

<b>TO:</b>	<b>CHAIR AND MEMBERS STRATEGIC PRIORITIES AND POLICY COMMITTEE MEETING ON AUGUST 29, 2016</b>
<b>FROM:</b>	<b>MARTIN HAYWARD MANAGING DIRECTOR, CORPORATE SERVICES AND CITY TREASURER, CHIEF FINANCIAL OFFICER</b>
<b>SUBJECT:</b>	<b>DEBT MANAGEMENT POLICY</b>

<b>RECOMMENDATION</b>
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That, on the recommendation of the Managing Director, Corporate Services and City Treasurer, Chief Financial Officer, the attached proposed by-law (Appendix “A”) **BE INTRODUCED** at the Municipal Council meeting on August 30, 2016 to enact a Debt Management Policy.

<b>BACKGROUND</b>
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The Corporation of the City of London (the “City”) strives to achieve and sustain a healthy financial position and debt management is a key component. A debt management policy is proposed to help guide the effective management of debt and ensure the delivery of the capital plan and other services in a manner that is consistent with the City’s Strategic Plan. Proactive financial management is included as part of the City’s Strategic Plan for 2015-2019 and with that the City strives to limit the tax burden on current and future rate payers.

Proposed Debt Management Policy

Debt financing is a mechanism for funding capital projects, along with capital levy and reserve funds. A municipality may issue debentures or other types of financing for long-term borrowing to provide financing for capital works. A municipality may also acquire temporary financing instruments for operating or capital purposes. The prudent management of debt is a fundamental component of financial health and stability. Executing the objectives and strategies in the policy will enable the City to maintain its long standing Aaa credit rating from Moody’s Investor Services as well as continue on the path of financial health and stability.

Objectives and Strategies

The objectives and strategies in this policy assist Civic Administration in defining appropriate guidelines and procedures to carry out the debt program. The City’s ability to finance capital works, maintain operations and partner in investment opportunities depends on its access to funding. Credit rating, debt level, servicing costs and capacity all play a critical role in obtaining the necessary funding to provide a means to achieving the City’s goals. Maintaining prudent debt management practices will maximize the City’s ability to service current and future needs of the city while minimizing the impact of debt servicing costs on the tax levy.

The strategies contained in the policy, are as follows;

**1. Limiting and Reducing Authorized Debt**

Limiting Authorized Debt - Financing the Capital Plan

Financing of the capital plan is authorized by Council through the budget process. This strategy is aimed at limiting the amount of authorized debt. The City’s strategy for limiting the amount of authorized debt is through the systematic use of debt financing as a source of funding for projects in the capital plan.

The City’s capital plan is comprised and prioritized into three main categories;

- i. Lifecycle Renewal: Projects that maintain the infrastructure that is in place today, for example resurfacing roads or replacing roofs.
- ii. Growth: Projects that extend services into newly developed areas of the City, for example road widening to handle additional traffic from new subdivisions.

- iii. Service Improvement: Projects that provide a new or improved level of service or address an emerging need, for example purchasing property for industrial land.

Generally, capital projects provide benefits to residents over a number of years and therefore it is appropriate to spread the cost over the benefit period and utilize debt financing as a source of funding. However, lifecycle renewal projects which maintain the infrastructure are more appropriately funded through pay-as-you go financing, i.e. capital levy. Debt financing is applied as a source of funding for projects in the capital plan as follows;

- i. The primary source of funding for lifecycle renewal projects shall be pay-as-you go financing (capital levy); debt financing shall be avoided as a source of funding for lifecycle renewal projects;
- ii. Growth projects may utilize debt financing as a source of funding; and
- iii. Service improvement projects may utilize debt financing as a source of funding.

#### Limiting Authorized Debt - Internal Debt Cap

The City also limits debt financing as a source of funding in the capital plan by implementing an internal debt cap. The internal debt cap is derived for each rate base (i.e. property tax supported, wastewater, water and development charges) according to their strategies and capital financing requirements as well as the City's long-term financing strategies as a whole. The internal debt cap limit is reviewed on an annual basis and modified as required at the discretion of the City Treasurer.

#### Reducing Authorized Debt

The City has various avenues for reducing authorized debt. The Council approved Surplus/Deficit and Assessment Growth Policies apply a portion of surplus and unallocated assessment growth funding to reduce authorized debt.

Another avenue for reducing authorized debt is by utilizing surplus in the capital financing budget. One example is the operating budget contains debt servicing costs based on projected interest rates and issuances of authorized debt. Changes in interest rates or issue amounts result in variances between budgeted debt servicing costs and actual debt servicing costs. At the end of the year, any surplus in the debt servicing cost budget is applied to reduce authorized debt.

## **2. Minimizing Risk Associated with Issuing Debt**

Also included in the debt management policy are strategies used to minimize the risk associated with issuing debt. These risks include, over-issuing debt on projects, changing market conditions, fluctuating interest rates and securing appropriate forms of financing.

#### Over-issuing Debt on Projects

The City generally issues debentures on projects that are substantially complete or a discernable phase of the project is complete. The Municipal Act, 2001 does not specifically provide that municipalities can only long-term finance capital works that are substantially complete. There are circumstances in which the City may issue debt on projects that are partially complete, for example large projects can be issued at significant completion points, or phases. The risk to issuing debt before the project is complete is that once debt has been issued it is generally not callable. If the actual expenditures for the project are less than budgeted and debt has already been issued the City will be committed to debt payments on funds that were not needed.

While the Municipal Act, 2001 does allow the additional proceeds on long-term debt to be used on another capital project as long as that other capital project is to be funded through the same rate base (i.e. property tax supported, wastewater, water) and the other capital project has a useful life at least equal to the term of the applicable debt, it is prudent to avoid over-issuing debt.

#### Market Conditions

The timing and amount of debt issued in a given year are important parts of financial planning. Proper planning and preparedness allow the City to take advantage of favourable market conditions for interest rates as well as systematically take on debt such that the impact on the tax levy from debt servicing costs is minimized. Consideration of cash flow requirements, budget constraints and market conditions all contribute to a successful debt issuance program. A

systematic approach in the debt program generates favourable levels of cash which allows the City to avoid short-term borrowing and additional interest costs.

#### Interest Rate

The City's general practice is to issue debt that is denominated in Canadian dollars with fixed interest rates over the term. Securing debt that has fixed interest rates ensures that costs are accommodated in the approved budget. Fluctuating interest rates create unpredictability in the debt servicing costs and a higher risk of deficits in the budget.

#### Securing Appropriate Forms of Financing

There are generally two forms of financing that can be secured by the City, temporary or long-term. Temporary financing can be issued for either operating or capital purposes. Temporary operating financing may be required for funding operational needs during the current fiscal year pending the receipt of taxes and other revenues. A temporary borrowing by-law is passed by Council each year to allow for borrowing of this type if it is required. The City has not utilized temporary borrowing since 2012.

Long-term financing, which is not considered temporary operating or temporary capital financing, is used to finance capital works. The City primarily issues debentures in the capital markets or through government agencies including Infrastructure Ontario, Federation of Canadian Municipalities and Canada Mortgage Housing Corporation. The main driver of the source of financing is market conditions and interest rates. Government agencies may have programmatic restrictions relating to the capital projects and this would also be a factor in determining the source of long-term financing.

### **3. Minimizing Debt Servicing Costs**

The final strategy addressed in the debt management policy is minimizing debt servicing costs. The City strives to minimize the cost of financing by structuring debt to achieve the lowest possible overall cost within the constraints of the prevailing capital market conditions while meeting the goals and objectives of the approved borrowing plan. Setting targets for debt servicing costs, maintaining a strong credit rating, issuing over a 10-year term and monitoring debt levels and servicing costs all contribute to minimizing debt servicing costs.

#### Setting Targets for Debt Servicing Costs

Setting targets for debt servicing costs allows the City stay on course with respect to the City's Strategic Plan and limiting the tax burden on current and future rate payers. It also ensures that the delivery of the capital plan. The targets will be set by the City Treasurer for each rate base (property tax supported, wastewater, water and development charges) in alignment with the City's long-term financing strategies. These targets will be a general guideline and utilized in the budget development process.

#### Maintain a Strong Credit Rating

Maintaining a strong credit rating is a factor in minimizing debt servicing costs and accessing the capital markets. In addition, a strong credit rating is required to enter into certain types of financing arrangements and investments. Each year Moody's Investors Service reviews the credit worthiness of the City and then assigns the City a credit rating for the year. The City's current rating is Aaa and the City has maintained this rating for 39 consecutive years. As a Aaa rated municipality, the City's debentures are considered to be of the highest quality with minimal credit risk making them appealing to institutional investors. This contributes to the City's favourable cost of borrowing on long-term financing, which may be between 3 to 5 basis points in comparison to being rated Aa depending on market conditions. This translates into approximately \$0.5 million of interest costs on a 10-year borrowing program of \$30 million.

#### Issuing Debt Over a 10-year Term

In accordance with the Municipal Act, 2001, the City cannot issue debt that exceeds the useful life of a capital project. Section 408 (3) Term Restriction of the Municipal Act, 2001 states that "*the term of a debt of a municipality or any debenture or financial instrument for long-term borrowing issued for it shall not extend beyond the lifetime of the capital work for which the debt was incurred and shall not exceed 40 years*". Generally, Civic Administration recommends issuing 10-year term debentures as opposed to 20-year term debentures because the interest savings to the taxpayer in the long-term is significant. Although the annual cash output is lower on a 20-year term debenture, the duration is longer and the interest rate is higher (approximately 80 basis points). These factors, when taken together, amount to over twice the

interest paid over the term of the debenture. For example, on an amortizing debenture of \$100 million the total interest paid over the life of the debenture (at the current capital market rates) on a 10-year and 20-year term is approximately \$14 million and \$37 million, respectively, a difference of \$23 million.

However, there are unique projects that are significant in value which may warrant issuing a debenture with a term that is longer than 10 years, for example 20-year debentures were issued for the Bud Gardens and Dearness Home Redevelopment Projects.

Monitoring Debt Levels and Servicing Costs

The City monitors debt levels and servicing costs as prescribed under Ontario Regulation 403/02: Debt and Financial Obligation Limits. Each year the City receives its “Annual Repayment Limit” or ARL from the Ministry of Municipal Affairs and Housing. This limit is based on data contained in the City’s Financial Informational Return (FIR) and represents the maximum amount the municipality has available to commit to payments related to debt and financial obligations. In general, debt payments are limited to 25% of a previous year’s “own source” revenue. The ARL, along with other benchmarks, measures, indicators, and ratios such as debt servicing costs as a percentage of gross operating expenditures, debt financing as a percentage of the capital budget, debt per household and debt servicing costs as a percentage of revenue provide analytics which contribute to the management of debt levels and servicing costs.

Conclusion

A debt management policy is proposed to help guide the effective management of debt to ensure the delivery of the capital plan and other services in a manner that is consistent with the City’s Strategic Plan. This policy will enable the City to continue to maintain its long standing Aaa credit rating from Moody’s Investor Services as well as continue on the path of financial health and stability.

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