Council Report

Report Number:	**CA2021-004**
Meeting Date:	August 10, 2021
Title:	**Kawartha Lakes Long-Term Financial Plan (LTFP) - Updates**
Description:	This report presents Council with the tax-supported capital forecast developed for 2022-2031 as well as a discussion around various capital financing challenges, limits on debt, a dedicated capital levy and key operating pressures.
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Recommendation(s):

That Report CA2021-004, **Kawartha Lakes Long-Term Financial Plan (LTFP) - Update**, be received;

That the tax-supported capital forecast outlined in Appendix A of Report CA2021-004 be utilized to inform the long-term capital forecast within the future LTFP;

That staff include in the future LTFP a recommended tax-supported capital levy dedicated to supporting and sustaining the capital reserve;

That staff include in the future LTFP a recommended target debt servicing ratio no greater than 10%;

That staff include in the future LTFP recommended debt limits by category, including water-wastewater, tax levy, housing, capital charges and development charges categories, collectively within the target debt servicing ratio;

Department Head: ______________________________

Financial/Legal/HR/Other: ______________________________

Chief Administrative Officer: ______________________________

That staff include in the future LTFP a recommended maximum percentage usage of the City's legislated Annual Repayment Limit with respect to debt; and

That staff reflect in the future LTFP the assumption that annual tax levy increases will be approximately 3% at minimum.

Background:

As Council is aware, staff is working on bringing forward in Q3, 2021 a long-term financial plan (LTFP) designed to inform the City's budgets over the 2022-2031 period and guide the City toward long-term financial sustainability. Throughout 2021 to date, Council has been updated on the progress of the plan at key milestones of its development. The occasion of this report represents another such milestone.

The purpose of this report is to present Council with the tax-supported capital forecast developed for 2022-2031 and provide a discussion around challenges relating to capital financing and operating pressures. That discussion culminates in recommendations respecting a dedicated capital levy, limits on the City's debt servicing ratio, separate debt limits by category of debt, including water-wastewater, tax levy, housing, capital charges and development charges categories, limits on usage of the City's legislated Annual Repayment Limit, and a minimum rate of annual tax levy increases.

As the Water-Wastewater Rate Study adopted by Council earlier this year contains a 10-year capital and operating forecast already incorporated into the draft LTFP, this report focuses on tax-supported capital and operating needs.

Rationale:

For ease of reference, this section is divided into subsections relating to the tax-supported capital forecast, capital reserve financing challenges, debenture and development charges (DC) financing challenges, and operating pressures.

Tax-Supported Capital Forecast

Based on the Asset Management Plan, service master plans, DC Background Study, prior budgets and other sources of direction provided by Council or legislation, staff has developed a 10-year tax-supported capital forecast for 2022-2031 – see Appendix A. The expenditure part of the forecast is divided into baseline, expansionary, external and special projects components.

Baseline capital expenditures are those needed to simply keep the City's existing asset portfolio in a state of good repair and thus in a condition facilitative of required municipal service levels. Almost all such expenditures are directed toward replacement or rehabilitation of existing assets. Based principally on the Asset Management Plan and prior capital budgets, the baseline capital forecast is presented in Table 1 of Appendix A wherein it is organized by capital program. Due to capital cost inflation, as measured by Statistics Canada's Non-Residential Building Construction Price Index, baseline capital needs are anticipated to increase by 3%/year, taking them from $41.6M in 2022 to $54.5M in 2031 in total.

Expansionary capital expenditures are almost exclusively growth-related, although some arise from legislation or upgrades in service levels (e.g. new services). Based principally on service master plans and the DC Background Study, the expansionary capital forecast is presented in Table 2 of Appendix A. By far the largest project in that forecast is the replacement of Victoria Manor, something presently legislated, for an estimated cost of $61.8M. Staff anticipate that project to be financed primarily by debenture, with the provincial government providing modest grant funding for the interest portion thereof. It is considered expansionary because the existing facility is aged only 32 years and the replacement facility must be of a considerably larger footprint even though no beds are being added. Setting aside that unusually large project, the balance of the expansionary capital needs average $16.1M/year over the planning horizon. An estimated 57% of expansionary capital costs outside of Victoria Manor are recoverable from the DC reserve.

External capital expenditures are those emanating from the Kawartha Lakes Police Service (KLPS) or Kawartha Lakes-Haliburton Housing Corporation (KLHHC). These are presented in Table 3 of Appendix A. For KLPS, baseline capital needs increase from $350K/year in 2022 to $456K/year in 2031 due to inflation, and growth-related and other capital needs are $284K/year and 40% DC-recoverable on average. Based on its asset management and master plans, KLHHC anticipates expending $224M over the planning horizon to replace and expand the stock of affordable housing in the City and County of Haliburton. Of this amount, approximately 16% is anticipated to be DC-recoverable.

Starting with 2020, a special projects budget was introduced to the City's budget compliment to accommodate operating projects, such as studies and other infrequent initiatives, better budgeted and managed in the same manner as capital projects. While special projects are technically operating in nature, the special projects budget has, since its inception, been presented alongside the capital budget because special projects are managed as though they are capital in nature. Hence, the special projects forecast is presented in Table 4 of Appendix A. Based principally on service master plans, the DC Background Study, previous budgets and legislation, $28.3M in special projects needs is forecasted for the planning horizon. Of this, approximately 16% is considered DC-recoverable, 25% relates to the Solid Waste EA project and another 8% relates to appeals at the Ontario Land Tribunal.

Appendix A concludes with Tables 5 and 6 which are, respectively, the expenditure forecast summary and the financing requirements forecast. Total capital and special projects expenditure is forecasted to be $959M over the planning horizon, which balances with the financing forecast. The capital reserve, debenture and the DC reserve are the main sources of financing for which requirements exceed existing financial capacity. Just to meet forecasted baseline capital needs under existing self-imposed debt limits, an average draw from the capital reserve of $28M/year would be required over the planning horizon. The capital reserve contribution is, however, only $9.1M/year at present, which is less than 35% of what is needed at minimum in 2022. In the absence of a dedicated capital levy, Table 6 notionally assumes this contribution remains static over the planning horizon, even though it is highly deficient.

In the draft LTFP, forecasted capital expenditures that cannot be met by other means are notionally financed by debenture. As indicated in Table 6 of Appendix A, total tax-supported debt issuance over the planning horizon amounts to $514M. Of this amount, 43% is related to baseline capital, 13% is related to expansionary capital, 32% is related to housing capital and 12% is related to just one capital project, namely replacement of Victoria Manor. Not reflected in Table 6 are additional pressures on debt emanating from DC revenue failing to keep pace with growth-related capital needs and from water-wastewater capital needs documented in the Water-Wastewater Rate Study.

Capital Reserve Financing Challenges and Dedicated Capital Levy

The current LTFP, adopted in 2017 for the 2018-2027 period, is largely geared toward implementing the City's Asset Management Plan and building up the City's financial capacity so as to support capital needs according to legislated and Council-adopted municipal service levels. The cornerstone of the current LTFP is a strategy for bringing the contribution to and balance of the capital reserve up to sustainable levels within the 10-year planning horizon.

However, as Council has been apprised on multiple occasions, the City has deviated from the current LTFP principally in two very consequential ways. Firstly, tax levy increases have been substantially less than those outlined in the plan, starving the capital reserve of contributions. The plan originally called for tax increases of 4.5%/year over 2018-2021, which were reduced to 4%/year through amendment in early 2018, whereas actual tax increases have averaged 2.8%/year over the same period. Secondly, and perhaps even more consequentially, operating expenditures have increased at an average rate of 5.4%/year over 2018-2021, which is far higher than the 2%/year assumed in the plan, further eroding contributions to the capital reserve.

The effect of these consequential deviations has been to render highly deficient the contribution to and balance of the capital reserve. Indeed, rather than having increased, the contribution to the capital reserve has in fact declined markedly, given it was approximately $13.1M/year in 2017 and is now $9.1M/year in 2021. Accounting for capital cost inflation, that is a loss of nearly 50% in annualized financial capacity of the capital reserve to meet baseline capital needs. Moreover, at just $2.1M, the 2020 year-end balance of the capital reserve is well below the corresponding value of $4.8M forecasted in the current LTFP. Despite the City receiving a few unplanned capital grants since 2017, the foregoing state of affairs severely compromises the City's ability to meet basic asset replacement and rehabilitation needs, much less those related to expansion, Council-directed service upgrades or newly legislated obligations.

As a result, staff recommends that the forthcoming LTFP include a dedicated capital levy that would: (i) provide the capital reserve with a segregated revenue stream and reduce pressure on the City's debt load; (ii) be designed to build up the contribution to and balance of the capital reserve to more sustainable levels and then maintain those levels; and (iii) be separately identified on tax bills to promote transparency, reassuring taxpayers that the revenue thereby raised is dedicated to tax-supported capital purposes.

As implied by Table 6 of Appendix A, a strategy for gradually closing the capital reserve contribution gap by 2031 would require the existing contribution of $9.1M/year to be transformed into a dedicated capital levy and increased annually by about 13% on average over the planning horizon. Roughly speaking, that would equate to building the capital reserve contribution up with tax levy increases of 1.5%/year cumulatively over the planning horizon in order to bring that contribution up to the $31.8M/year minimum required by 2031 and enable the City to thereafter build a sustainable balance in the capital reserve. While staff is not yet in a position to recommend a specific form for the proposed dedicated capital levy, the above figures provide context for Council and a working benchmark for further development of the forthcoming LTFP.

Experience in peer municipalities in Ontario suggests that dedicated capital levies have proven effective at improving alignment between financial capacity and capital needs. The success of such levies is likely due in part to their tendency to: (i) keep municipalities committed to meeting capital needs; (ii) encourage Councils to approve capital budgets and levies simultaneously (instead of approving the capital-related portion of the tax levy after capital budget approval); and (iii) find general acceptance among taxpayers.

Debenture and DC Financing Challenges and Debt-Related Limits

In absence of a dedicated capital levy, in which case the current capital reserve contribution of $9.1M/year remains static over the planning horizon, the baseline capital plan would require an increase in the tax-supported debt limit of over $15M in 2022, a figure that is projected to grow to over $22M by 2031. These figures are in excess of the existing tax-supported debt limit of $25M and the existing tax-supported special debenture limit of $24M which declines gradually as it is repaid. It is expected that the tax-supported baseline capital forecast will be modified to align with the debt-related limits and the dedicated capital levy proposed by this report. This requires further review to determine whether and to what extent capital projects could be deferred.

The expansionary capital forecast places significant pressure on the City's debt load as well as the DC reserve. The forecast entails issuance of $131M in debt, starting with a small issuance ($2M) in 2022 and peaking at over $73M in 2024 due to the replacement of Victoria Manor. This would cause the existing tax-supported debt limit to be significantly exceeded. It also entails $92M in DC financing requirements, which would require an offsetting $9.2M/year in DC revenue on average to avoid putting the DC reserve into a negative position long-term.

At about $6M to date, DC revenue (inclusive of deferred DC payments) in 2021 has been robust compared to recent years. Based on that and projected development approvals for the balance of 2021, the City can expect to collect close to $10M in DC revenue by the end of 2021, which would be a record for the City. Based on recent years' experience, however, it would be prudent for the LTFP to adopt a less aggressive DC revenue forecast (e.g. $5M/year) going forward. In addition to the requirements outlined in Table 2 of Appendix A, DC revenue is required to support: (i) existing debt issued to cover prior DC reserve deficits ($2M/year); the capital forecast approved as part of the Water-Wastewater Rate Study ($1.4M/year); the housing capital forecast outlined in Table 3 ($0.45M/year); the special projects forecast outlined in Table 4 ($0.45M/year); and issuances of debt in the near future to cover the existing unfunded deficit in the DC reserve ($15M-$20M).

As the DC reserve is an obligatory reserve, its balance must, by law, be restored to zero or better at the close of each year. Because borrowing indefinitely for this purpose is unsustainable if future DC revenues resemble those of recent years, staff anticipates the LTFP to limit pressure on the DC reserve through deferral of growth-related capital projects, limitations on DC-supported debt, review of existing non-residential DC exemptions and encouragement of developers to front-end certain growth-related capital projects. Without decisive action on that front, the City faces the risk of having existing and forthcoming committed DC-related debt servicing costs exceed DC revenue, whereby the difference would have to be interim-financed by a tax-supported source. Such an outcome should be avoided if at all possible.

The external capital plan relating to KLHHC includes a mix of financing instruments: sales of assets, DC reserve, grants and debentures. As the availability of grants is largely unknown, KLHHC's capital plan relies significantly upon debenture financing. The first six years of the plan identifies specific projects, which entail about $33.5M in debenture financing. The remaining four years of the plan entails over $130M in debenture financing for housing capital needs which have yet to be specified as identifiable capital projects. Overall, the housing capital plan places substantial pressure on the City's debt load and thus debt limits, even though housing-related debt is expected to be supported entirely by housing rental revenues. It is anticipated that KLHHC will refine capital project identification as it implements its asset management and master plans.

Overall, the capital forecast presented in Appendix A, which is based on prevailing municipal service levels, is unsustainable under the City's existing financial capacity. While adoption of the recommendations of this report will enhance financial capacity, staff still expect that deferral of some capital projects will ultimately be necessary, even with the added financial capacity.

On prior occasions, Treasury informed Council about the Annual Repayment Limit (ARL) imposed by the Municipal Act on all municipalities in Ontario other than the City of Toronto. Specifically, the ARL is the maximum annual debt servicing cost (principal plus interest) a municipality can incur as a fraction of its own source revenue. The Municipal Act sets this fraction at 25%, and defines "own source revenue" as total revenue less remittances to school boards, most grants, DC collections and other restricted revenues.

The City's ARL is anticipated to be $48M/year in 2022 and to increase to about $61M/year by 2031 due to projected increases in revenue. If the tax-supported and water-wastewater capital forecasts for 2022-2031 are pursued in their current form, it is anticipated that the City would increase its debt load from $135M at 2020 year-end to $435M by 2031. That would leave only about $19M/year in ARL room, or equivalently $100M in available debt financing. Such a state would be quite concerning as it would render the City financially vulnerable in the event of a catastrophic asset failure.

Alongside the ARL, the Ministry of Municipal Affairs and Housing has established a benchmark referred to as the debt servicing ratio, which is equal to debt servicing cost divided by own purpose revenue (as opposed to merely own source revenue, as is the case for the ARL) on an annual basis. Debt servicing ratios within the range of 5%-10%

are considered medium-risk, while those below and above that range are considered low-risk and high-risk, respectively. In its present state, the draft LTFP takes the City's debt servicing ratio notionally from 6.5% to about 15.5%, moving the City from the medium-risk to the high-risk range. On prior occasions, Treasury indicated that the City's debt servicing ratio ideally should not exceed 7.5%, and that a debt servicing ratio exceeding 10% would be cause for concern and not recommended. Hence, staff is recommending that the City's self-imposed target debt servicing ratio not exceed 10%. Such a limit is comparable to that adopted in peer municipalities, such as Port Hope.

Operating Pressures and Minimum Annual Tax Levy Increase

Staff has taken a conservative approach to the tax-supported operating forecast within the draft LTFP. With the exception of grants, tax levy, interest income, overtime expenses and utility expenses, revenues and expenditures have been indexed at 2%/year to account for general inflation.

Grants other than the Ontario Municipal Partnership Fund (OMPF) are maintained at 2021 levels in the absence of projections provided by grantors. As the OMPF was, prior to the pandemic, the focus of several announcements indicating a reduction to this grant is forthcoming, it is assumed to decline at 5%/year over the planning horizon. Tax levy increases are set to 3%/year while tax levy growth deriving from assessment growth is projected to be 1.25%/year. Interest income is maintained at 2021 levels due to uncertainty regarding future interest rates. Water-wastewater utility expenses are increased by 3%/year to align with the Water-Wastewater Rate Study, while those for other utilities are increased by 1.015%/year based on informal discussions with those utilities. Overtime expenses are maintained at 2021 levels.

Over the planning horizon in the draft LTFP, increased operating pressures alone are projected to exceed increased financial capacity, even with tax levy increases set at 3%/year. Key drivers of this challenge are as follows:

- Increases in wages and benefits due to contractual obligations equate to an average tax levy increase of 2%/year.

- Increases in contracted service expenditures equate to an average tax levy increase of 1%/year.

- Increases in transfers to external organizations, such as the OPP and local health unit, equate to an average tax levy increase of 0.5%/year once increases in offsetting grant revenues are accounted for.

In total, these pressures equate to a tax levy increase of 3.5%/year, which exceeds the target of 3%/year and leaves no financial capacity for required increases to the capital reserve contribution. As alluded to in previous remarks, continuance of the status quo whereby operating costs escalate annually to the point of reducing capital-related financial capacity is entirely unsustainable. Indeed, this is largely why the capital reserve contribution is as highly deficient as it is presently. With respect to making the forthcoming LTFP viable, this state of affairs suggests that bringing operating pressures under control should generally take precedence over deferring capital projects, recognizing the necessity of both measures ultimately.

Other Alternatives Considered:

As the capital forecast outlined in Appendix A is based on the Asset Management Plan, service master plans, DC Background Study, prior budgets and other sources of direction provided by Council or legislation, staff is not proposing at this time an alternative to incorporating the forecast into the forthcoming LTFP. That is, staff is presently taking as given prevailing Council direction respecting municipal service levels and the capital needs they imply. Of course, Council may wish to provide alternative direction at this time or at another touchpoint with the development of the LTFP.

It is the expectation of staff that a dedicated capital levy would be an effective means by which to gradually bring the City's financial capacity in line with its baseline capital needs in a prudent, affordable and transparent manner. Hence, staff recommend that such a levy be incorporated into the forthcoming LTFP. To that approach, there are two readily apparent alternatives: (i) implement a one-time special tax increase of about 15% in 2022 in order to immediately close the capital reserve contribution gap (i.e. increase the contribution from $9.1M/year to approximately $25.5M/year) and begin building the capital reserve's balance; (ii) reduce service levels (e.g. close underutilized facilities) in order to reduce operating and capital obligations sufficiently. Given the City's extensive capital needs as outlined in Appendix A, the status quo or "do nothing" approach is not a financially viable alternative. Also non-viable would be continued indefinite deferrals of capital projects without commensurate reductions in municipal service levels.

In lieu of the recommended maximum debt servicing ratio of 10%, Council could elect a higher maximum, which would necessarily reside in the high-risk range (>10%) defined by the Ministry of Municipal Affairs and Housing. Staff, however, recommends that the City avoid placing itself in this range, especially under prevailing credit market conditions. While interest rates are presently very low by historical standards, they are expected to begin rising at some point within the first half of the planning horizon, raising the cost of borrowing accordingly. Erring on the side of prudence, staff recommends that the City avoid overleveraging itself in the near term and thus excessively restrict its ability to issue debentures in the medium-to-long term under less favourable borrowing conditions.

In lieu of the recommended minimum annual tax levy increase of 3%, Council could direct staff to base the forthcoming LTFP on a lower or higher minimum. As the draft LTFP is unsustainable even with annual tax levy increases set at 3%, staff recommends that these increases absolutely be no less than 3%. Should Council nonetheless elect a lower minimum, it would be obliged to identify corresponding reductions to municipal service levels designed to achieve and maintain long-term sustainability accordingly. While a higher minimum (e.g. 4%) would necessarily provide for greater improvement to long-term financial capacity and sustainability, Council would in this case be obliged to balance that benefit with taxpayer affordability considerations.

Alignment to Strategic Priorities

The recommendations of this report support responsible financial and asset management, and hence align with the strategic priority of "Good Government" identified in the City's 2020-2023 Strategic Plan.

Financial/Operation Impacts:

The financing implications of the 2022-2031 capital forecast are summarized in Appendix A, and explained throughout this report. The introduction of a dedicated capital levy will improve the City's financial outlook as it relates to baseline capital, where the degree of improvement will depend on the levy's initial size and its escalation over time as ultimately reflected in the LTFP. Respecting the City's reliance on debt, the replacement of existing dollar-value limits on debt by limits on the debt servicing ratio and usage of the Annual Repayment Limit will enhance debt management in a prudential and flexible manner. A minimum annual tax levy increase of 3% provides a sensible initial benchmark that balances the needs of financial capacity with taxpayer affordability. However, even that minimum is expected to entail a mix of capital project deferrals and reductions in operating pressures, with relatively greater weight on the latter factor, as the forthcoming LTFP is further developed by staff.

Consultations:

Director of Corporate Services

CAO

Attachments:

Appendix A: Tax-Supported Capital Forecast – 2022-2031

Tax-Supported
Capital Forecast 2022-

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