Fiscal Strategy
Town of Newmarket

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Outline

Part A: Fiscal Strategy

1. The concept of financial sustainability
2. Intergenerational equity
3. Fiscal strategy framework

Part B: The Fiscal Strategy In Practice

4. Managing the capital plan
5. Building reserves
6. Using debt wisely
7. Finding additional revenue
8. Concluding Comments

Part A
Fiscal Strategy

1. The concept of financial sustainability

Financial sustainability is about the stewardship of the long term

A pragmatic approach to financial sustainability focuses on capabilities

In practical terms, a municipality is financially sustainable if….

1. Its tax effort and other revenues are commensurate with its level of service aspirations
2. It can adjust its capital plan, its operating programs and its service levels in response to changes in economic conditions (e.g., pandemic) or transfer payments
3. It can keep its infrastructure in a state of good repair and replace it at the right time
4. Financial responsibility is shared fairly between current and future residents (inter-generational equity)

And a couple more conditions for growing municipalities

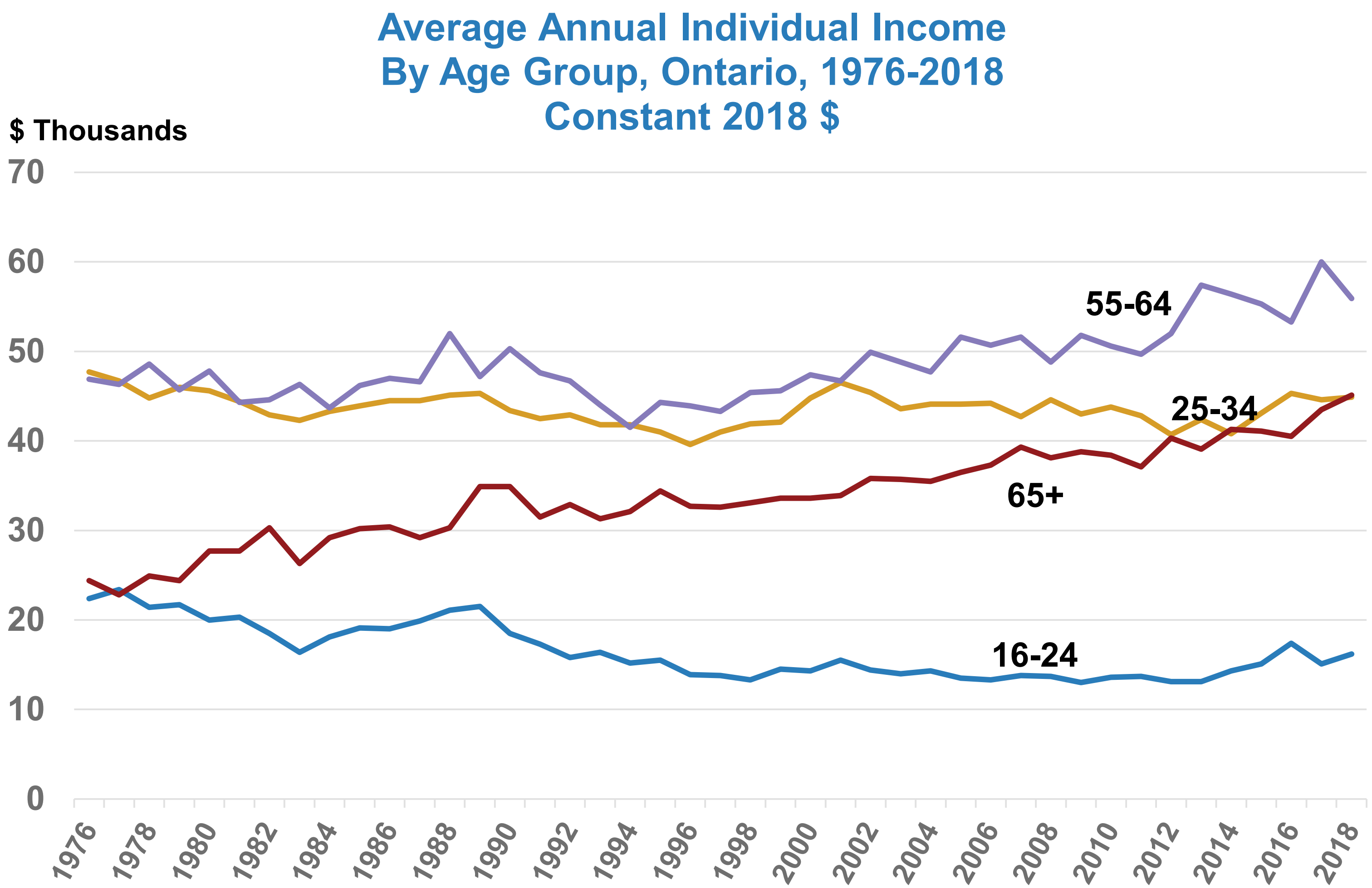
6. Growth can be accommodated without unacceptable tax levy, user rate or debt increases
7. Service levels can be increased as the municipality urbanizes

2. Inter-Generational Equity

Inter-generational equity is a sleeper issue

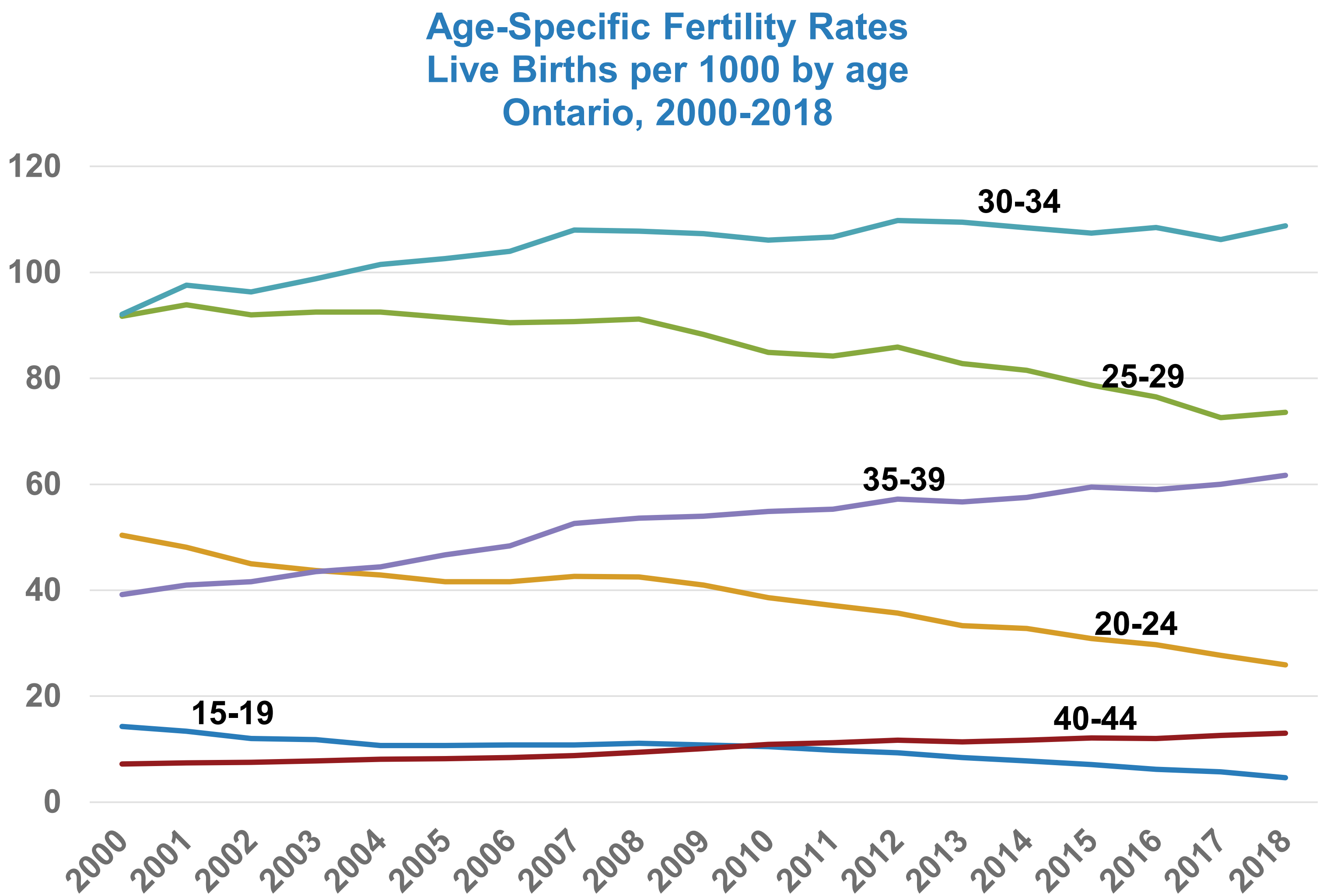
- Good fiscal planning means that the generation of people who benefit from an asset is also the one paying for it
- The children of baby boomers will likely be the first generation to have lower lifetime incomes than their parents
- The introduction of tangible capital asset accounting in 2009 is helping municipalities realize that a “pay-as-you-go” philosophy substantially disadvantages future generations

Income gains are going to the older generations



Source: Income Statistics Division, Statistics Canada
Does not include impact of TFSAs, which increase incomes among older people especially

Family formation is being delayed



Inter-generational equity has profound implications for municipal finance

- There is a growing realization in municipal circles that meeting future asset management needs is going to be very expensive
- Because infrastructure is less expensive in the early part of its life and more expensive later when life cycle rehabilitation and replacement expenses occur, it is easy for today's generation of tax- and rate-payers to pay significantly less than the true cost of their use of infrastructure
- The implication for municipal finance is that robust saving for future asset management needs is a matter of inter-generational fairness

3. Fiscal strategy framework

The purpose of a fiscal strategy is to provide a path to financial sustainability

The key elements of a Fiscal Strategy for Newmarket

Newmarket's overall financial position is good

- Newmarket is well-positioned to implement a sound long-term fiscal strategy
- The strategy should seek to:
  - Manage the capital plan to balance delivery ability and short- and long-run financial capacity
  - Aggressively build reserves, particularly for future asset management needs and contingencies
  - Keep a watchful eye on debt levels
  - Identify additional sources of revenue

Part B
The Fiscal Strategy in Practice

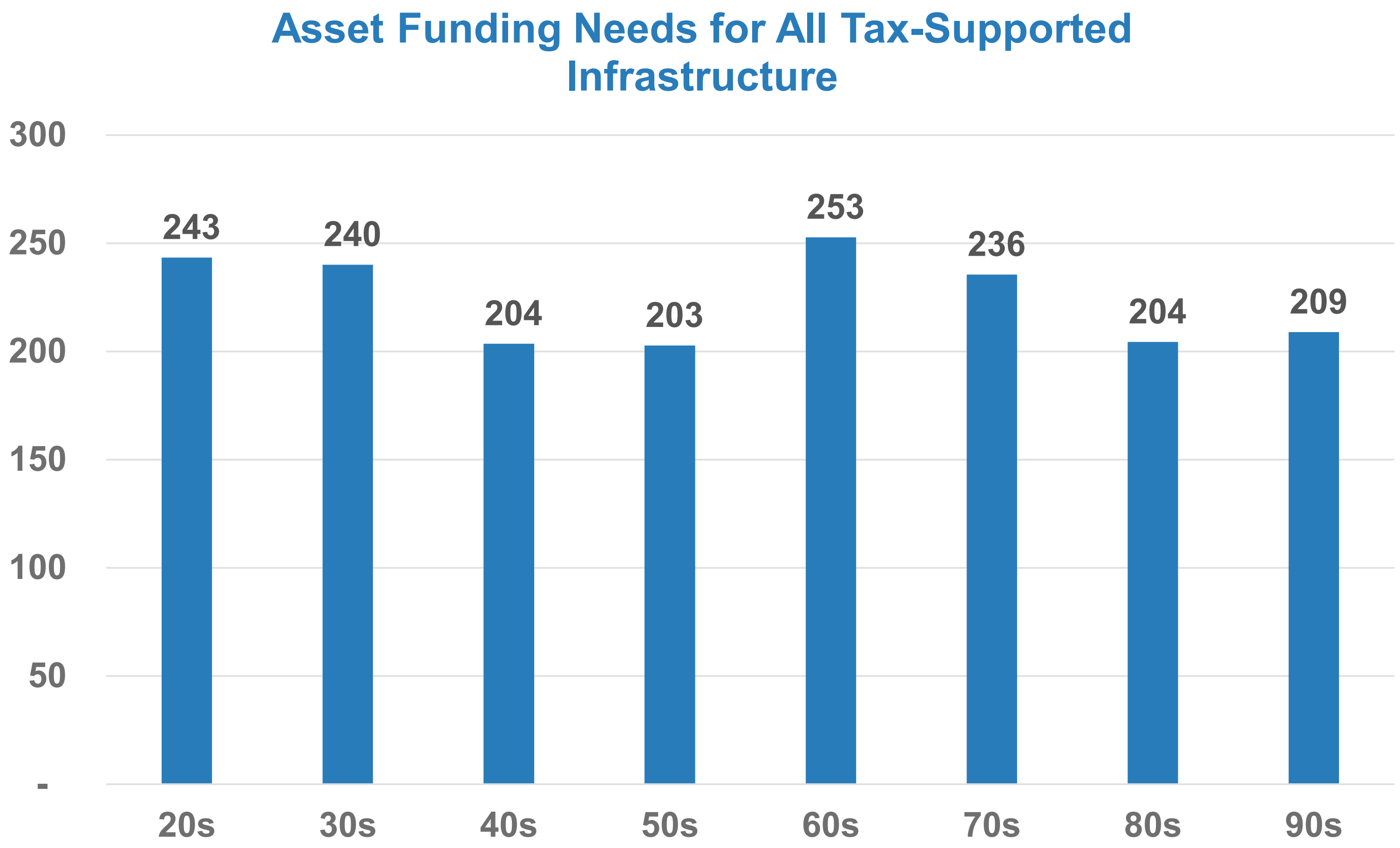
4a. Managing the capital plan:

Asset Management

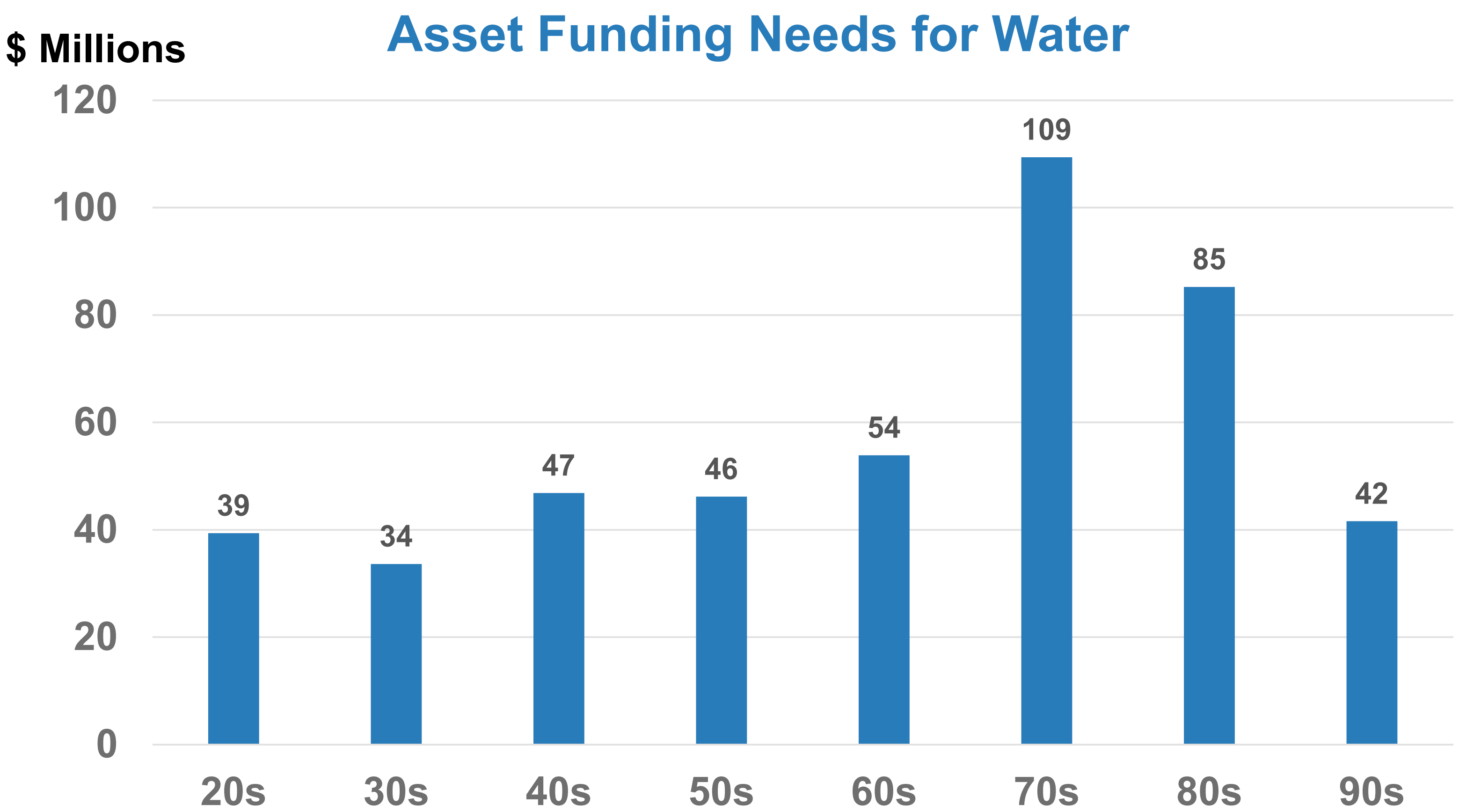
The big challenge for asset management policy will be to achieve integration between asset management plans and financial plans

Good asset management planning requires a commitment to savings. Almost all municipalities will have to save much more aggressively to meet future asset management needs and achieve reasonable intergenerational equity. Newmarket is no exception.

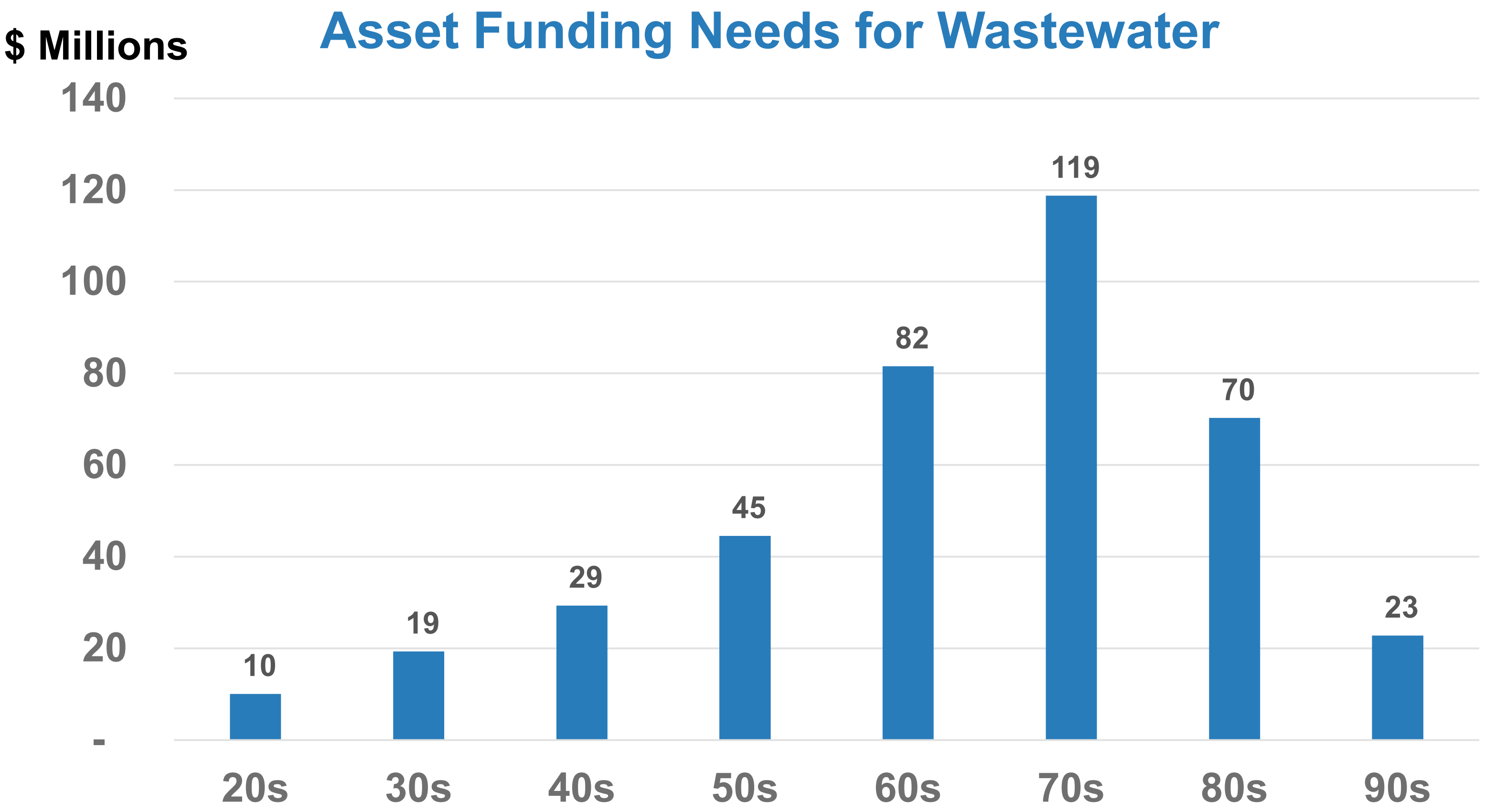
Funding needs for asset management for all tax-supported infrastructure are over $200 million per decade



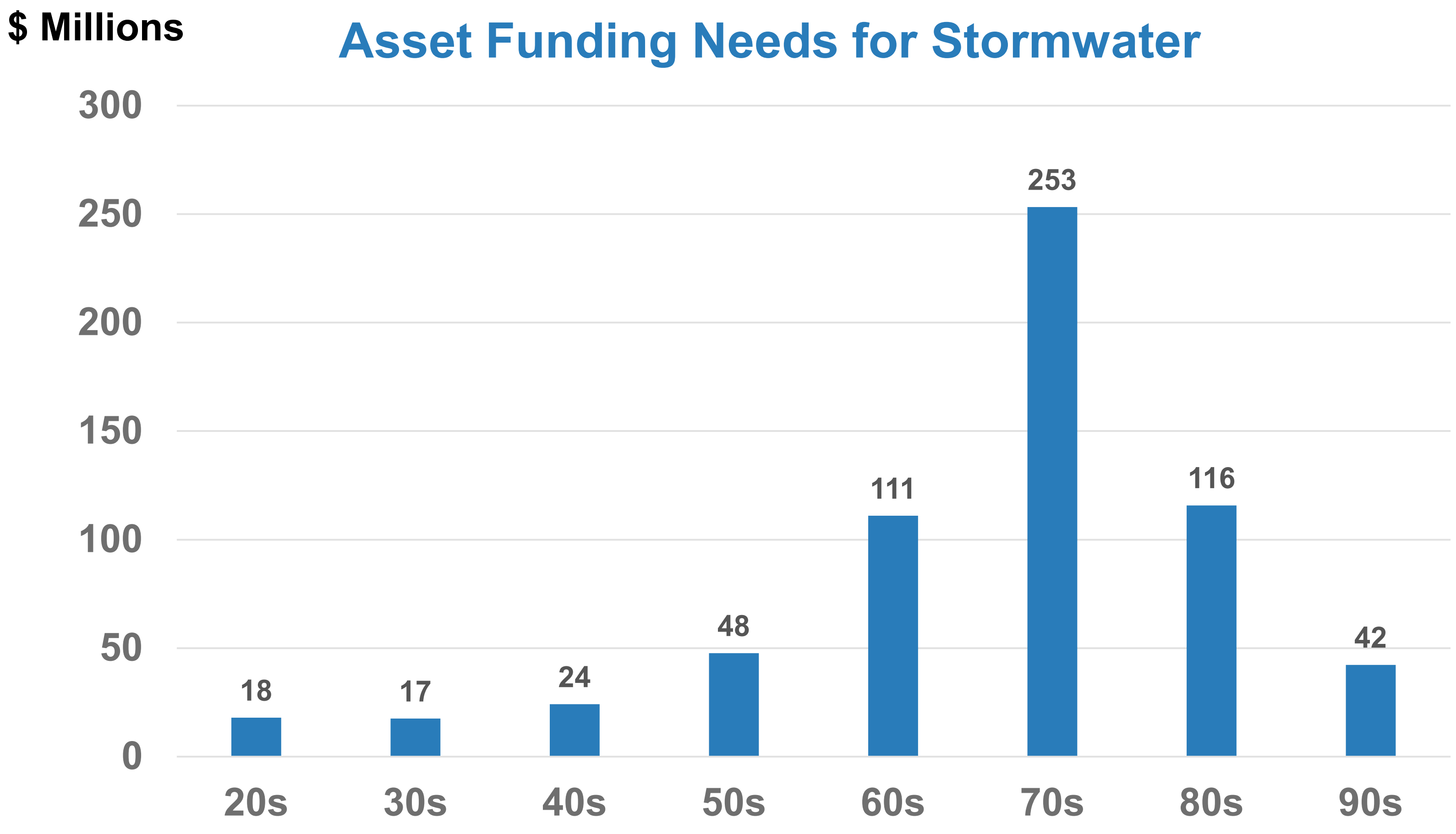
Asset funding needs for water balloon as assets age



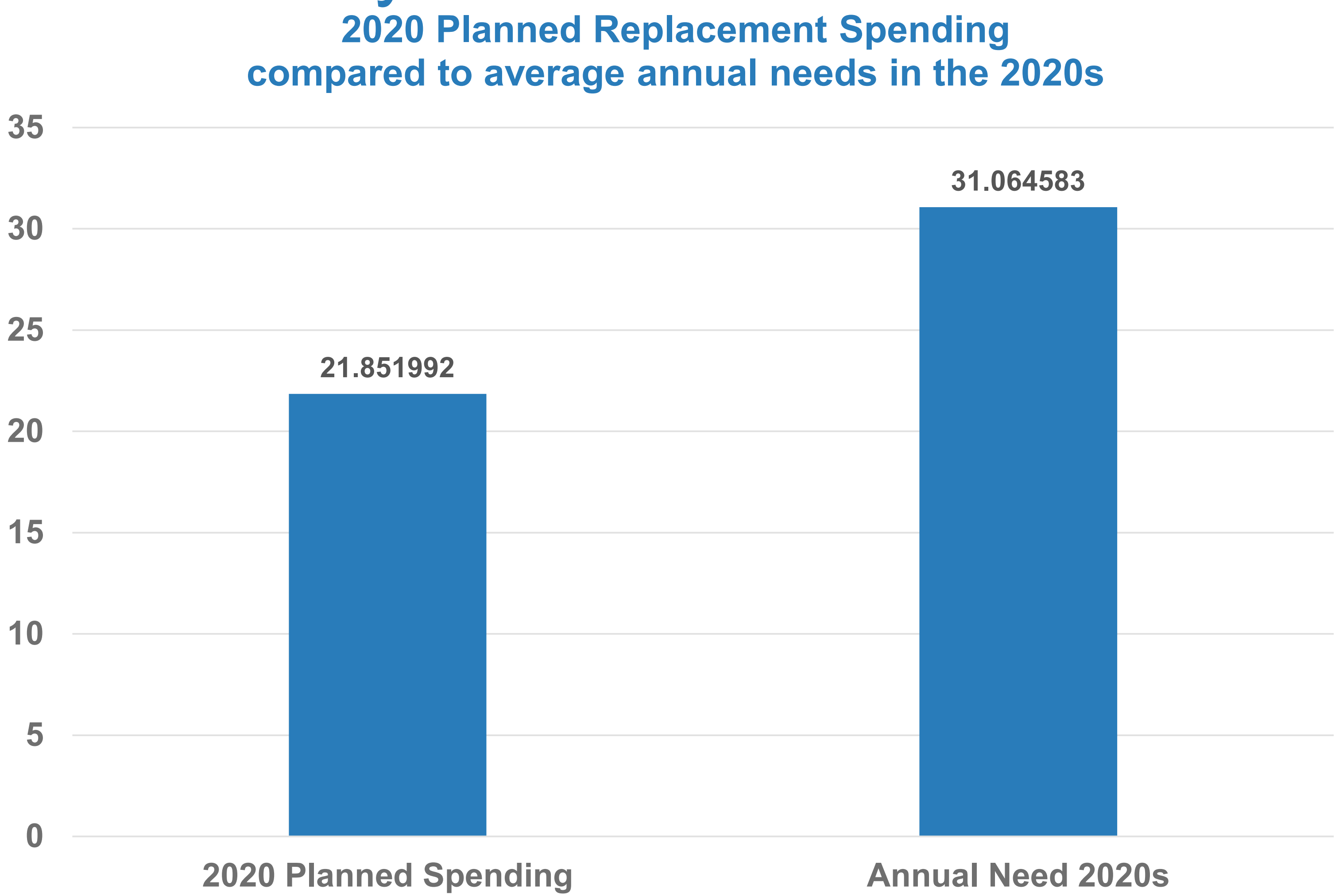
Asset funding needs for wastewater almost double by the 2030s and then escalate rapidly until the 2080s



Stormwater needs are modest initially but then become very large in future decades



Newmarket’s investment is below the average annual need for the 2020s identified by staff

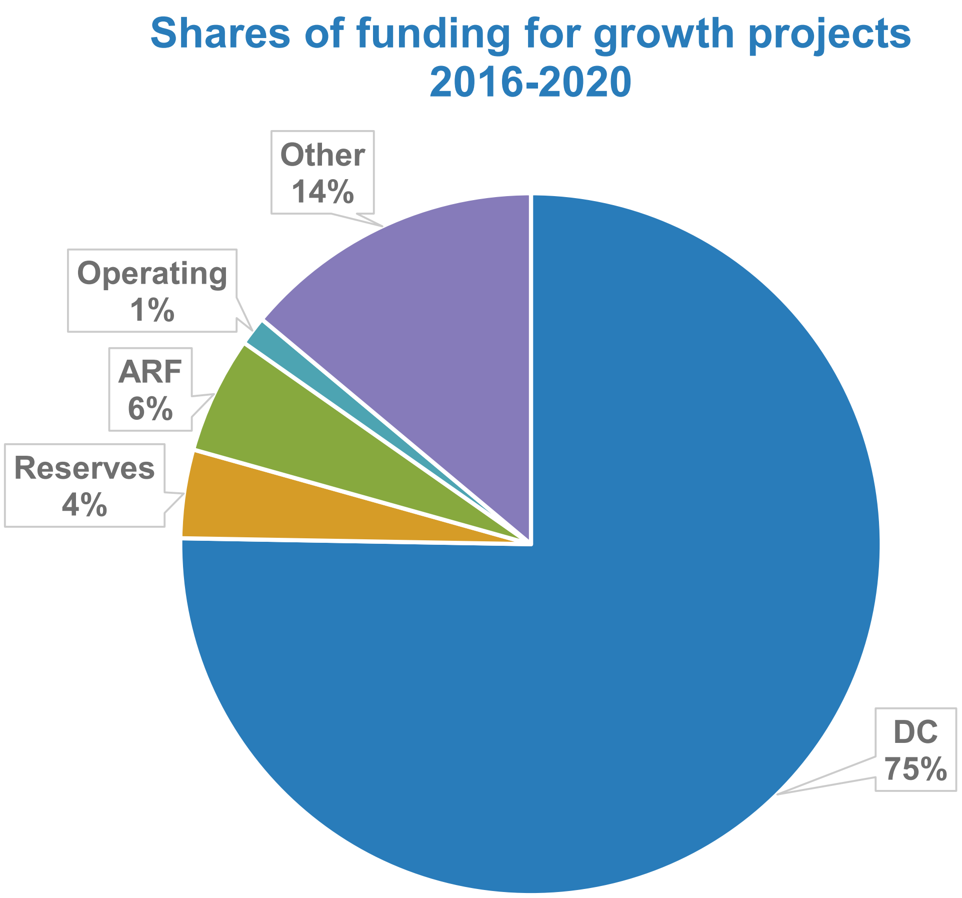


Key Recommendations

1. Asset management plans should include level of service considerations and a funding plan from the beginning
2. The asset management funding strategy should be integrated with the budget process and the next update of the Development Charges Background Study
3. The Town should plan to increase future spending on infrastructure rehabilitation and replacement

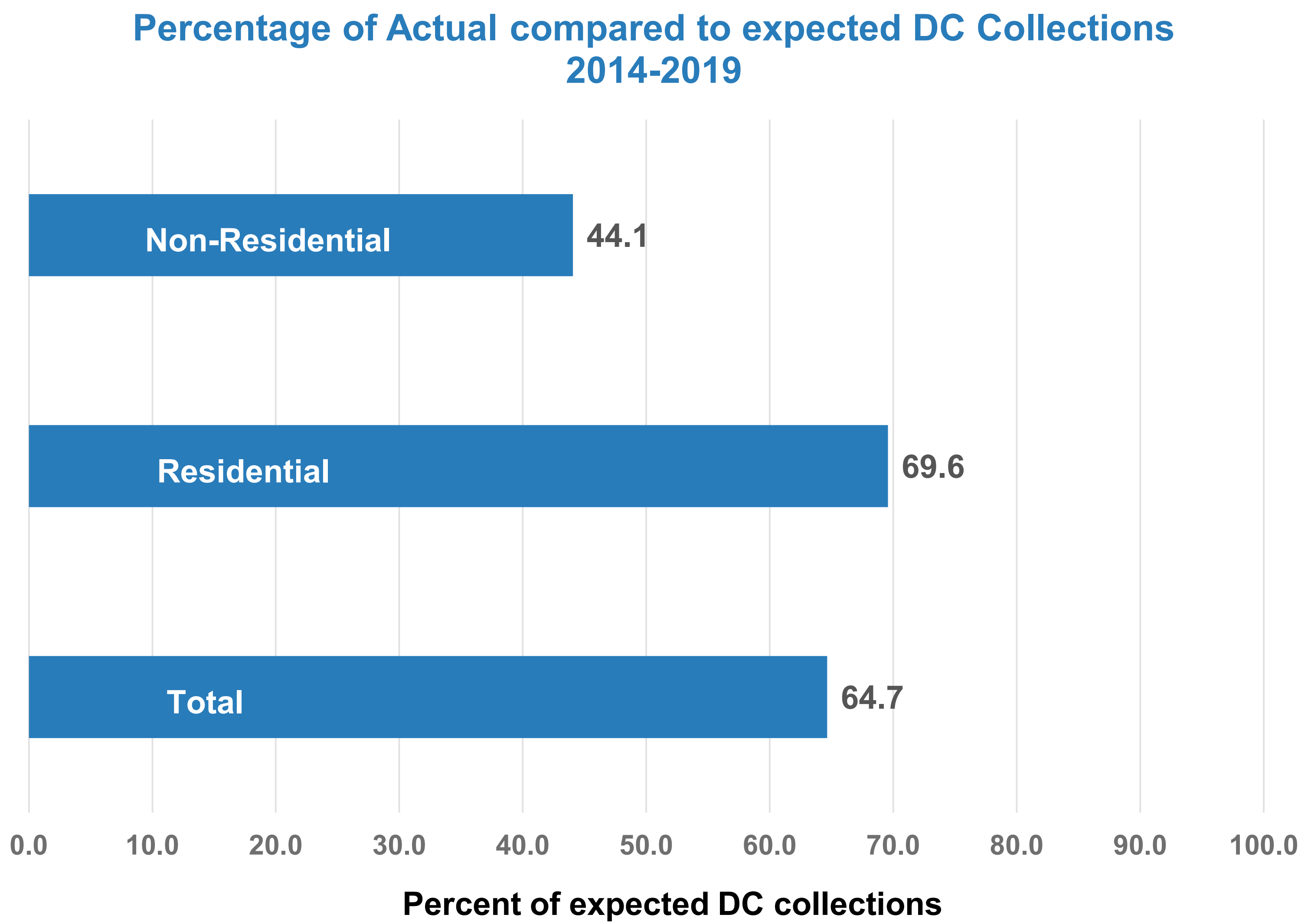
4b. Managing the Capital Plan:
Growth Capital

Three quarters of budgeted funding for growth projects is from DCs

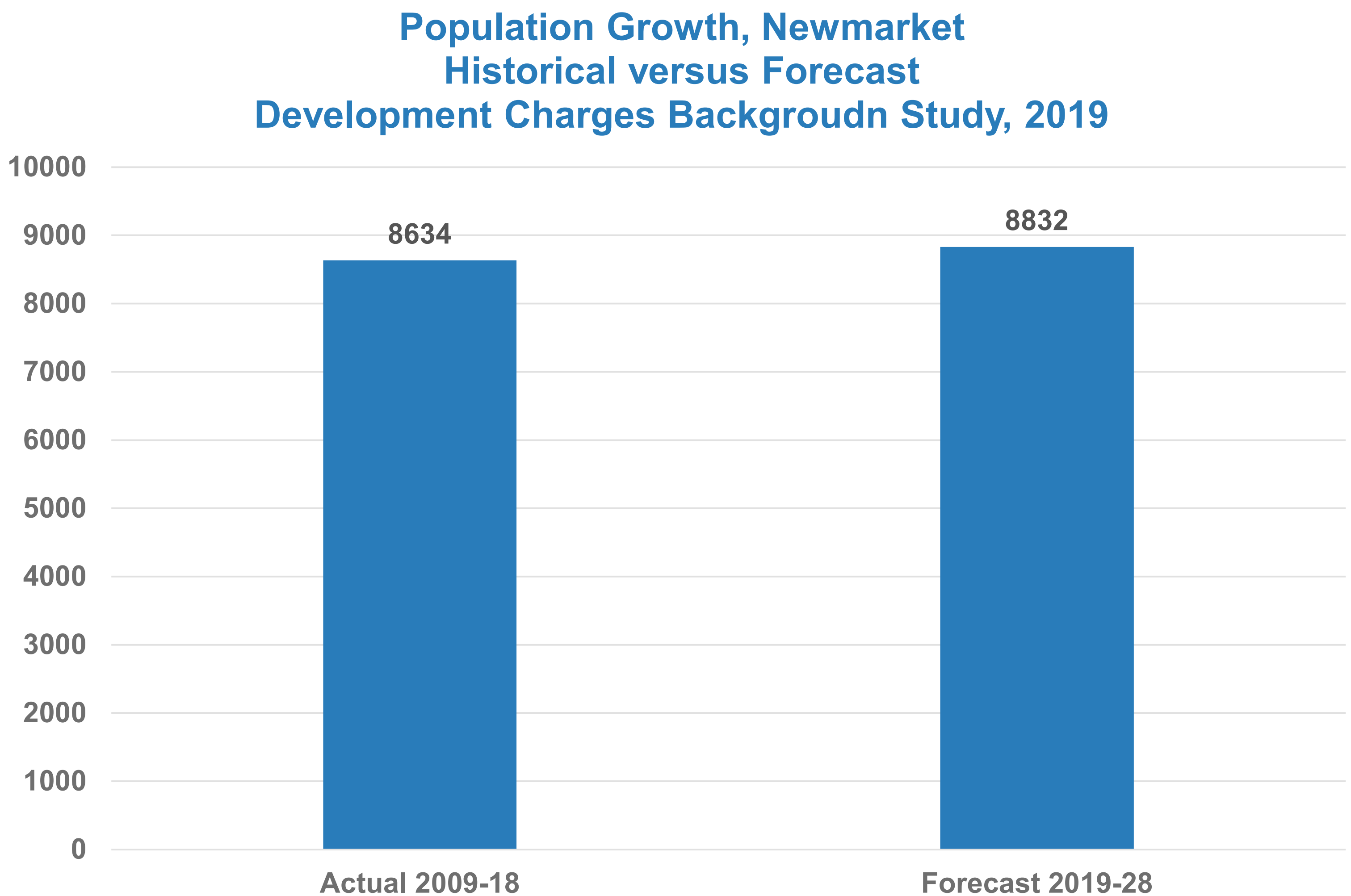


Note: These numbers are estimates based on the recommended budget in the capital budget detail appendices. Funding based on actuals is not available.

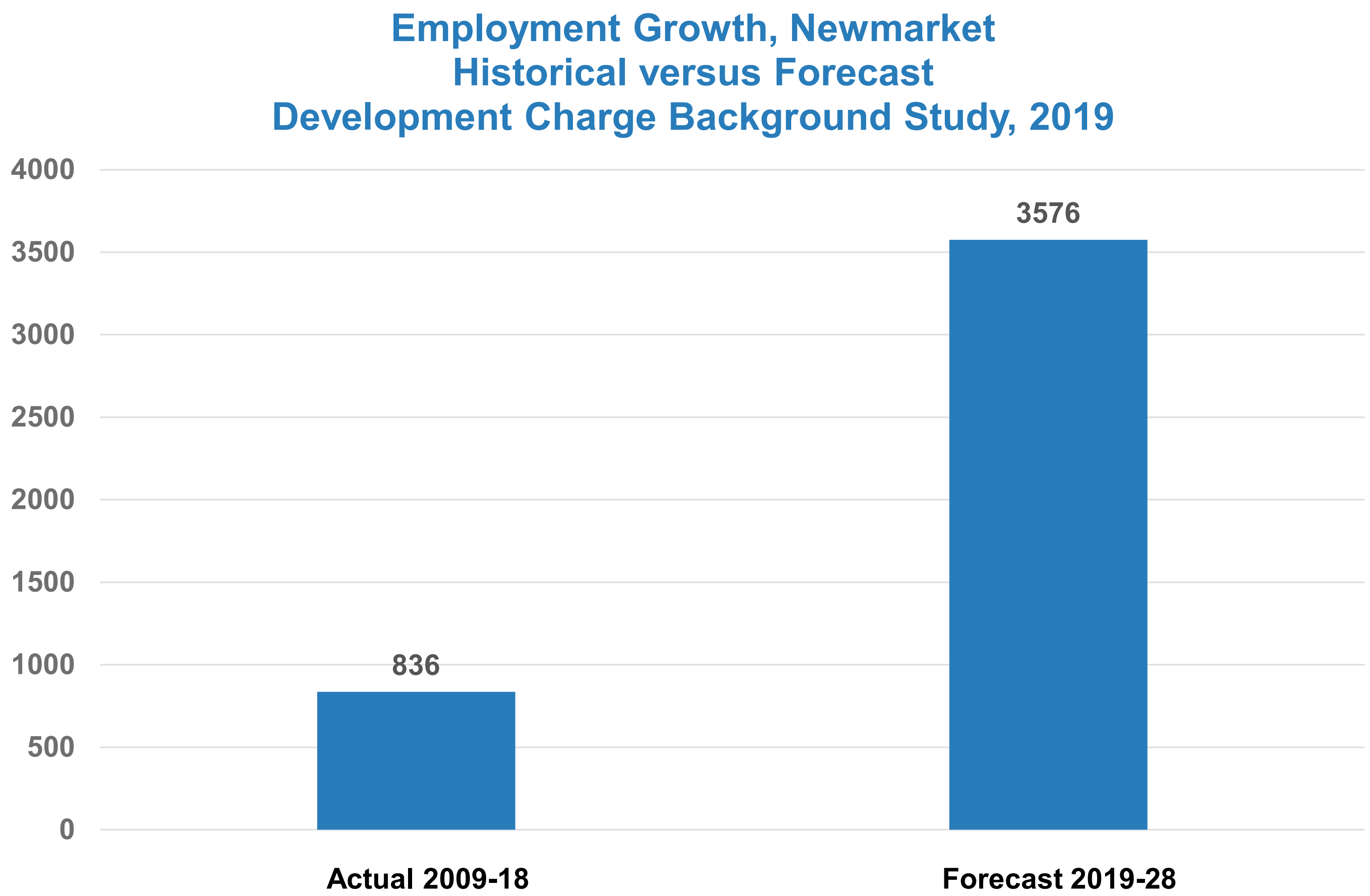
$13 million shortfall in expected DC collections over the last five years



The residential growth forecast for Newmarket seems reasonable



The employment forecast in the DC Background Study is highly optimistic



Note: Excludes work from home

Work-at-home and office densification trends may permanently affect DCs

- Work at home will likely grow much more rapidly than previously thought due to the effects of the pandemic
- In addition, offices and industrial developments are seeing a trend towards less space per worker
- More work-at-home and less space per worker mean that DC Background Studies over-estimate the number of employees who require floor space and floor space per worker, and non-residential DCs therefore are set too low

New legislation eliminating the 10% discount creates an opportunity

- The *COVID-19 Economic Recovery Act,* eliminates the 10% discount for soft services
- This creates two opportunities:
  - To increase DC rates to cover more of the cost of growth
  - To increase contributions to the asset replacement fund using assessment growth revenue, a portion of which is no longer needed to pay for the 10% discount (see section on reserves)

Key Recommendations

1. Develop a plan to address the tax levy impact of the shortfall in non-residential DC collections
2. As soon as is practicable, update the development charge bylaw to reflect the elimination of the 10% discount for soft services
3. Develop a community benefits charge strategy and bylaw

4c. Managing the Capital Plan:

A Sidebar on Water, Wastewater & Stormwater

Newmarket's cost of water is 17% above the average for its size category

Is Newmarket at full cost recovery at current prices?

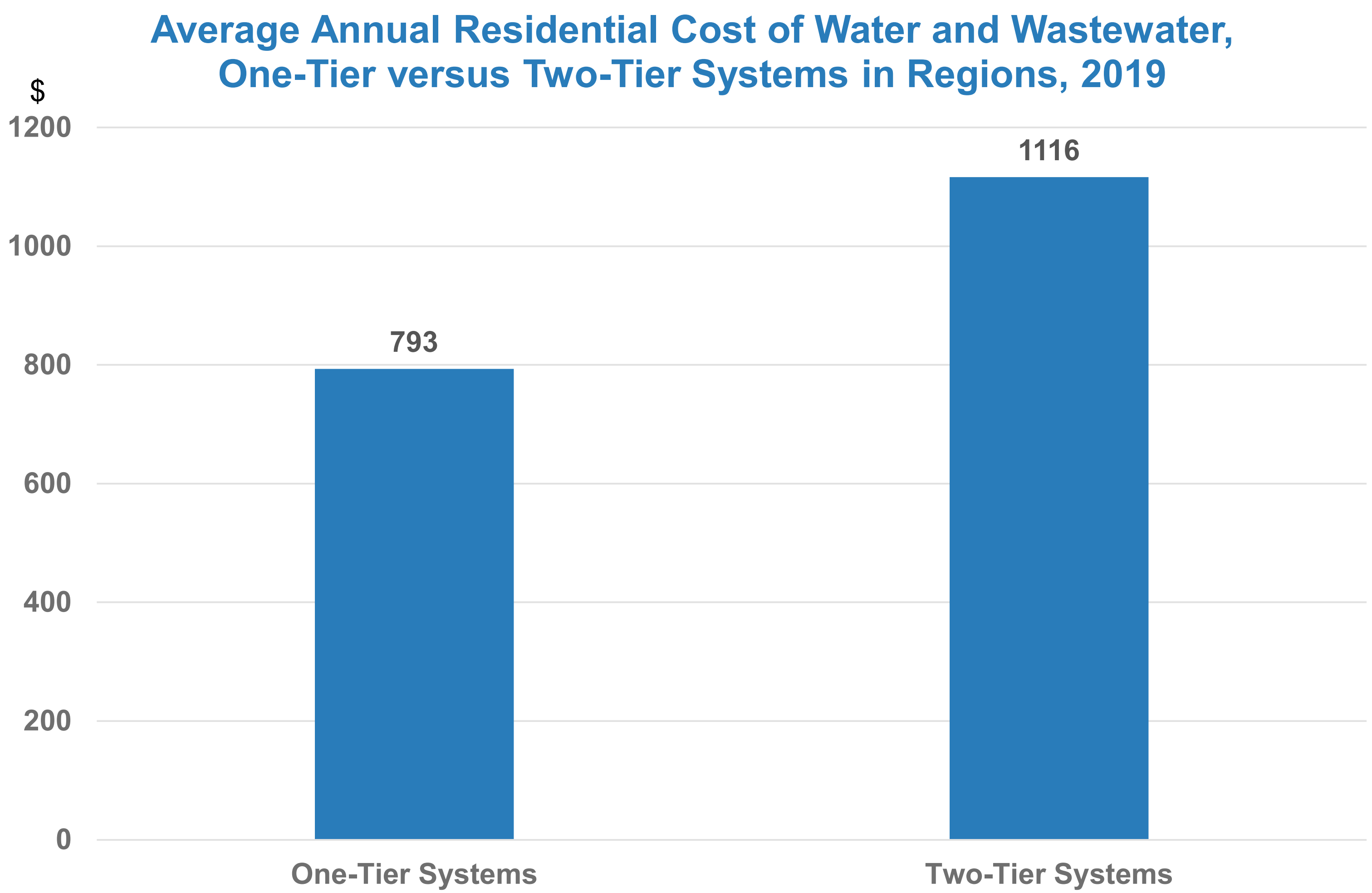
- The answer is “no”
- Although the water and wastewater financial plans show large surpluses, this relies on book value amortization
- If amortization is based on current replacement value and the expected life is set at 70 years to account for the presence of some shorter-lived assets (such as valves), net income was almost $3 million below full cot recovery in 2019

Note: This assumes the revenue and expenses found in the financial plans for 2019, as the segmented information in the financial statements includes waste management

It may be worth looking at single-tier delivery

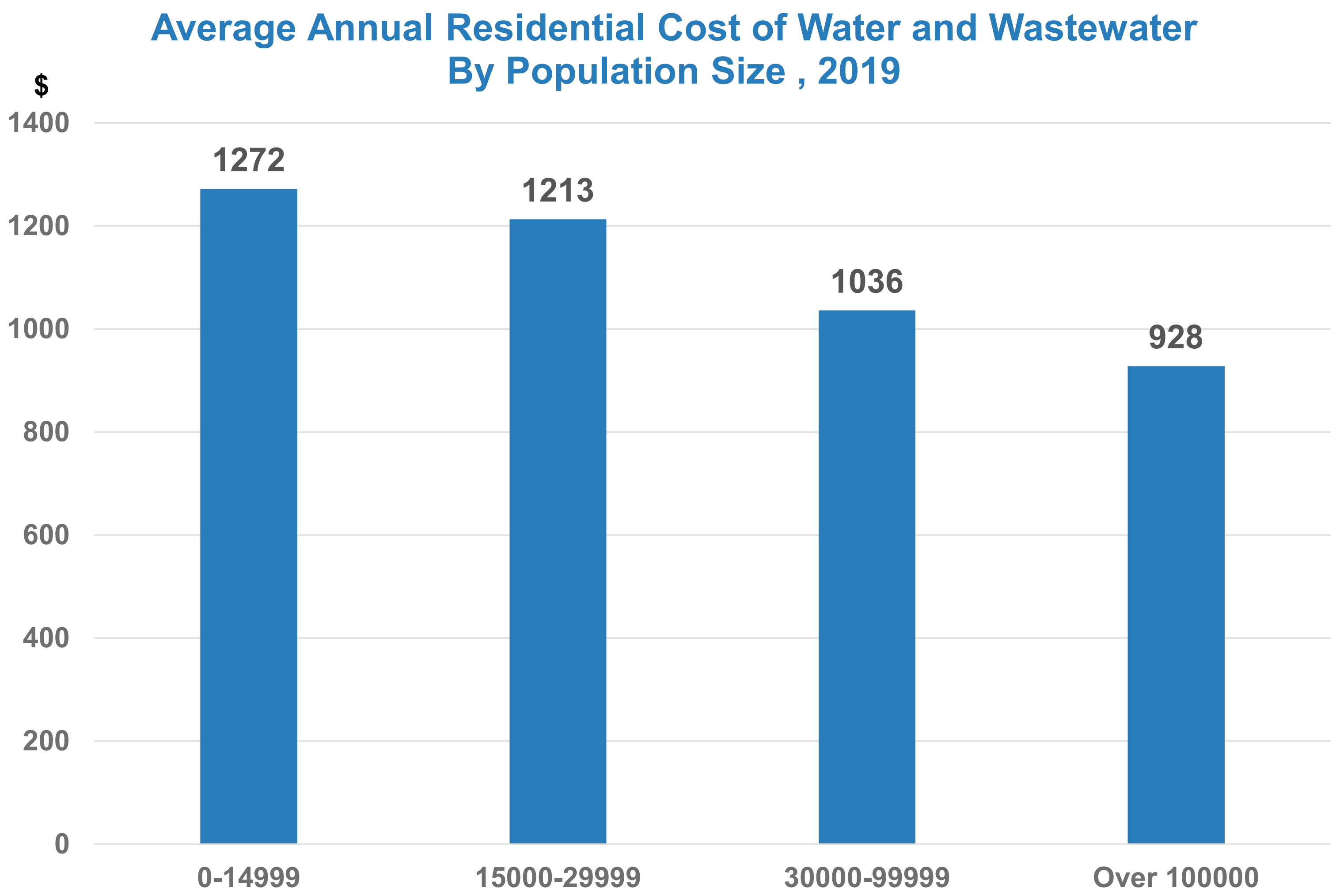
- York is one of only three regions in the province with two-tier water delivery
- The others are Niagara and Waterloo
- “Watertight”, the report of the Water Strategy Expert Panel, recommended consolidation of two-tier systems in 2005
- Hemson’s 2014 Capital Financing sustainability Strategy recommended that the Town look at uploading part or all of its water and sewer system

Two-tier systems are more expensive than one-tier systems in regions



Source: BMA, 2019

There are economies of scale



Source: BMA, 2019

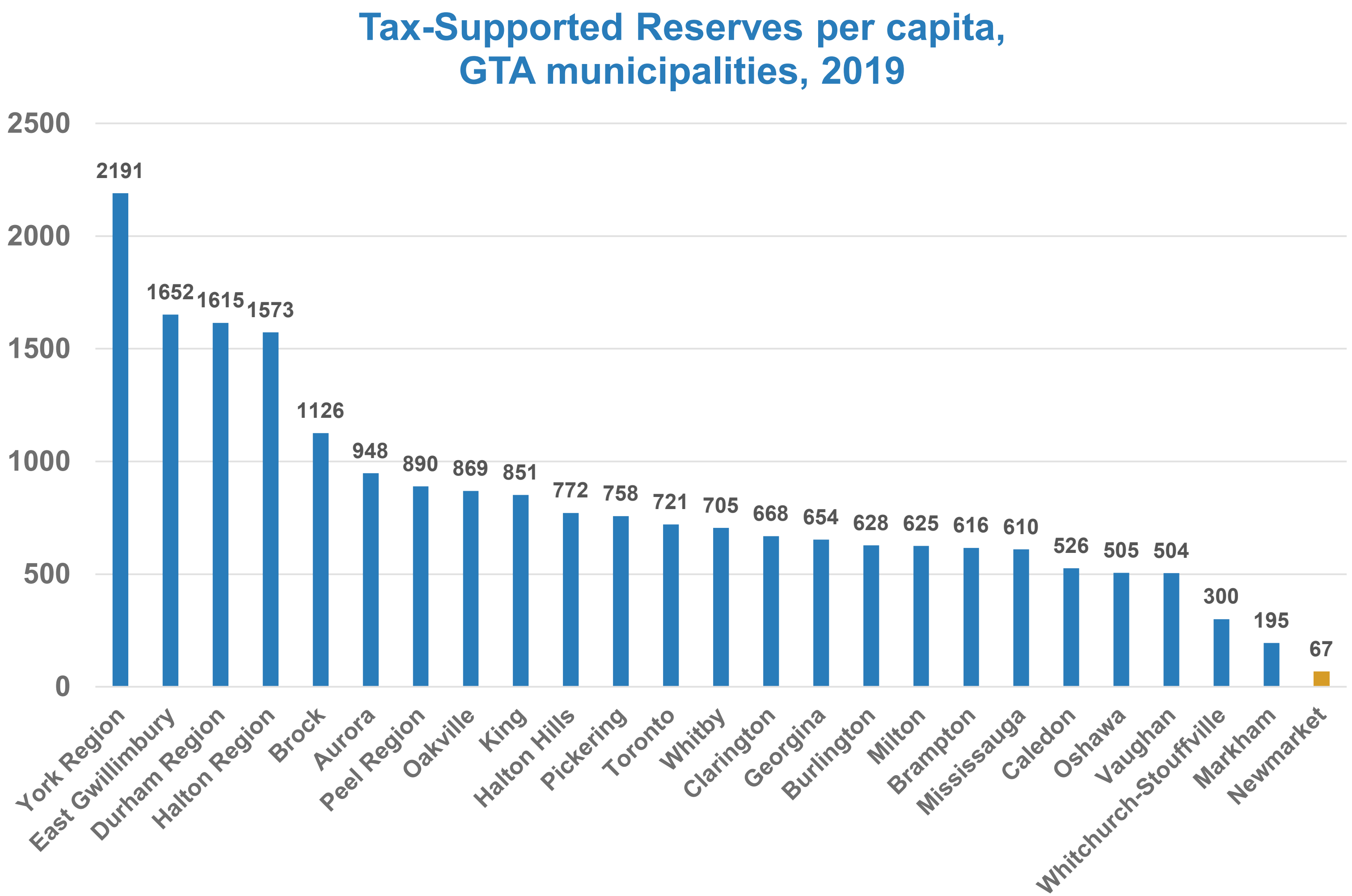
Key Recommendations

1. Develop detailed ten-year financial plans for water, wastewater and stormwater
2. Consider working together with the other "Northern Six" municipalities in York Region to investigate the benefits and costs of transferring local water and wastewater responsibility to the Region or cooperating in other ways

5. Building Reserves

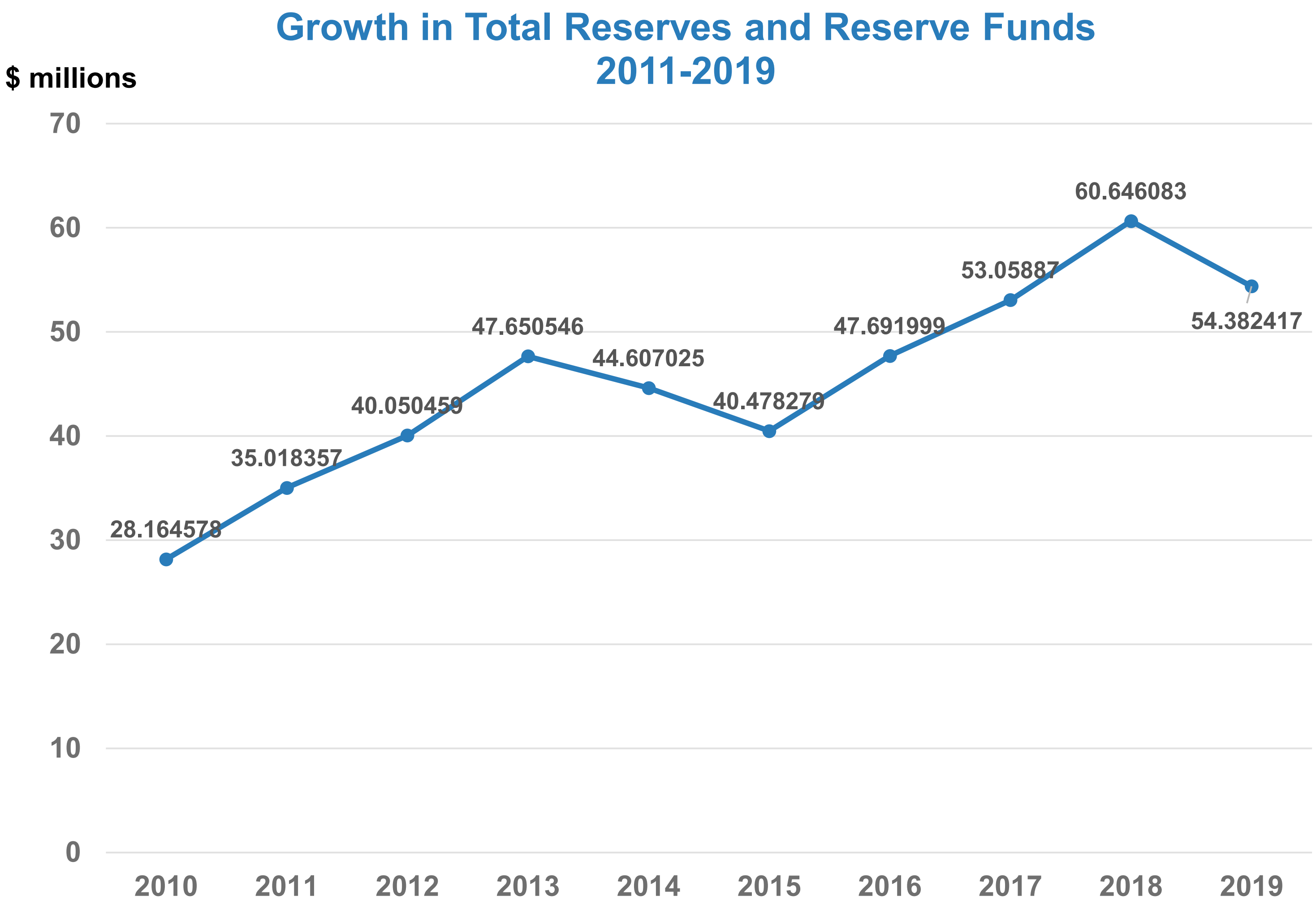
Building and managing reserves is key to achieving financial sustainability

Newmarket's tax-supported reserves per capita are the lowest in the GTA



Source: BMA Consulting

Newmarket has almost doubled its total reserves over the last ten years



Note: Excludes obligatory reserves

Newmarket has three key reserve challenges

- The main reserve-related issues for Newmarket to address are:
  - The need to build asset management reserves aggressively over time
  - Inter-reserve borrowing
  - Lack of reserves needed to manage newly realized future risks
- In addition, there has been a proliferation of reserves as the Town's needs have evolved

Elements of a reserve strategy

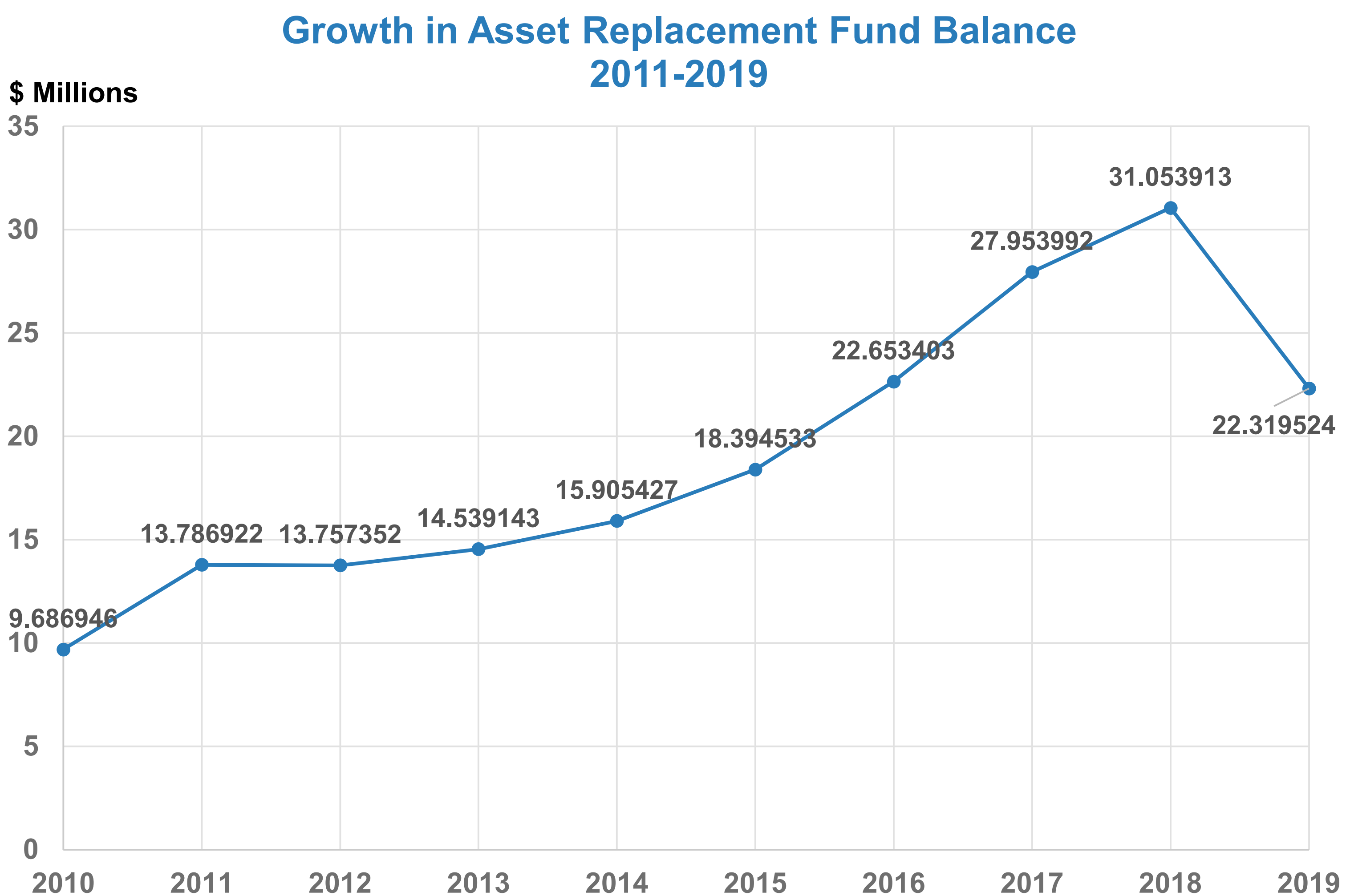
1. A plan to build asset management reserves

2. Resolution of the inter-reserve borrowing issue

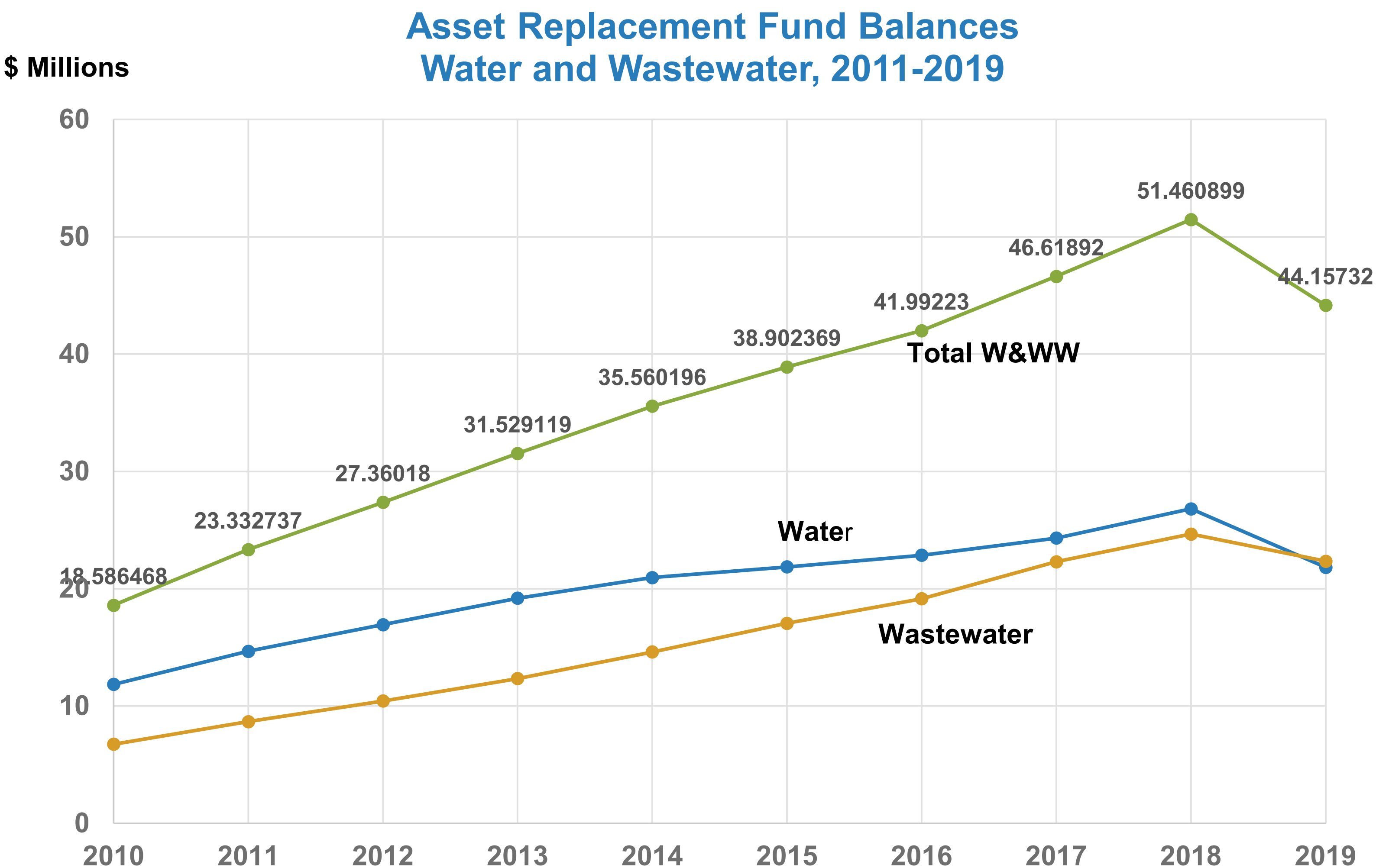
3. A new contingency reserve

4. A new growth capital reserve to deal with protracted or permanent shortfalls in development charge collections and to pay for non-DC-eligible infrastructure

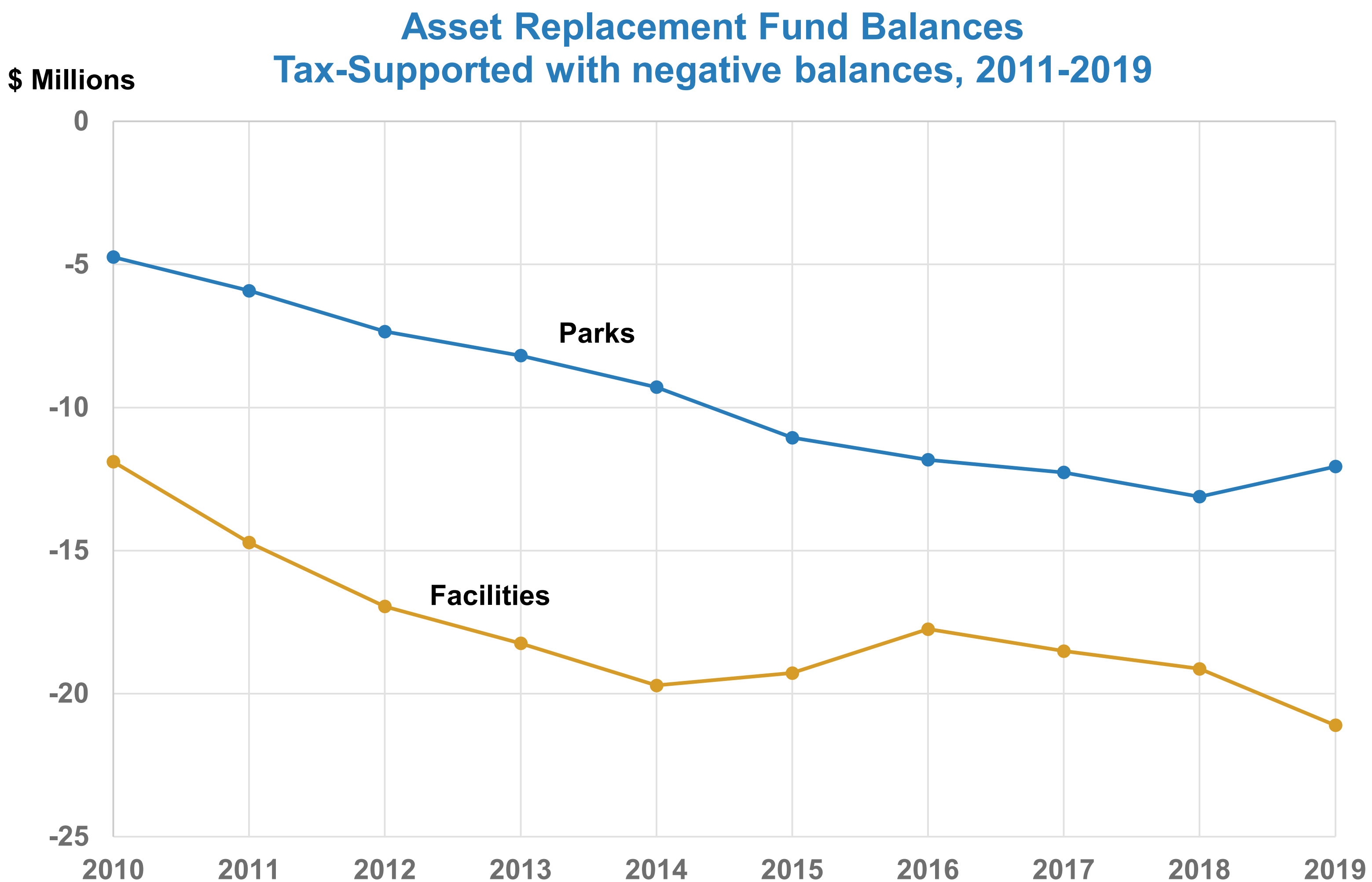
The current Asset Replacement Fund is just over $22 million



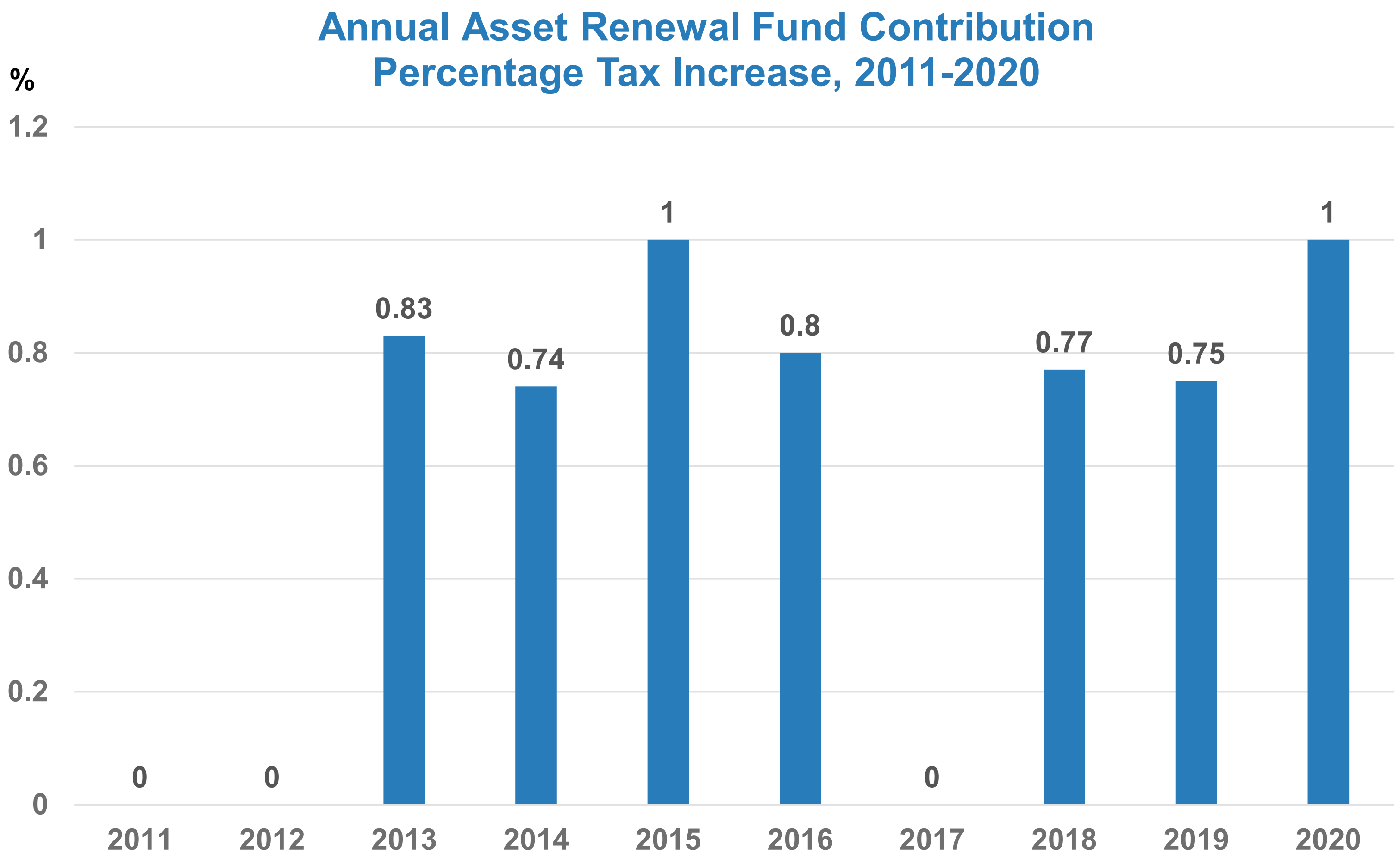
The water and wastewater ARF balances amount to $44 million



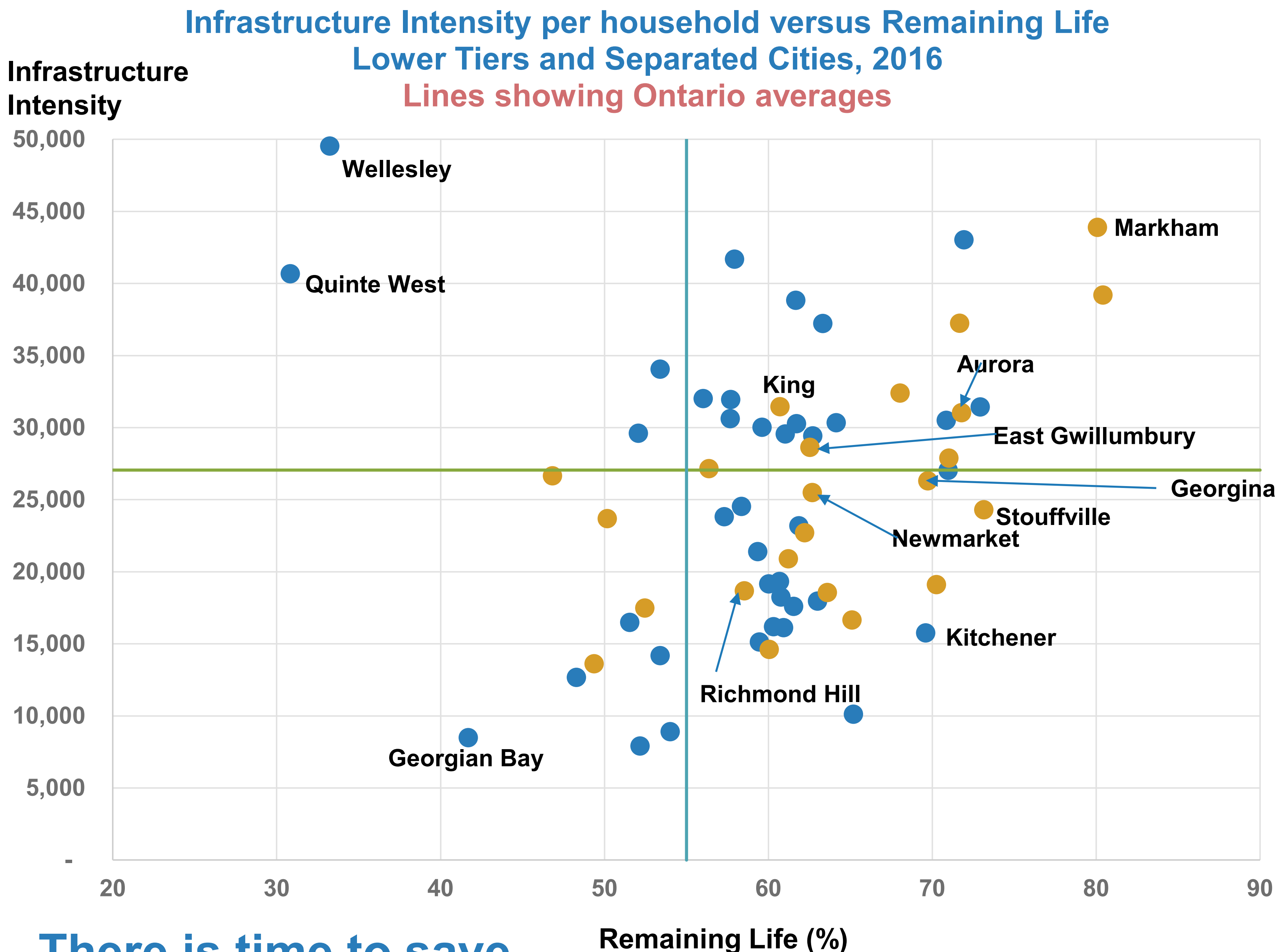
Parks and Facilities have large negative ARF balances



Contributions to the Asset Replacement Fund have been quite variable



Substantial savings for asset management needs to start now



There is time to save

Some intra-fund borrowing has developed in the ARF

- Tax-supported asset replacement reserves are currently borrowing about $23 million from rate-supported asset replacement reserves
- There is little prospect that this internal “book-keeping” loan can be repaid in the foreseeable future, given that a 1% increase in the property tax levy yields about $625,000

Restructuring the Asset Replacement Fund

- The Asset Replacement Fund needs to be restructured to address past imbalances between the various sectors of the fund
- This will involve eliminating the internal book-keeping loan, and adjusting reserve balances so that all sectors have a reasonable positive balance
- Restructuring the ARF should reflect asset management plans to the extent possible

Funding contributions to the Asset Replacement Fund

- Additional funding sources will be needed to build the Asset Replacement Fund
- These could include:
  - Repurposing the Hydro dividend over five years to contribute the entire dividend to the ARF, rather than using it to subsidize operating expenditures
  - Transitioning to allocating a consistent minimum of a 1% incremental tax levy to the ARF

Reducing draws from the Asset Replacement Fund

- To temporarily reduce draws on the Asset Replacement Fund, rehabilitation spending could be distinguished from replacement spending and draws from the ARF could be restricted to replacement spending only
- Rehabilitation spending would be funded directly from the tax levy or rates, as the case may be

Chaos theory and the butterfly effect

"Tiny differences in input could quickly become overwhelming differences in output—a phenomenon known as "sensitive dependence on initial conditions." In weather, for example, this translates into what is only half-jokingly known as the Butterfly Effect—the notion that a butterfly stirring the air today in Peking can transform storm systems next month in New York."

James Gleick, Chaos: Making a New Science

We are seeing chaos theory realized in municipal finances

- As a result of the COVID-19 pandemic, it is now clear that small, unexpected changes can materially affect municipal financial conditions
- Most municipalities will likely be able to cope with the financial effects of the pandemic, particularly with provincial assistance
- However, it is a warning that non-financial events can have significant financial impacts
- The exact nature of these events is inherently unpredictable (they could be health-related, environmental, economic shocks, etc.)

Making provision for the unexpected and the unknown

- It would be prudent to establish a new contingency reserve of significant size to enable the Town to deal with unexpected revenue or expenditure shocks
- Such shocks could last for multiple years or occur in close succession
- The reserve could be used for either capital or operating purposes

A growth reserve is also needed

- Another new reserve could be a growth reserve
- This reserve would be designed to address shortfalls in growth-related revenue and growth-related costs that are not currently eligible for development charge funding
- It would also be a hedge against potential changes in the legislative or regulatory regime governing development charges

Funding sources for the new growth reserve

- The growth reserve could be funded through:
  - A budgetary allocation each year corresponding to the avoided cost of the 10% discount, once a new development charge bylaw has been passed
  - A share of the annual surplus

Key Recommendations

1. Establish a new Contingency Reserve
2. Establish a new Growth Reserve
3. Establish a separate pay-as-you-go reserve for ongoing rehabilitation spending
4. Restructure the Asset Replacement Fund Reserve based on asset management plans
5. Restrict draws from the Asset Replacement Reserve to replacement spending only for the next ten years

Recommendations continued

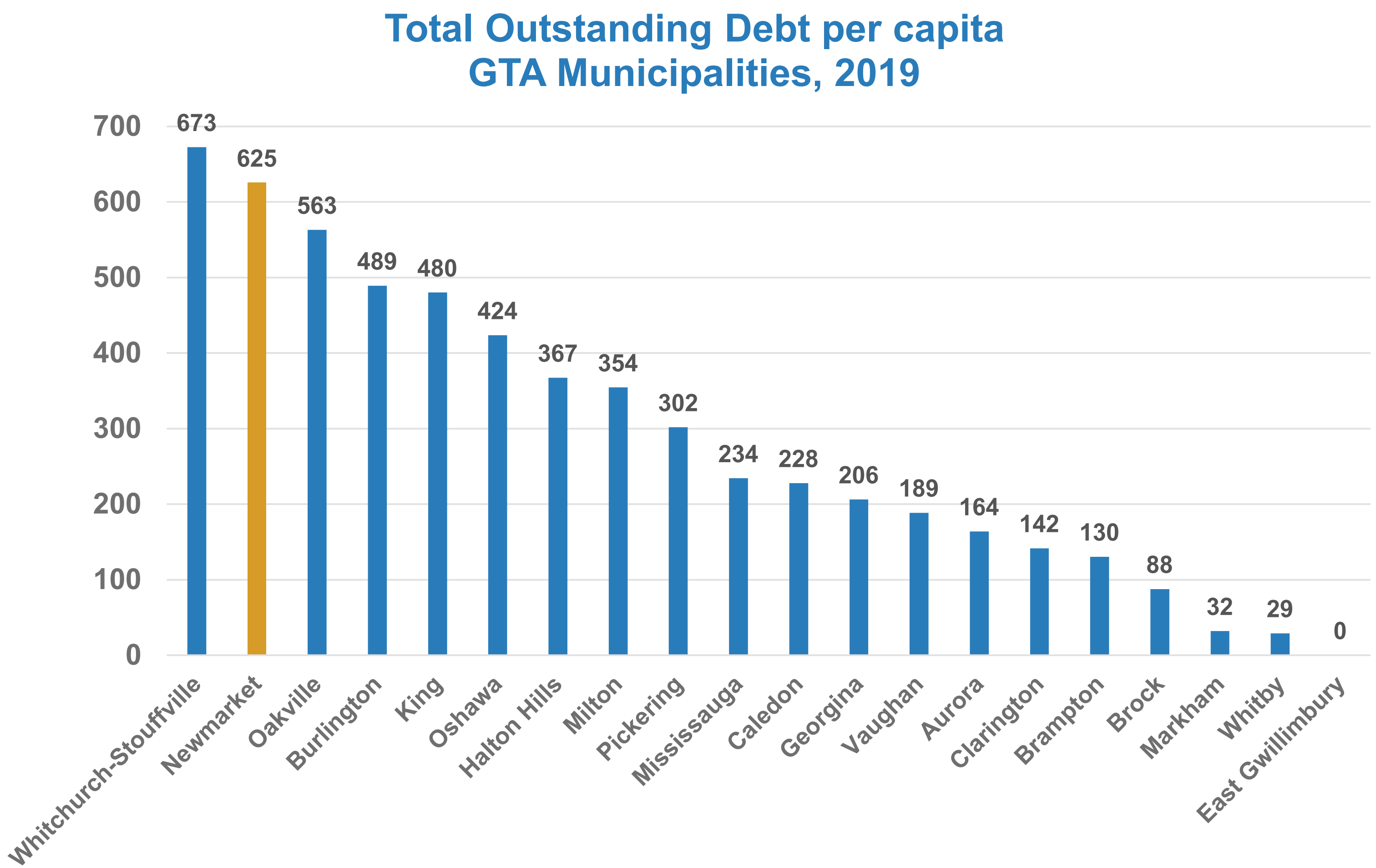
6. Increase the contribution to the Asset Replacement Fund by a minimum of 1% per year for the next ten years
7. Drop the policy of pooling rate and tax-supported Asset Replacement Fund reserves, and do not permit borrowing between tax and rate-supported reserves
8. As part of restructuring the Asset Replacement Fund, eliminate the internal “book-keeping” loan between the rate- and tax-supported parts of the Asset Replacement Fund

Recommendations continued

9. Over the next five years, transition the Hydro dividend to a contribution split 75:25 between the tax-supported Asset Replacement Fund and the new Contingency Reserve
10. Over the next five years, transition the annual surplus to a contribution split:
    - 50% to the new tax-supported Growth Reserve
    - 25% to the new Contingency Reserve
    - 25% to other reserves that are below target, and if none, to the Asset Replacement Fund

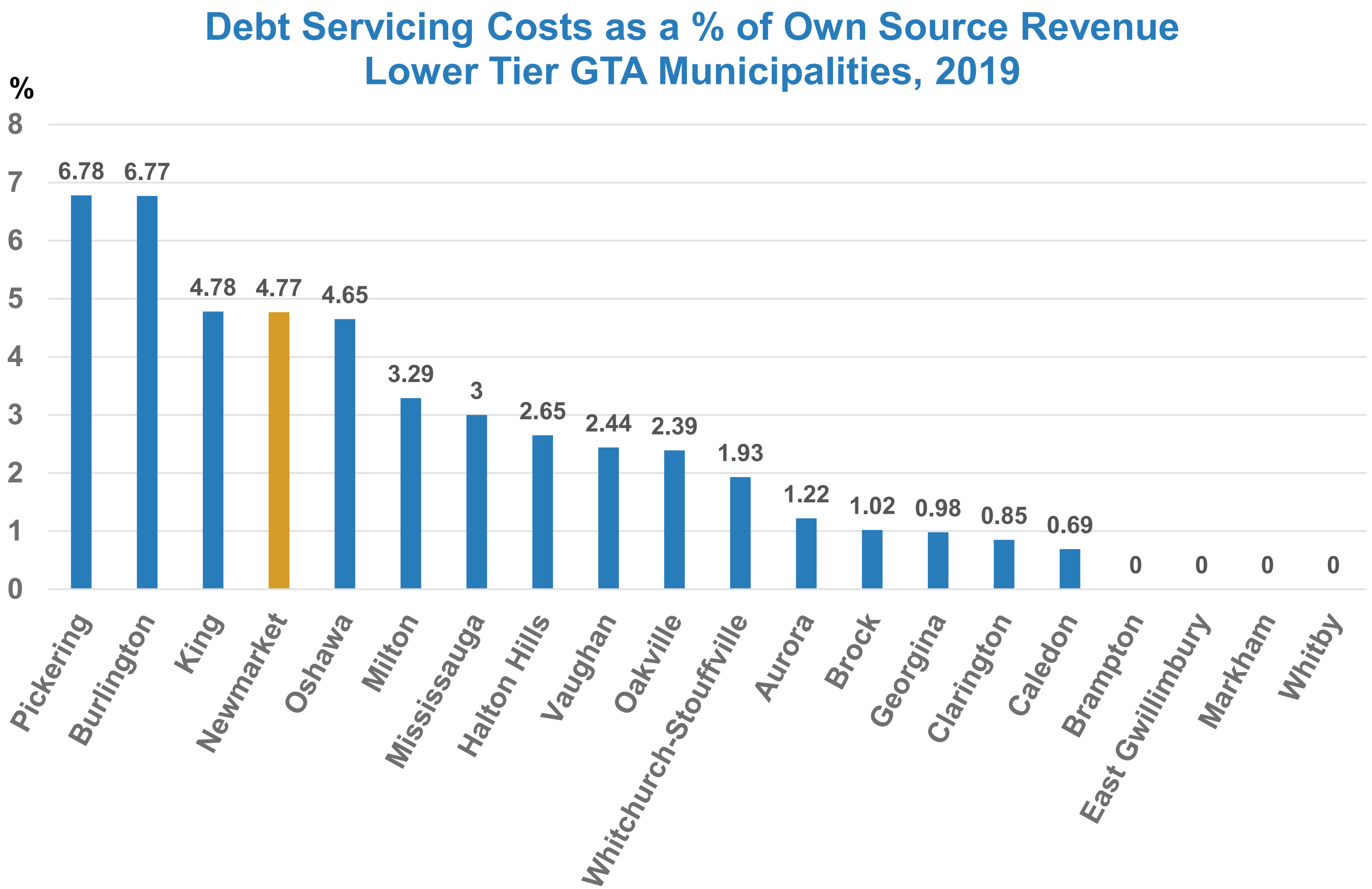
6. Managing Debt

Newmarket's debt per capita is relatively high among lower-tier GTA municipalities



Source: BMA Consulting

Debt servicing costs are relatively high



Newmarket’s debt has increased in the last three years

- Newmarket’s total outstanding debt at the end of 2019 was approximately $45.1 million
- Two years ago, the Town owed $33.7 million in long-term debt
- The main reason for the increase is the purchase of the Mulock farm in 2018, which resulted in the issuance of a $26 million 30-year debenture at 3.65%
- This increase was partially offset by a decision to pay off the remaining $8.1 million owing for the Joint Operations Centre constructed in 2009

Excluding the debt for the Mulock Farm, most of the remaining $20 million of existing debt will be paid off by 2024 and all of it by 2026.

The Mulock Farm debt makes sense

- The rationale for the 30-year term of the Mulock Farm debt is sound, but the rate seems somewhat high in the current environment
- York Region recently issued a ten-year debenture at 1.49%
- It may be worth investigating the potential for refinancing at a shorter term and a lower rate

Newmarket’s debt management policy is sound

- The Town’s debt policy was updated in 2018
- It provides that annual debt servicing costs (principal and interest) plus annual capital lease payments must not exceed 10% of the previous year’s own source revenue
- Actual debt servicing costs were less than 5% in 2019

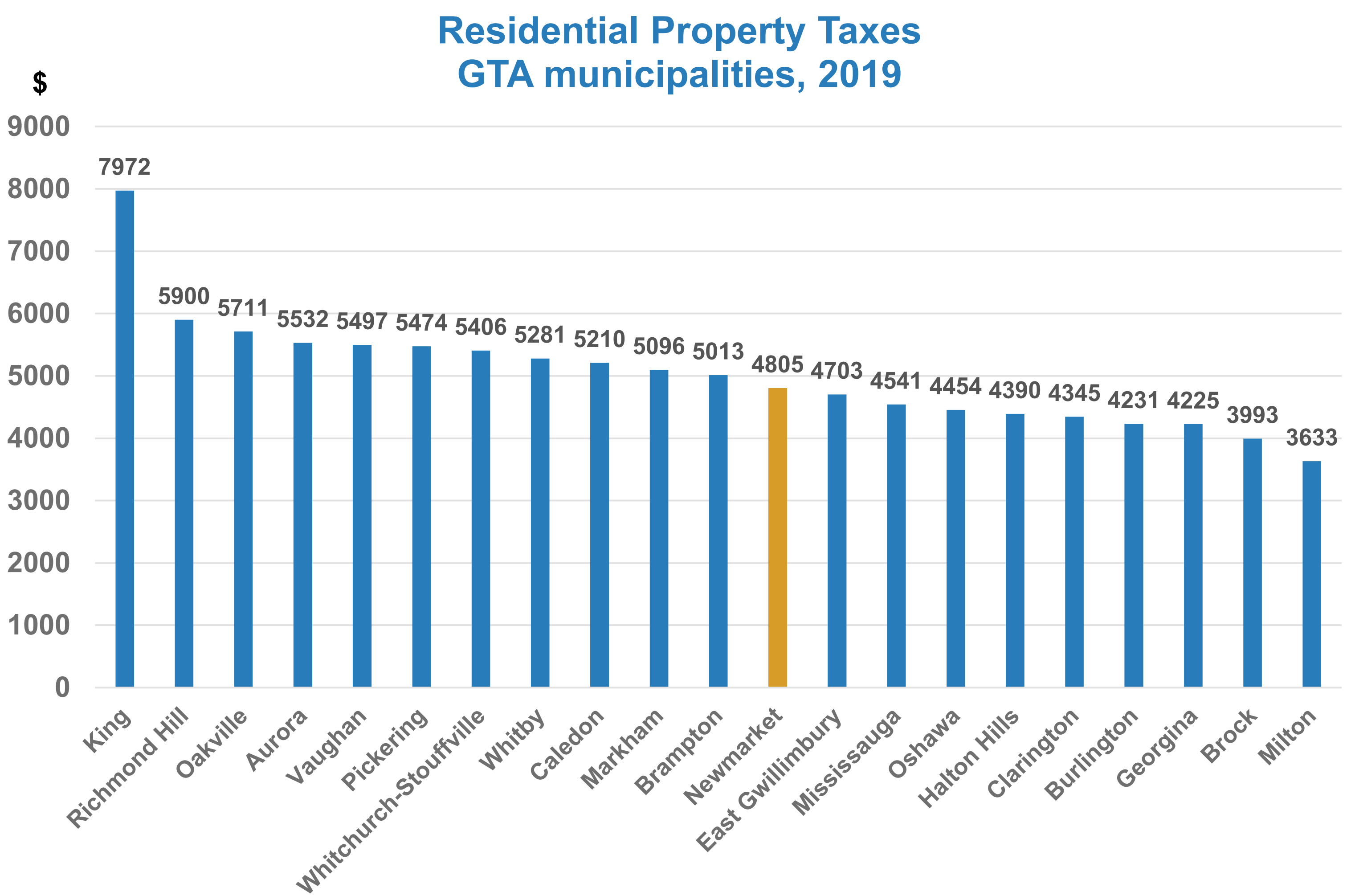
Key Recommendations

1. Pay off existing debt by 2026, save for the Mulock Farm debt
2. Keep debt servicing costs as a share of own source revenue below 5% in practice

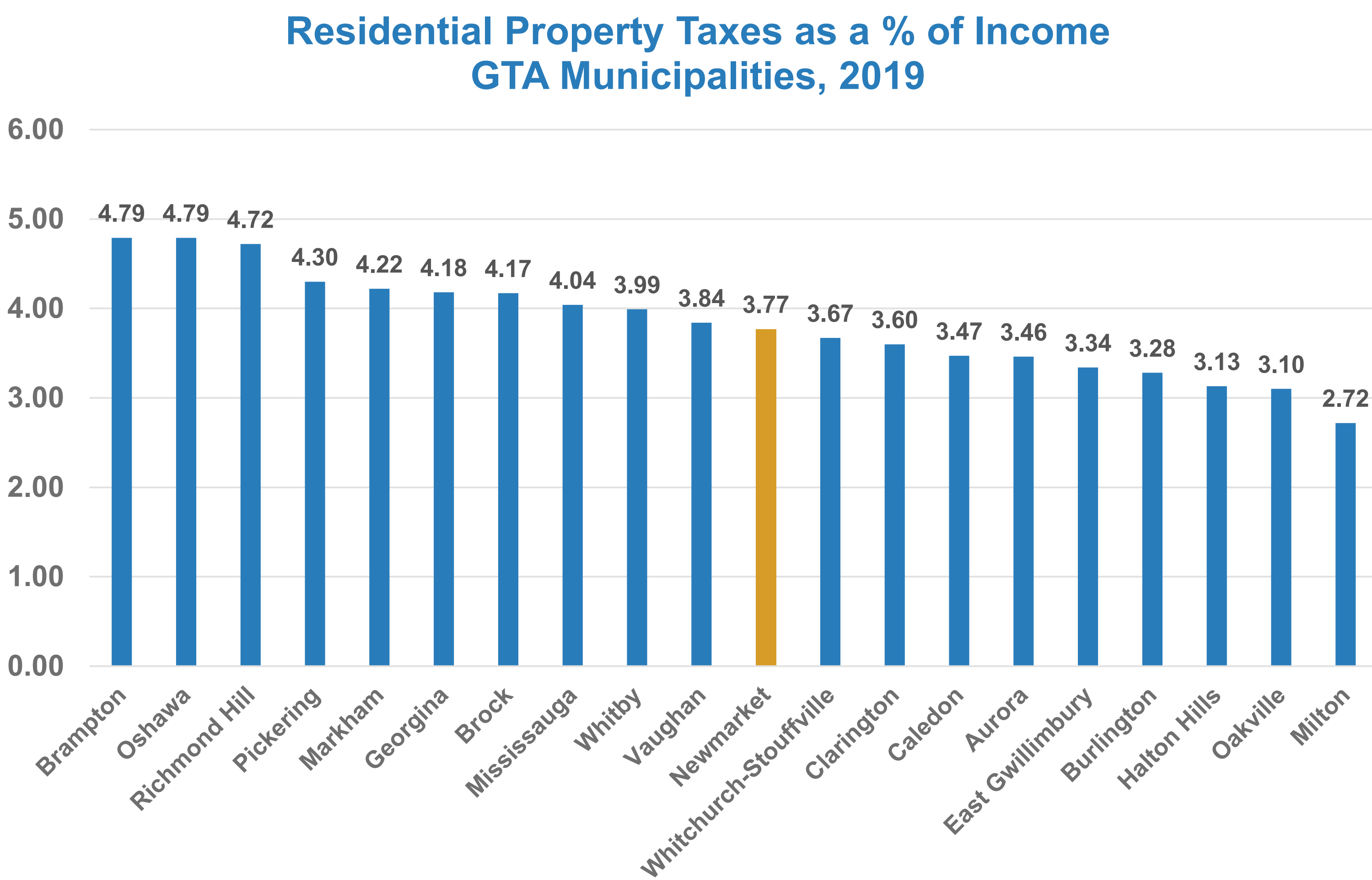
7a. Enhancing Revenue:

Property tax revenue

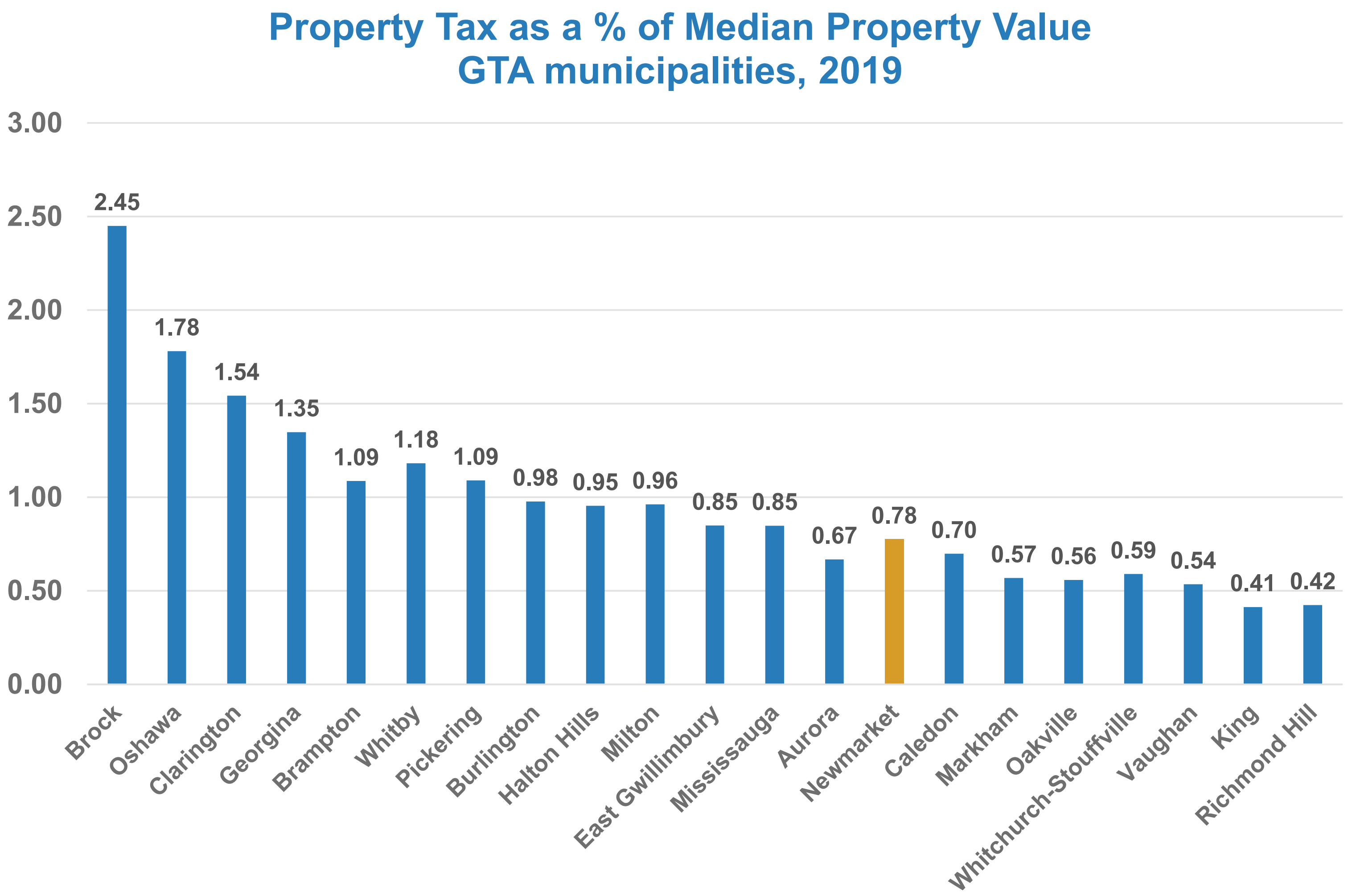
Newmarket's residential property taxes are about 5% below the GTA average



Newmarket's residential property taxes as a share of income are below the GTA average



Newmarket’s property taxes are quite low in relation to median house value

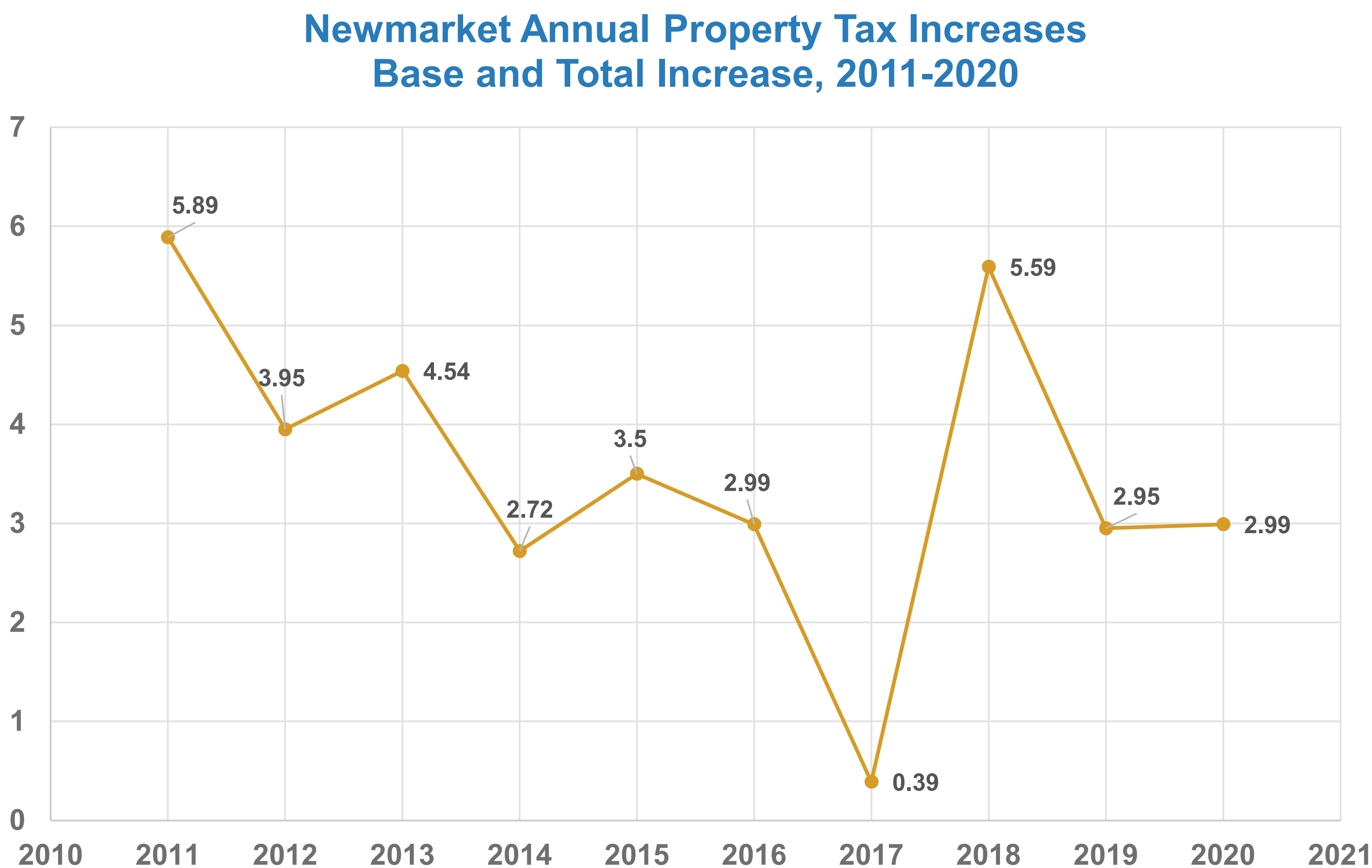


By virtually any measure, Newmarket's residential property taxes are below the GTA average

Lower-than-average taxes are not necessarily positive

- Lower taxes suggests one or more of the following:
  - Fewer services
  - Lower service levels
  - More efficient delivery of services
  - Inadequate savings (contributions to reserves)
  - Or a combination of the above
- Lower residential taxes may also indicate a large commercial and industrial sector with high tax ratios (e.g., Toronto)

Current practice is to keep property tax increases below 3%

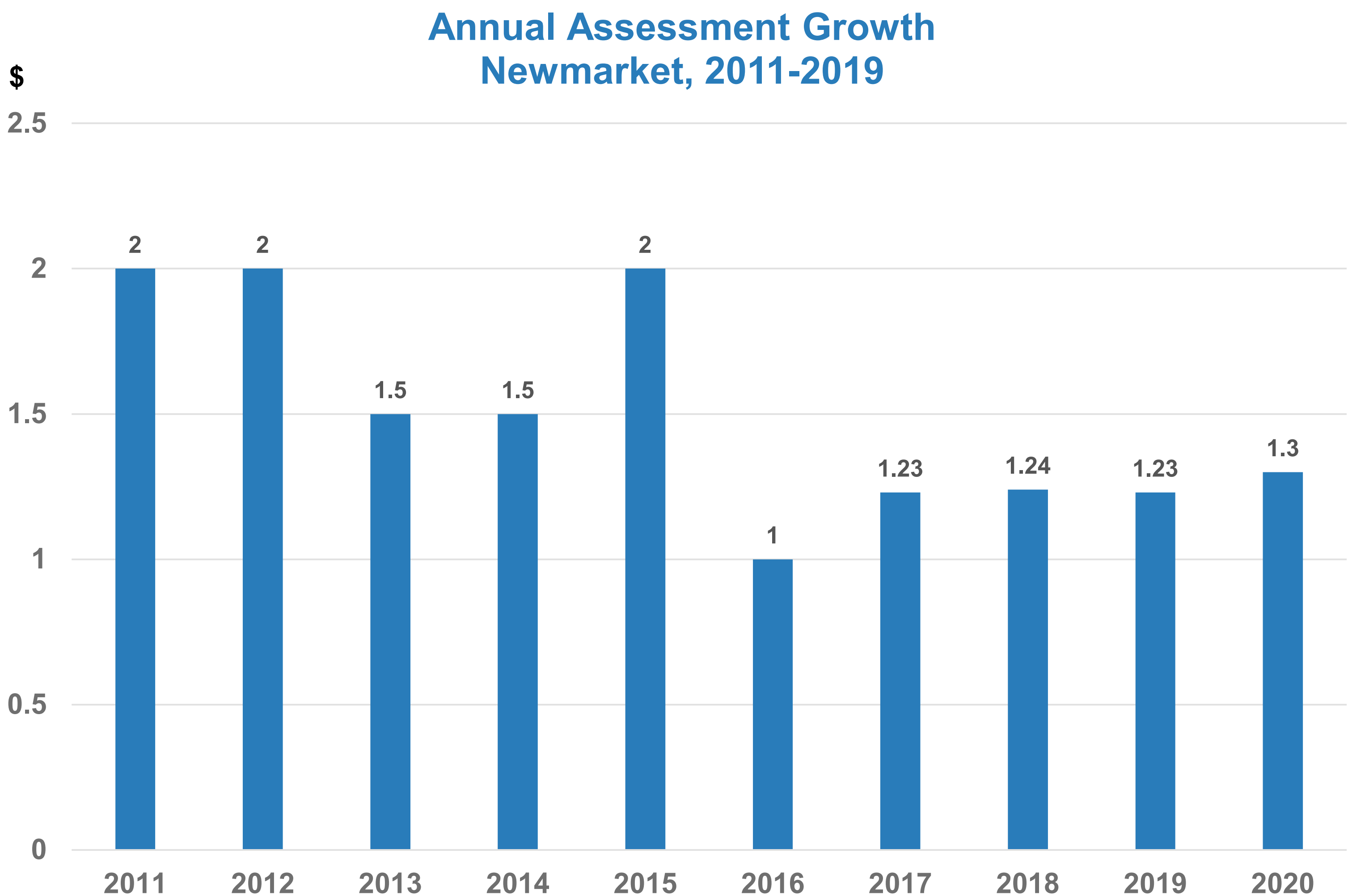


There is some room for property tax increases above the rate of inflation plus population growth when the economy improves

7b. Enhancing Revenue:

Assessment growth

Annual assessment growth is typically in the 1-2% range—growing but not fast



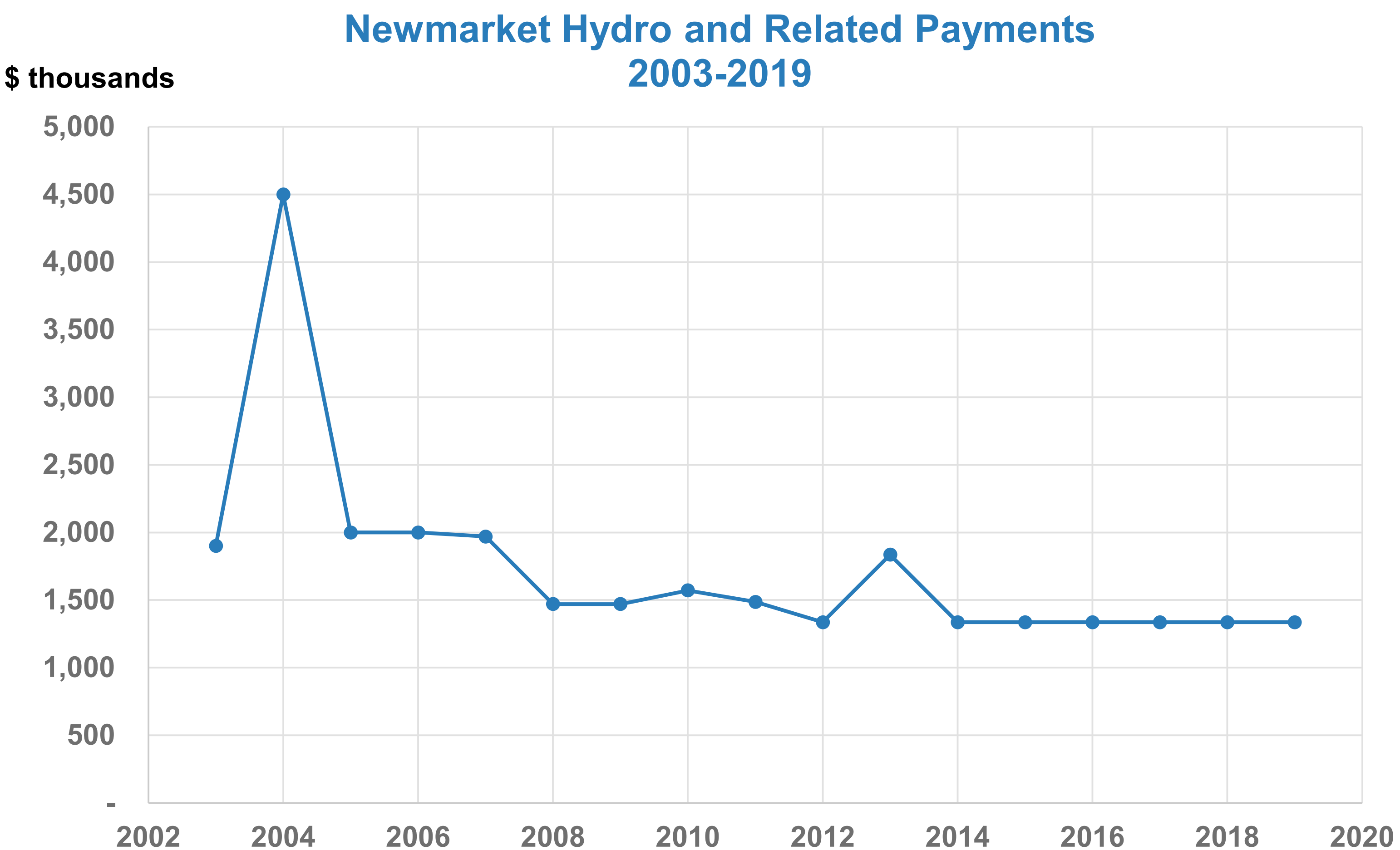
Assessment growth revenue may increase

- If population growth picks up in York Region as expected in the Growth Plan, assessment growth in Newmarket may see a corresponding increase
- The pandemic and its associated changes in home and work preferences may contribute to growth in the Region and therefore in Newmarket

7c. Enhancing Revenue:

Newmarket Hydro

NT Power distributes a dividend to the Town



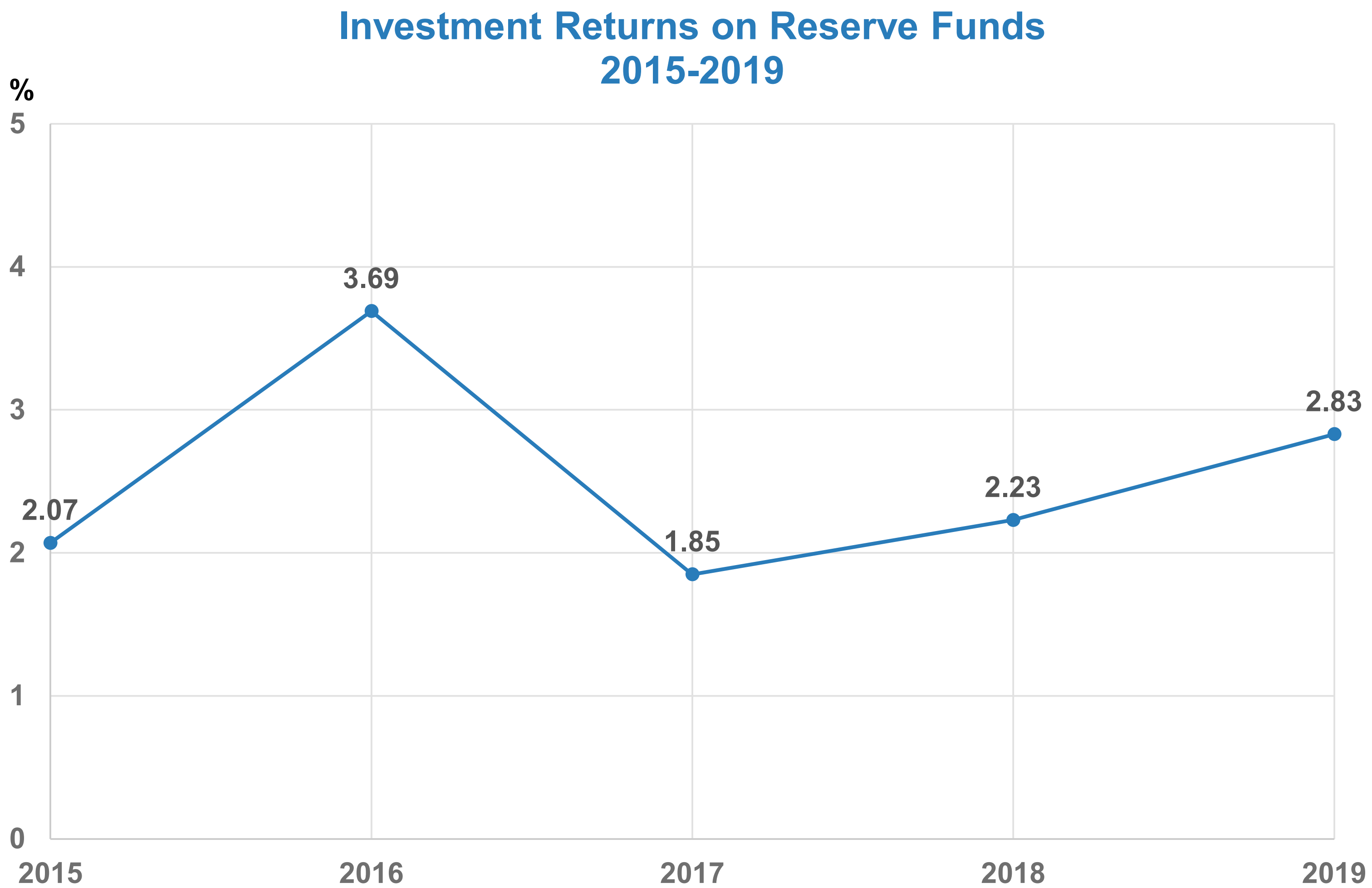
The Town could consider a comprehensive review

- The Town may wish to undertake both a strategic/policy review and a financial review of NT Power and Envi Network
- These reviews could be done separately or together and commissioned by the Town or the boards
- The review of NT Power should identify options for increasing the dividend or other revenue
- In the meantime, the Town should gradually move away from using the dividend to subsidize the operating budget, as previously discussed

7d. Enhancing Revenue:

Investment

Newmarket’s investment returns are consistent with its investment strategy



Investment returns are substitutes for future tax and rate increases

- Capital budgets and long-term capital plans are usually expressed in current dollars
- Investment returns can accomplish three things:
  - Increasing reserves to deal with inflation in capital costs
  - Providing for unanticipated increases in infrastructure costs (unrelated to inflationary increases)
  - Contributing to future asset management costs--as a substitute for a portion of the tax and rate increases that would otherwise be necessary

The Province provides municipalities with two broad options for investing

Municipalities can choose to invest under:

1. The “Legal List” ---a restricted list of fixed income investments, mostly government and bank debt. Canadian equities only through ONE Investment
2. The prudent investor standard---effective January 1, 2019, a municipality can invest in **any security**, provided that it exercises the care, skill, diligence and judgement of a prudent investor and meets certain conditions

The best options for improving investment returns lie with external experts

- The best options to improve returns are:
  - Ask York Region to invest on the Town’s behalf*
  - Invest through One Investment Legal List funds
  - Invest through One Investment Prudent Investor funds

*Although Regional Council approved investing on behalf of local municipalities some time ago, the $100 million minimum has been a barrier

Strictly as a "Legal List" illustration

- Newmarket had approximately $54,082,164 invested throughout 2019
- The Town earned $1.6 million on these funds
- As an illustration, if the Town had invested in ONE's Legal List offerings in the following ratios—20% High Interest Savings Account, 20% Government Bond Fund, 40% Corporate Bond Fund, 20% Canadian Equity Fund—the return would have been over $6.6 million
- Of course, this is a point-in-time illustration and it would be possible to have scenarios where the return would have been less than $1.6 million

The prudent investor standard holds the promise of higher risk-adjusted investment returns over the long term

The requirements for prudent investing are deliberately onerous

- Municipalities must individually or collectively have at least $100 million to invest or individually have net financial assets of at least $50 million
- Newmarket qualifies on the second criterion
- A municipality must also establish its own Investment Board or participate in a Joint Investment Board with other municipalities
- The municipality must delegate control and management of the municipality’s investments to the Investment Board (based on the municipality’s definition of “money not required immediately”)

ONE has established a Joint Investment Board open to all municipalities

- Six founding municipalities have cooperated to establish the ONE Joint Investment Board: Bracebridge, Huntsville, Innisfil, Kenora, District of Muskoka and Whitby
- Others are expected to join

Key Recommendations

1. Consider moderate increases in property taxes, after economic conditions have improved
2. Allocate any portion of assessment growth revenue not needed for growth purposes in the budget to the new Growth Reserve
3. Commission an analysis of the corporate strategy and financial prospects of both NT Power and Envi Network
4. Consider allocating a portion of the Town's investments to ONE Investment, either through the Legal List or prudent investor

8. Conclusion

Concluding Comments

- Newmarket is well managed financially and well positioned to adopt and implement a long-term fiscal strategy
- The Town needs to aggressively build reserves for the foreseeable future
- A significant restructuring of the Town’s reserve funds is needed
- The Town should keep a watchful eye on debt
- The Town would benefit from a careful examination of options to increase revenue

Concluding Comments

- An annual fiscal strategy discussion can improve the budget process by lifting the discussion beyond a focus on scrutiny of tax-based expenditures
- Newmarket’s budget process would benefit from an introductory presentation that included operating, capital and rate budgets
- Generally the Town would benefit from extending the time frame for its financial planning

Elements of a Fiscal Strategy for Newmarket