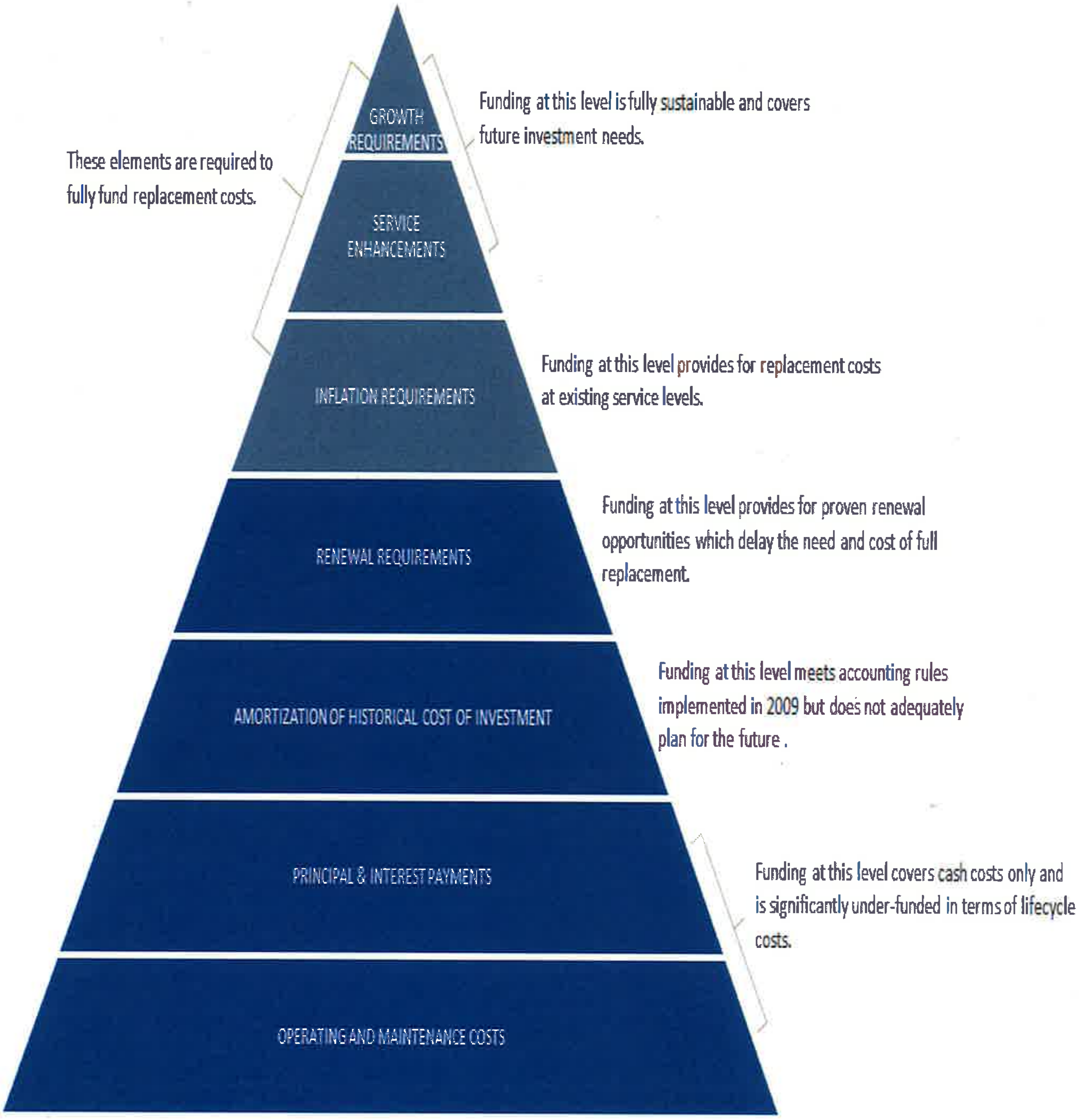
5. FINANCIAL STRATEGY

To make this AMP effective and meaningful, it must be integrated with financial planning and long-term budgeting. Here is a commonly referenced hierarchy of capital asset funding levels, presented in many AMPs, that measures the funding provided for capital needs, by seven levels:



Southgate currently is only slightly above Level Three. However, for many years Southgate was like many other municipalities, including others in Grey County, with its funding below Level Three. It was during those years that large backlogs developed in work to be done, backlogs commonly referred to as the Infrastructure Gap (the I-Gap).

At its current funding level, the I-Gap in Southgate is still growing. Every municipality has an I-Gap today, including the very largest municipalities, with the most human and financial resources at their disposal. The I-Gap is large enough now, in practically every municipality, that realistically it will never be fully resolved.

Stated simply, speaking realistically, there will always be an I-Gap, in every municipality.

What every municipality can do is, to the best of their ability based on resource restraints, firstly prevent their I-Gap from growing any larger, and secondly, do as much as is affordable to reduce their Gap gradually, year-by-year. It should be the AM Strategy of all municipalities to make consistent progress against their I-Gap in every single future year. There should be no "time-outs" taken, progress should be uninterrupted, barring catastrophic events that are unforeseen.

There will be bumps in the road. The economic damage from COVID may set back the progress against the I-Gap in the short term; many municipalities may find it more difficult to increase taxes to reduce their I-Gap while their local economy is suffering. There may also be unanticipated setbacks from weather-related events, that likewise could cause municipal finances to be temporarily re-directed away from the work to be done against the I-Gap. Even in those years, a reasonable compromise would be to make only a minor amount of progress against the I-Gap, less that what had been planned, but at least some improvement is made.

It will always require taxation increases to make any progress on an I-Gap. Taxation is the largest source of infrastructure funding, except when a very large borrowing is done in the year of a large project. Borrowing is appropriate for a major infrastructure project that results in an asset that will last many years, because borrowing spreads out the cost over future years, and over future taxpayers, who benefit from the services that asset will provide. However, borrowing adds to the cost of the asset by adding an interest expense. Borrowing also limits Council's control over its own budget, since debt servicing costs are a fixed cost that Council cannot cut from the budget.

In addition to raising more money, there are other actions to take, as mentioned earlier, such as better asset data gathering, proper asset maintenance and regular repairs, long term planning, and seeking out grant funding. Senior government levels recognized the I-Gap issue years ago, and so in recent times we have seen many actions they have taken:

- Doubling the amount of Federal Gas Tax provided to municipalities, in specific years.
- Expanding the kinds of projects eligible for Gas Tax funding.
- Expanding the range of services eligible to use Development Charges.
- Increasing the frequency and amounts of competition-based, single project-based grant funding programs available.
- Increasing (albeit gradually) the funding for annual non-competitive, per-capita grant programs, such as OCIF
- Uploading of some services by the Province, the direct opposite of the downloading of both services and capital asset responsibilities (specific roads, social housing, for example) onto municipalities, that happened during the same years when the I-Gap was growing.

Here is a review of how Southgate has recently stepped-up against its I-Gap:

Year	Taxes levied for Capital and Special Projects (e.g. studies)	Deprec. Expense on Audited Fin. Statements *(excludes W&S)*
	excludes Water Systems and Sewer Systems which are user-fee funded	
2011	$ 450,200	$ 1,334,243
2013	$ 831,000	$ 1,357,499
2015	$ 1,373,777	$ 1,399,672
2017	$ 1,447,896	$ 1,523,272
2019	$ 1,766,700	$ 1,647,668
2020	$ 2,055,854	$ 1,761,500
2021	$ 2,236,539	Estim. $ 2,000,000

Taxes levied annually, for tax-supported capital assets in Southgate, were inadequate until about 2015. Level Three, namely taxation matching the depreciation expense, is a bare minimum to reach, since depreciation is a flawed number that is based on often extremely outdated asset historical-cost values, and therefore Level Three funding will not come close to the cost of replacing an asset at current prices. This situation is particularly bad in low-growth municipalities, where many municipal assets are quite old, and there are not many newer assets because there has been no pressure coming, from municipal growth, to build new assets to service growth.

Southgate had not reached Level Three until 2015. Growth had picked up at about that time. Like most other municipalities, the I-Gap in Southgate was getting larger every year, until about 2015 when taxation-funding levels for capital assets began to approach what was necessary to stop things from continuously getting worse. However, since the I-Gap problem kept getting worse for roughly a twenty year stretch from 1995 to 2015, it will take many years of gradual progress, around enhanced financing, to resolve the problem.

Southgate's 10-year Capital Plan, as shown in its 2021 budget documents, recognizes the I-Gap problem and does strive to keep up with the need for increased attention to capital assets. Tax levy forecasts for Capital (and Special Projects):

Year	Forecasted TAX LEVY for Capital Budget (and Special Projects)	Increase in $$	Increase % over prior year	Gross Capital project costs for the year, forecasted
2020	$ 2,055,854 Adopted	$299,154	17.03%	
2021	$ 2,236,539 Adopted	$180,685	8.79%	$11,215,797
	Draft amounts from 10-year Capital Plan			
2022	$ 2,555,635	$319,096	14.27%	
2023	$ 2,828,163	$272,528	10.66%	
2024	$ 3,146,084	$317,921	11.24%	
2025	$ 3,508,870	$362,786	10.34%	
2026	$ 3,930,985	$422,115	12.03%	
2027	$ 4,410,125	$479,140	12.19%	
2028	$ 4,927,548	$517,423	11.73%	
2029	$ 5,519,127	$591,579	12.01%	
2030	$ 6,198,637	$679,510	12.31%	
	excludes Water Systems and Sewer (W&S) Systems which are user-fee funded			

Under this plan, taxation for capital projects would increase by 201.5% over 10 years, from 2020 to 2030; in other words, tax support would triple in ten years. This would be a major increase, going by the standards set by Southgate's budgets prior to 2020. On the other hand, for some perspective take note that:

- Sept. 2020 OSIM report from RJB on Structures provides a five-year proposed Capital Plan (Table 8 in the report) costing $5,605,500 (no inflation adjustment)
- The same RJB report shows a forecasted cost for the next ten years of $28,322,400 for Structure "rehabilitation and replacement", NOT INCLUDING associated costs for roadside protection work and additional investigations (another $4.7 million). These costs are not adjusted for inflation (so 2020 costing is used throughout the ten-year period)
- The 2019 Triton Road Needs Study estimated a cost of $20.11 million over ten years for major rehabilitations and new pavements (again no inflation adjustment)

Taking these numbers, at the lowest options, it works out to roughly $2 million per year for roads capital and $1.1 million per year for structures ($5.6 M/ 5 years) for a total of $3.1 million per year of gross capital spending recommended by external consultants, just for roads and structures.

The Southgate Tax Levy for 2021 capital projects, per the Table above, is $2.236 million for all its departments, and all its assets (not just roads and structures), including vehicle fleet, machinery and buildings, but excluding water and sewer (W&S) assets. The net levy for Public Works, for 2021 road and structure projects only, is $761,830 or about one-third of the full 2021 Levy, on gross project costs of $2.7095 million. This does not include fleet replacements, equipment, signs or debt servicing, it just includes road and structure projects. [*Funding of the $2.7095 million of work for 2021 comes from Grants $828K, from Reserves $294.4K, from borrowing $825.3K and from Taxation $761.8K.]* The

$2.7 million amount of approved road and structure capital costs for 2021 is getting reasonably close to the $3.1 million figure from the consultants. Southgate is making some progress against its I-Gap.

It is unusual to see borrowing as a funding source, especially when every infrastructure project in Public Works, across the entire ten-year Plan, are rehabilitations or replacements of existing assets. There are no new assets appearing in the Plan, just replacements or upgrades of assets already in place, but wearing out. In every year in the ten-year Plan, the projects listed are for an existing structure (as proof, the Structure ID # is given) or an existing section of road. In fact, borrowing appears as a financing source not just in 2021, but also in 2022, 2023 and 2024.

This use of debt for financing asset replacement is a signal of financial stress; in many municipalities, it is their adopted policy to only use debt for the construction of new assets, such as a building, where there is no asset currently. In Southgate, certain projects are placed within the capital plan, in specific years, because the work needs to get done, but there are not enough funds available to pay for them, so the shortfall is made up by borrowing some money every year. Late budget changes were made by Council to reduce the amount being borrowed in 2021, while keeping within Council's limits for the overall taxation increase. The debt service costs, created by this planned borrowing, become an annual expense in later years of the Plan, so that by year 2025 there are four infrastructure debt-servicing amounts (principal plus interest) appearing, under Public Works, taking up 2025 taxation revenue room, and leaving less room for new project costs.

The financial stress situation, shown by the need for borrowing for asset replacements, comes from prior years of under-funding capital assets, years when the I-Gap was expanding. It should also be noted that this stress is also reflected, but less noticeably, in the timing of capital projects throughout the ten-year Plan. You can point to multiple cases where Township staff would want to see specific projects scheduled earlier, but projects reluctantly get delayed to the year when they could be "fitted" within the Plan's annual financial limitations.

Another serious source of stress on asset management is capacity issues. It might be great to expand budget dollars, and to make plans to get more work completed each year. What must not be overlooked is the realistic capacity to accomplish the work. Consideration must be given to the human resources available to design, supervise and complete projects. Capital work projections, and capital budgets, that do not consider capacity limits will result in multiple unfinished projects, unspent funding, and high levels of work-in-progress.

One further point to be made about capacity issues is Covid-19's impact. Covid has put many 2020 projects of other municipalities into deferral, province-wide, (but not Southgate, however), leaving a work backlog to be filled by the same number of potential contractors, or perhaps even fewer contractors, when you consider that perhaps some were put out of business by Covid.

Looking at the final year in the Plan, 2030, the taxes levied are forecasted to be $4.920 million for the roads and structures segment of Public Works (79% of the forecasted 2030 capital tax-support Levy of $6.198 million). Within that amount, $450,000 is for debt payments, leaving $4.47 million [4.92 – 0.45] for 2030 project costs. This is about double the overall amount of adopted 2021 taxes levied for capital, in all departments combined, of $2.236 million, and is much improved over the $0.7618 million levied in 2021 tax support for road and structure projects.

Many other municipalities have adopted an "Infrastructure Levy" as part of their annual budget process. Typically, you will see others have approved 1% or 2% annual municipal tax levy increase commitments, for capital assets. Southgate's overall Tax Levy for 2020 was $7,584,704 (capital and operations) so the increase in 2021 taxes levied for capital purposes, namely $180,685 per the table above, was effectively a 2.38% increase over the 2020 levy, so Southgate is making a similar commitment to capital without naming it directly as an "infrastructure Levy". Notice that in the table above, draft tax increases for capital support, planned in 2022 and beyond, are all greater than the 2021 increase.

It is recommended that Southgate stay determined to meet those targets shown in the years 2022 to 2030 in its Capital Plan. Another recommendation is to pursue other revenue sources such as external grants and subsidies, to enable the Township to advance planned capital projects to earlier timeslots, without amending the targets for annual taxation support.

It is also recommended that as debt payments for past projects expire, the "savings" from the debt payments dropping off should be applied to new projects in the capital budget, and not be "returned to the taxpayer" by lowering the taxes levied for capital.

It is often asked "what is the appropriate level of taxes to raise for capital purposes?". There is no standard answer for this question; circumstances are different in every municipality. The size of the I-Gap, resulting from past actions (or lack thereof), is one factor, and municipal growth is another factor.

For example, the County of Grey tax levy for 2021 is 26.75% for capital costs and 73.25% for operations. For comparison, in 2020 Grey County's tax levy was 24.74% for capital costs and 75.26% for operations. Further, in 2015, the Grey County tax levy was 20.77% for capital costs and 79.23% for operations. For Southgate, its tax levy for capital in 2021 was 28% of the total levy; in 2018 it was 27% of the total levy; in 2013 it was 20.57% of the total levy.

A 25% / 75% target ratio is quite typical in larger municipalities. Grey County has 887 km of County roads and 192 structures. This does not mean 75/25 is the right target for Southgate. The taxation ratio split depends on the kind of services being delivered. Upper-tier municipalities, like the County of Grey, perform many "soft services" such as Child Care, Elder Care and Social Assistance, where the costs are weighted towards personnel and are more operational, as opposed to Public Works where there are a high number of capital assets to maintain. Notice the County levy-share going to capital costs has been increasing; this is what should ideally be happening in municipalities that are actively trying to address their I-Gap. This has also been happening in Southgate.

AMP's often will illustrate the I-Gap on a line-graph, as part of a Financial Strategy designed to close their I-Gap over time, using increased property taxes and other actions. These graphs will often show the tax increases that would be necessary to get the I-Gap all the way down to zero in the future. Where the I-Gap is large, this analysis can result in calculations that give required annual tax increases, needed to "eliminate" the I-Gap in the specified timeframe, that are not reasonable or realistic, and very unlikely to ever be approved by Council.

This approach is not recommended.

In the case of Southgate, it is more realistic to state honestly that the I-Gap will never be zero; instead, we recommend that the municipal leaders be disciplined in their efforts to raise property taxes, for capital project purposes, at a manageable but steady pace, and consistently accomplish as much capital work each year as the municipality has the capacity to complete. Avoid the "over-promise and under-deliver" scenario. The targets for tax support already in the Southgate Capital Plan are a good start.

The evidence of future advances accomplished by Southgate, against the I-Gap, will be clearly measurable, by using the future PCI and BCI results in external consultants' reviews of the state of Southgate's core infrastructure (Roads and Structures), when these reports are completed in future years. Results achieved (or not achieved) will also be reflected through comments and opinions received, from local ratepayers, about the state of township core infrastructure.

<u>User-rate Supported Assets (Water and Sewer system)</u>

Water and sewer systems are required by Ontario legislation to be self-sustaining financially. User Rates must be set at levels needed to fund all operational costs, capital costs and debt-servicing costs. Capital costs can be more than what is needed to finance current-year capital projects, to build capital-project reserves, in anticipation of major capital project costs upcoming.

Even when reserves for water and sewer projects are built in advance of major capital projects, the reserves may not be built up to the full project cost by the time of project construction. This could happen because there was not enough time available to build reserves before a project was started, or some unusual events happened from an operational standpoint, that resulted in higher operating costs, leaving smaller amounts to go into the reserves than what was planned for.

For very large capital projects, it may be necessary to plan long-term borrowing for those projects. Then user rates would be set such that annual debt-servicing costs can be fully carried from the rate revenues collected. This is like securing a mortgage loan on the purchase of a home. Borrowing is appropriate for the purchase (or major rehabilitation) of a long-lived asset, such as a new sewage treatment plant, so long as the debt payments can be carried by rate revenues.

Southgate operates utilities in Dundalk only. The User Rate system ensures that only the residents in Dundalk are paying for the costs and the debt of the utilities, and not the residents in the remainder of the township. Southgate does in fact have several large capital purchases scheduled in the medium-term for both its water and sewage systems (projects of $1.0 million or more). Capital project data obtained from the 2021-2030 Plan:

YEAR	SANITARY SEWAGE SYSTEM CAPITAL BUDGET	FORECASTED NEW DEBT	DEBT TERM		WATERWORKS SYSTEM CAPITAL BUDGET
2021	60,000	0			233,000
2022	16,316,200	10,993,185	20 yrs.	SWR	
2022		3,225,000	20 yrs.	WTR	3,337,000
2023	0	0			172,000
2024	0	0			47,000
2025	1,500,000 (but no debt)	0			352,000
2026	0	1,684,000	10 yrs.	WTR	1,736,000
2027	1,000,000 (but no debt)	0			242,000
2028	0	4,250,000	20 yrs.	WTR	4,202,000
2029	0	0			2,000
2030	1,000,000 (but no debt)	0			2,000
		20,152,185			
	SANITARY SEWAGE SYSTEM CAPITAL BUDGET	FORECASTED NEW DEBT			WATERWORKS SYSTEM CAPITAL BUDGET

Southgate borrowed $3,731,925 in 2019 in respect of Well D5 waterworks capital project. Plans are in place, per this table, to take on a further $20 million of debt over the next ten years for utilities projects. Future user rates must take the future debt-servicing costs into consideration. Interest rates for municipal borrowing are very favorable at the current time, and they are expected to remain that way for many years ahead.

Major projects in the Capital Plan, reflected in the table above, are:

- 2022 sewage treatment facility upgrade
- 2022 construct new water tower

- 2025 Ida St. S. & Eco Parkway sewage pumping station
- 2026 Main St. W. watermain (oversizing) [Main St. E. mains were done in 2019/20]
- 2027 Glenelg St. sewer
- 2028 construct new Well D6
- 2030 Ida St. N. & Glenelg St. sewer

The Plan expects to have adequate funds in reserve for the pumping station (2025) and the two sewer projects (2027 and 2030) to fully fund those projects from the sewer system reserve, without issuing any new debt. From the seven projects above, four are expected to require incurring new debt.

Debt-servicing costs can also be funded from Development Charges (DC), so long as the projects were DC eligible (in other words, they were growth-related projects, in full or in part, and they were in the current DC Bylaw). At the time of project construction, it is likely there will not be enough DC funds collected to date, to pay the DC-eligible share of project costs in full. Instead, over subsequent years, as more DC are collected each year, they may be applied annually towards debt-servicing costs.

Additional Financial Considerations

One further point to make about financing is for information only, as Southgate is a long way from being in the following position. [This point also appeared in the 2013 Southgate AMP.]

Municipalities with strong levels of financial resources available to them, due to large populations and high property values, may follow the "Sinking Fund Method (SFM)" for financing capital assets. The SFM takes asset management planning to another level. SFM builds large reserve balances for the future replacement of assets. These reserves get started soon after an asset is replaced, contributions are made to the reserves consistently every year, and the outcome is many subsidiary reserves, covering nearly every asset class. These large reserves are invested, to earn investment income that gets added to the reserves, to build the reserves more quickly, and to be put towards the future project costs. The practice of SFM is part of formal Long-Term Financial Plans (LTFP), found more commonly in larger municipalities with "deeper pockets".

For one example, there could be subsidiary reserves in place for the replacement of the HVAC systems and the parking lots of every single building owned by the municipality. The need to replace any one HVAC system or parking lot could be five to ten years away, but some funds are being raised and placed into reserve now, and in every future year, so that when the asset replacement time arrives, the full funding is in place. These capital reserves are often pooled by asset component. For example, a single "HVAC reserve" and a "parking lot" reserve, are recorded, and used for the next HVAC or parking lot project (but not a separate reserve for every lot).

The problem with this approach comes from those who may object to taxing current residents today, for part of the cost of a project that will not be undertaken for at least five years. This approach results in very large reserve balances and very large cash balances in the municipality, which can create the appearance that the municipality is "over-taxing" its residents today, and simply accumulating large sums of money, even though the municipality can always explain specifically what its plans are, for its reserve funds, if asked to do so. This financial position, of large cash balances and large reserve balances, can be found in the financial statements of many larger municipalities.

Rather than being able to implement SFM, the capital project taxation raised by Southgate in any given year is directly applied to projects to be undertaken in that same year. Funds raised in 2021 are not being set aside for future years (see one exception noted below). This is the result of Southgate having a substantial I-Gap, being in the position of playing "catch-up" with its capital asset work. There are more assets in need of attention now than there is funding available to rehabilitate them. Instead of using SFM, Southgate finds itself having to defer capital projects to one or two years further on, within the capital plan, than it would otherwise prefer, because of limited funding. Capital Reserves are not large.

One exception to this situation in Southgate arises if, in any given year, the projects completed for that year, or the assets bought (like vehicles for example), turn out to cost less than the taxes raised (being under-budget). Annual tax contributions beyond the actual capital costs would be transferred to a "capital replacement reserve fund" for future needs. Unspent funds placed into Capital Reserves also protect against the possibility of the opposite situation happening, in another year (project costs turn out to be greater than the taxes raised, or over-budget). This practice for handling variances from budget helps ensure that Southgate does not need to deviate from its (recommended) commitment to gradually, but consistently, increase its tax support for capital work.

Other strategies for financing capital projects include:

- Actively seeking out and applying for grants and subsidies
- Implementing operating efficiencies, reducing operating costs, to permit directing more funds to capital projects
- Decreasing expected levels of service, to reduce operational costs and make more capital funding available
- Updating the Development Charges Bylaw, to more closely match with the capital plan project list, normally resulting in higher DC rates
- Approaching the development community for funding assistance with respect to growth/expansion related project