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Financial Sustainability Update

Staff Report

Report Number: 2018-75

Department(s): Financial Services

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Meeting Date: December 10, 2018

Recommendations

That the report entitled Financial Sustainability Update dated December 10, 2018 be received for information.

Executive Summary

See below.

Purpose

The purpose of this report is to provide an update on the status of the factors that constitute the Town's Sustainable Financial Strategy. This should be done at least on an annual basis and it is appropriate to do so now at the commencement of the 2019 budget process.

This is an opportunity to outline any new initiatives that may be undertaken related to financial sustainability, such as upcoming policy recommendations or housekeeping matters.

Background

The Town's Sustainable Financial Strategy contains the following five elements:

1. Asset Management
2. Debt
3. Investment Strategy
4. Revenues
5. Reserves and Reserve Funds

The last update was provided as part of Finance Report 2018-11, Policies for Financial Sustainability, dated April 30, 2018.

The performance data comes from the Town's audited financial statements and two main third party sources:

1. The Ministry of Municipal Affairs and Housing (MMAH) produces the following annual report cards for each Ontario municipality:
    a. The Financial Indicator Review, which reports on sustainability and flexibility indicators; and
    b. The Annual Repayment Limit (ARL), which puts a statutory restriction on borrowing.

2. BMA Consulting prepares an annual report for 113 participating Ontario municipalities, which includes almost all of the GTA. It utilizes financial information from municipal financial information returns (FIR's), tax data, and fees & charges postings; along with demographics from Statistics Canada to identify trends and make comparisons.

The final report for 2018 has not been issued yet; any BMA reference is to the draft report.

Discussion

Updates since April 30, 2018.

Asset Management

Central York Fire Services (CYFS) has prepared an Asset Management Plan (AMP) which was approved by the overseeing Joint Council Committee (JCC) on June 12, 2018. This is part of the 10-year financial plan and covers all vehicles and equipment. It now forms the basis for future CYFS capital requests.

AMP's will be required for all of our core assets by July 1, 2021 and for the remaining assets by July 1, 2023.

Council adopted the Town's first Asset Management Policy on January 11, 2016. This will need to be updated every 5 years.

Continuing implementation of the Asset Management Strategy will include work on levels of service, conditions assessments, data inventories, processes and software. An update will be provided in 2019.

The Town's current Development Charges (DC) By-law is due for update by September 2019. A staff task force is currently working with our consultant to develop a background study to support the new by-law. This background study will be the basis for future growth-related capital requests.

Debt

A revised debt policy was adopted earlier this year which clarified the use of debt financing. No changes were made to the overall restrictions on debt.

On July 16, 2018, the Town borrowed $26 million to purchase the Mulock Estate. The funds were borrowed from Infrastructure Ontario, through the Regional Municipality of York. The loan is in the form of a 30-year debenture at a fixed interest rate of 3.49%. This loan has a significant impact on debt-related indicators.

Debt levels are monitored with reference to:

- Strength of the underlying asset – long-term debt as a percentage of the net book value of tangible capital assets. (Net book value of an asset is its original cost less accumulated depreciation applied to it.)

2012	2013	2014	2015	2016	2017	2018 projected
11.2%	10.3%	9.4%	8.5%	7.7%	6.9%	10.7%

- Capacity to pay the debt servicing cost - debt servicing cost as a percentage of total own-source revenue. Debt servicing costs include both the principal and interest portion of payments. Own-source revenue is essentially property taxes and user fees excluding development charges, grants, proceeds on disposal of tangible capital assets, increase/decrease in government business enterprise equity. It is the metric that the province uses for the Annual Repayment Limit that municipalities are required to adhere to.

2012	2013	2014	2015	2016	2017	2018 projected
5.5%	5.3%	5.3%	4.9%	4.6%	4.5%	5.8%

The Debt Policy sets a limit of 10%. We are still well within that limit. The MMAH will still rate the Town’s debt levels as a low level of risk to financial flexibility. At the current Infrastructure Ontario rates for 20-year debentures, we could borrow another $60 million.

One of the Town’s debentures will be due for renewal in 2019. This is the debt for the Operations Centre. It is amortized over 20 years and has an initial 10-year term that expires in 2019. If renewed, this would be at current interest rates. Staff is recommending that this loan be paid out – this is covered in a separate Financial Services Report entitled Debt Retirement.

Investment Strategy

The Town's Investment Policy and Strategy were both updated in January of 2016. They will be reviewed again in 2020.

Our investments are based on a 3-stream approach:

1. The first stream is short-term investment of operating funds, taking advantage of seasonal and cyclical cash fluctuations.
2. The second stream is medium and long-term investment of reserve funds, using the projected surplus of long-term balances.
3. The third stream is in business enterprises. These include internal projects that pay for themselves by generating revenues or saving costs, such as the Honeywell streetlight retrofit; and external investments such as our ownership in Newmarket-Tay Hydro.

The Strategy establishes a benchmark, which is the return earned on our bank balances, i.e. a status quo of no investment effort. Success is measured by how much the actual investment return exceeds the benchmark, which is referred to as incremental investment income earned. This income is allocated to the operating and reserve funds based upon targets set in the budget process.

The table below is a measure of the relative success of our 1st and 2nd streams of investments. The recent increases in interest rates have reduced these returns but have more than compensated that with a better return on our passive investments – interest on our bank accounts.

2013	2014	2015	2016	2017	2018 Projected
$59,767	$221,951	$244,299	$417,522	$279,223	$120,000

The Town maintains high cash balances due to not having a solid multi-year capital budget. Improvements in capital forecasting will allow the Town to invest more of its cash and receive higher yields.

Revenues

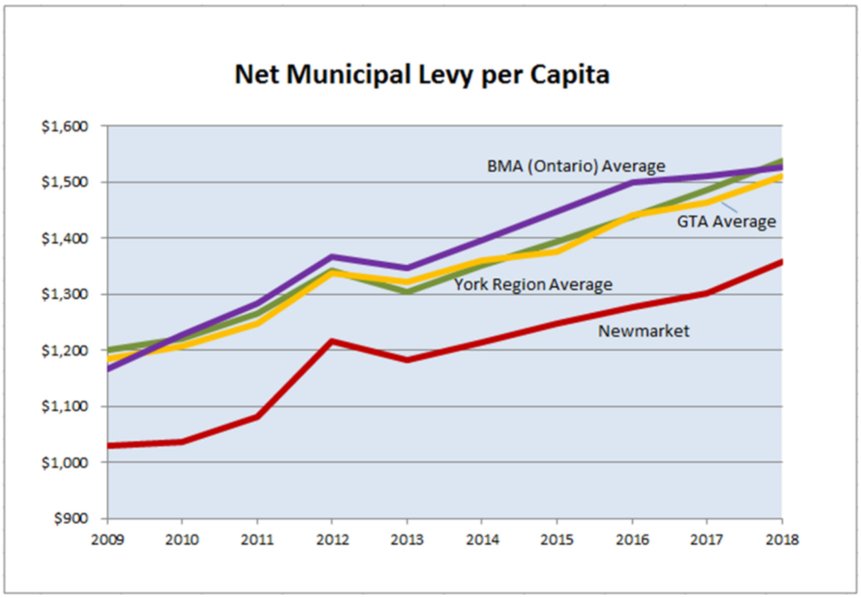
With 80% of the Town's revenues coming from property taxation and user fees, the strategy has focused on these two areas.

Proactive Assessment Management (PAM) was implemented in 2016 to protect our property tax assessment base. In recent years, the base has been put under more risk with changes in legislation and assessment and classification challenges from significant non-residential taxpayers. We have been collaborating with the Municipal Property Assessment Corporation (MPAC), making more extensive use of tax and assessment analysis tools and have become more diligent in the application of the policy.

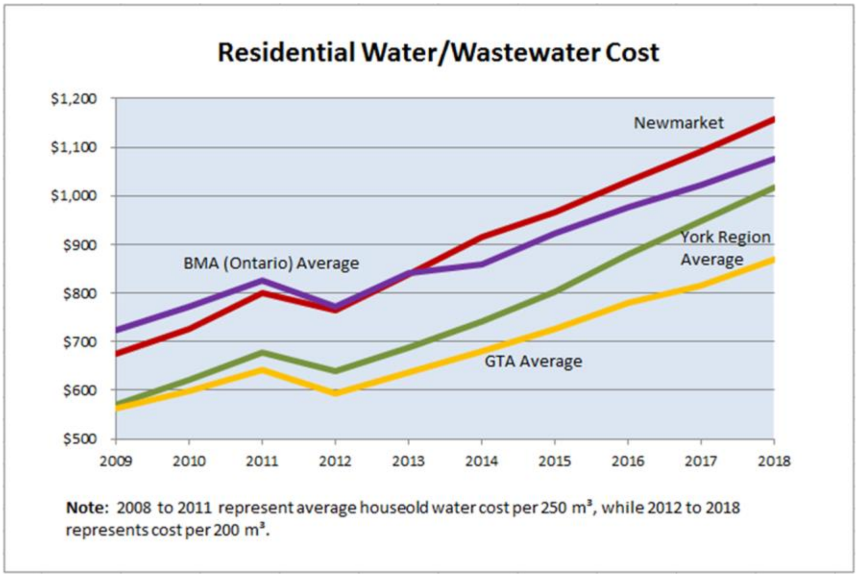
As a result, while there have still been material adjustments, we have been able to predict and mitigate some of the impact.

The Service Pricing Policy was adopted by Council in 2006. It's goal was to create a cost-based framework for setting user fees and to relieve the pressure on property taxes. Staff is reviewing the policy to ensure that the Town's service pricing best promote social well-being. All the while, the policy will ensure that taxpayers are not overly burdened by subsidizing services. This review will be done in coordination with the Recreation Master Plan Playbook as it reviews pricing.

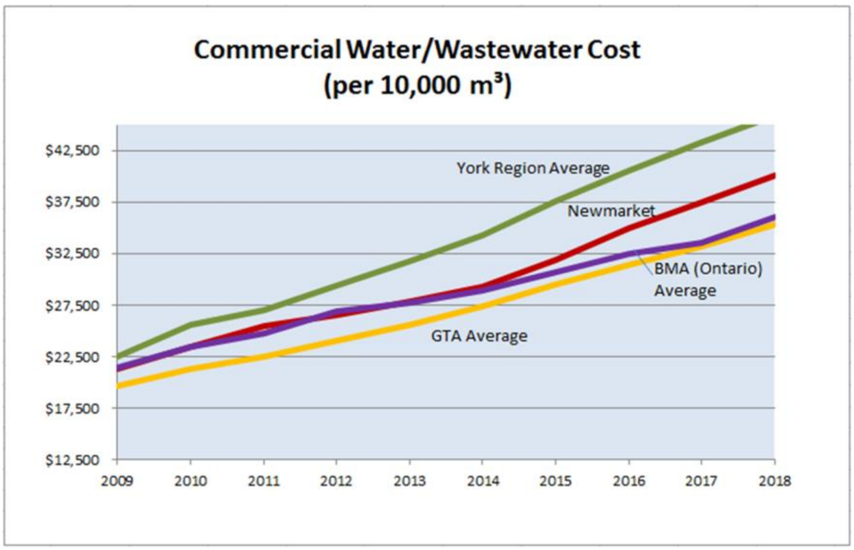
Per the BMA study, Newmarket's property taxes continue to be competitive:



Newmarket's water and wastewater rates, which are at sustainable, full cost recovery levels, are higher than our neighbours for residential users. We have the 2nd highest residential rates in York Region.



However, our charges to heavy commercial and industrial users are relatively lower:



For this reason, the Town started implementing tiered water rates in 2017, with full implementation by 2020 with the goal to shift the burden off the residential user to balance out the higher residential rates and the lower commercial rates.

Reserves and Reserve Funds

Reserves and reserve funds are operating surpluses set aside for future purposes. Whether the funds are a contingency or a savings account, they provide for rate stabilization by preventing future rate spikes. The spikes may be due to events that are either unforeseen (contingency) or foreseen (e.g. savings for a capital replacement). Reserves tend to be shorter term and do not earn interest.

The Town has many different Reserves and Reserve Funds established by Council for a variety of purposes. A Reserve and Reserve Fund Policy was adopted earlier in 2018. This sets a framework for a review of our current practices. The review will be undertaken in 2019 and will consolidate, create and eliminate reserves as appropriate. It will also define targets and funding sources. A by-law will be enacted to formalize the policies on reserve funds.

The Elman Campbell Museum has a separate fund, the Museum Fund, which has been set up similar to a separate trust fund. A separate Financial Services report will be recommending that this be reconfigured to align more with the original intent for this fund.

Collectively, reserves and reserve funds for operating purposes are usually compared to the expenses they support or the revenues that they stabilize. Those for capital purposes will be discussed in the next section.

The primary measure for MMAH is Total Reserves and Discretionary Reserve Funds as a Percentage of Operating Expenses.

	2013	**2014**	**2015**	**2016**	**2017**
Newmarket	48.7%	43.2%	37.9%	43.7%	46.1%
Median	47.3%	46.3%	51.1%	52.7%	58.2%
Average	52.5%	52.0%	55.7%	58.0%	59.5%

No reasonable projection for 2018 can be provided at this time.

Although the Town is below the Ontario average, the Ministry of Municipal Affairs considers it a “low level of challenge”, i.e. good.

As the main purpose of reserves and reserve funds is rate stabilization, levels should be compared by fund to the primary funding source.

	2012	**2013**	**2014**	**2015**	**2016**	**2017**
Tax Discretionary Reserve as a % of Taxation Revenue	27%	32%	15%	7.4%	8.2%	7.3%
Water Reserve as a % of Water Revenues	132%	140%	149%	154%	161%	165%
Wastewater Reserve as a % of Wastewater Revenues	85%	93%	106%	116%	121%	139%

The Town's overall Reserve and Reserve Fund position is good, but as can be seen from the above table, this is due to the Water and Wastewater Reserves. The BMA Study reinforces this by showing that Newmarket's tax-supported reserves are ranked as the 3rd lowest while our water reserves (4th highest) and wastewater reserves (9th highest) are ranked much higher. This is the result of investments in asset replacement as will be shown in the next section.

Asset Replacement Fund

The Asset Replacement Fund (ARF) was created in 1998. It's original goal was to ensure that Newmarket could afford to replace future capital assets as required.

Contributions were based on the amount needed to be set aside on an annual basis to cover the cost to replace an asset at the end of its life cycle. The amounts were based on the current replacement value and not historical cost. No adjustments were made for contributions that should have been made prior to creation of the ARF.

The initial annual contributions to the ARF were only 50% of the estimated requirements. Exceptions were made for water, wastewater and fire, which all started at 100%. Over time, the contributions on the other assets were increased and they hit 100% in 2008.

There were no further increases in ARF contributions until the Capital Financing Sustainability Strategy in 2013 recommended annual infrastructure levies of 1%. This resulted in infrastructure levies in 2013 (0.84%), 2014 (0.74%), 2015 (1%), 2016 (0.80%) and 2018 (0.68%). There was no increase in 2017.

Funding the Asset Replacement Fund takes up a significant portion of our operating budgets – approximately 14% – and with the infrastructure deficit, it is a perennial budget driver. A separate ARF policy was created earlier this year. Its main budget impact was to restrict ARF funding to tangible capital assets (TCA). There will be a separate Financial Services Report to detail the implications of this within the 2019 budget.

There is no industry standard measure available at this time. The usual providers of municipal key performance indicators, MMAH and BMA have not yet provided a suitable recommendation.

A metric has been considered by the Municipal Finance Officers Association of Ontario (MFOA) and used by our internal auditors in their review of our infrastructure levy. That metric is capital reserves as a percentage of the accumulated amortization of tangible capital assets. BMA has started making some limited use of this but they use all reserves and not just those set aside for asset replacement.

Amortization is the accounting term for depreciation, the proportional annual allocation of the original cost of an asset. Accumulated amortization is the sum of the depreciation over the years. Net book value is the original cost of the asset less its accumulated amortization at a given point in time. At the end of an asset's expected useful life, the accumulated amortization will equal its original cost and the asset is then considered fully amortized and has no net book value.

To illustrate, take an asset purchased for $20,000 with a 20-year life expectancy. It would have annual amortization of $1,000 and after 5 years would have an accumulated amortization of $5,000, and a net book value of $15,000. Setting aside the amortization of $5,000 in a reserve fund would be prudent. (Note that market value or replacement cost is not considered for accounting purposes – setting aside 25% of the projected replacement cost would be even better).

If funds are set aside on an annual basis equal to the amortization, then the capital reserves would be at 100% of the accumulated amortization at the end of the asset's lifecycle. That would represent current ratepayers paying for the cost of the tangible capital assets that provide services to them. This has not been the experience of Newmarket or most municipalities.

Capital Reserves as a % of Accumulated Amortization

	2012	2013	2014	2015	2016	2017
Combined	8%	10%	9%	8%	9%	11%
Tax Supported	-5%	-4%	-7%	-10%	-8%	-10%
Rate Supported	46%	50%	53%	55%	58%	42%

Contributions to Capital Reserves as a % of Amortization Expenses

	2013	2014	2015	2016	2017
Combined	86%	88%	92%	106%	101%
Tax Supported	74%	85%	82%	81%	69%
Rate Supported	99%	94%	113%	212%	244%

The tax-supported deficit is being financed by the rate-supported surplus. An ARF Strategy will be developed to deal with these issues. It is on the list of outstanding Committee of the Whole issues to be presented in the 3rd quarter of 2019.

Future Policies

Budget Policy

The 2018 and 2019 budget processes are test runs for an upcoming budget policy: the principles that will be incorporated into the policy are being put into practice. A formal policy will be presented for review and adoption prior to the start of the 2020 budget process.

Gas Tax Policy

The Federal Gas Tax allocation can be used for a wide variety of capital projects but the Town's practice has been to restrict it to roads projects. There is a reasonable cost/ benefit relationship with that choice. Consideration could be given to formalizing that arrangement or expanding its scope.

Ontario Community Infrastructure Fund

Similar to the Gas Tax, the province provides a formula-based allocation that the Town has been using for road re-surfacing and it's Asset Management Strategy. This could be formalized into a policy.

Allowances for Employee Benefits

Certain employee benefits require the establishment of an allowance for them, either as a reserve fund or a liability. These include Post-Retirement Benefits, Long-Term Disability and Health and Dental benefits. We should also consider provisions for short-term leaves – vacation, illness, parental, etc.

There are currently procedures in place. A comprehensive policy, developed by Financial Services and Human Resources would provide clear funding targets.

Conclusion

These policies and strategies, if and as approved, will be factored into the 2019 and future budget processes as appropriate.

Business Plan and Strategic Plan Linkages

This report links to Newmarket's key strategic directions in being Well Managed through fiscal responsibility.

Consultation

The Senior Leadership Team (SLT) has been consulted in the development of these policies. Data was obtained from our audited financial statements, the Ministry of Municipal Affairs and Housing's Financial Indicator Report and Annual Repayment Limit report, and the draft BMA Study.

Human Resource Considerations

Not applicable.

Budget Impact

This information may inform future Operating and Capital Budgets.

Attachments

None.

Approval

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