%	0.85%	1.0% - 2.0%	Assessment growth funded.
2019 Annual Capital Contribution (A)	$17.0M	$49.8M	$59.5M	>$26.0M[2]	$163.0M	>$31.5M[1]
Total Tax Supported Assets (B)	$2.7B	>$1.6B[3]	$5.0B	$3.1B	$6.0B	$4.0B
Annual Capital Contribution as a % of Total Tax Supported Assets (A/B)	0.59%	3.12%	1.19%	0.84%	2.72%	0.79%
Strategy	Capital Financing Policy	Based on Asset Management Plan. Varying increases.	Forecasted 6 annual increases to close gap, 11 approved historically.	1% of previous year's tax levy for 2 years historically; or based on Asset Management Plan.	11 % of separate levy increases. Forecasted 3 annual increases for specific projects.	Based on Asset Management Plan.

[1]Roads and bridge rehabilitation only, does not include all assets
[2]Referenced in 2018 Reserve Strategy
[3]$1.6B book value; $2.3B implied proration based on 2013 AMP (A/B = 2.16%)
[4]A one-time increase of 1% on the tax levy was approved in 2017

Based on above, principles have been established in the policy under the following headings.

1. **Ensure long-term financial sustainability and flexibility**

The appropriate level of funding will be recommended in the operating budget and the allocation of that funding to specific projects will be recommended based on the above.

2. Maintain a strong credit rating

Niagara Region's credit rating has a direct impact on the Region's cost of borrowing for capital projects. Therefore with a significant portion of our capital program being funded with debt it should be a priority to minimize the cost of borrowing by way of maintaining a strong credit rating. Niagara Region is currently rated "AA stable" as determined by the Region's credit rating agency, Standard and Poor's (S&P). Niagara has maintained this rating since 2001 which provides a positive message to stakeholders and investors.

3. Adherence to Statutory Requirements

Adherence to legislated requirements is mandatory and necessary to leverage funding from other levels of government, in particular the following need to be considered:

- Municipal Act, 2001 - The Act provides several legislative safeguards to ensure that fundamental activities and responsibilities are adhered to in the management of the budget and debt financing.
- O.Reg 588/17 Asset Management Planning for Municipal Infrastructure - A life cycle management and financial strategy will need to be approved by July 1, 2024. Without adequate funding the AMP levels of service will need to be modified to align to the funding available.

Alternatives Reviewed

The status quo entails proceeding without a capital financing strategy, however this is **NOT RECOMMENDED** as it has been identified as a Council strategic priority. Risks and consequences of maintaining the status quo are as follows:

- Continued deferral of projects.
- Asset degradation erodes service levels and user satisfaction.
- Increased maintenance costs due to asset failure may be required.
- Without a separate levy increase, the Region will continue to rely on debt

Relationship to Council Strategic Priorities

The recommendations in this report will support sustainable and engaging government.

Other Pertinent Reports

CAO 9-2019 – Shape Niagara Corporate Implementation Plan
CSD 40-2019 – 2020 Budget Planning
CSD 65-2019 - Budget Planning By-Law
By-law 2017-63 - Budget Control By-Law
C-F-003 - Capital Asset Management Policy

[PW 4-2019 - Financial Plan for O.Reg. 453/07](#)

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Appendices

Appendix 1 Capital Financing Policy

Appendix 2 Capital Asset Management Policy (C-F-003)