THE DISTRICT MUNICIPALITY OF MUSKOKA

CORPORATE AND EMERGENCY SERVICES DEPARTMENT
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TO: Chair and Members
Corporate and Emergency Services Committee

FROM: Stephen Cairns,
Commissioner of Finance and Corporate Services

DATE: July 4, 2008

SUBJECT: Debt Reduction Initiative

REPORT NO: CES-6-2008-6

RECOMMENDATION

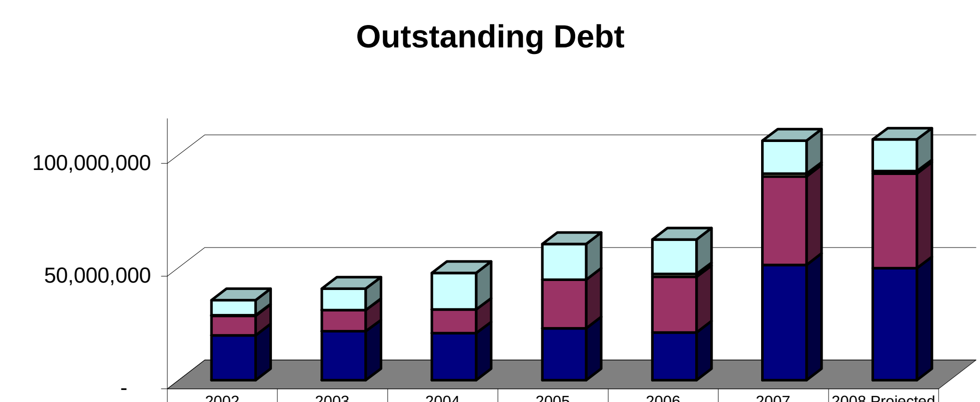
None. For information only.

ORIGIN

During the deliberations of the 2008 Rate Supported Operating Budget and the 2008 Rate Supported Capital Budget and Forecast staff was directed to prepare a future report on Debt Reduction strategies as outlined in the Treasurer's Report which formed part of the Draft Budget documentation. The report, to be prepared by the end of June, was to outline in detail some debt reduction strategies for consideration by Committee and Council.

<u>Debt History</u>

The level of debt incurred and outstanding by The District Municipality of Muskoka has increased substantially over the last 5 years as reflected in the following graph.



	2002	2003	2004	2005	2006	2007	2008 Projected
Homes for the Aged	6,721,000	9,511,000	16,292,383	15,779,564	15,240,146	14,672,152	14,075,553
Solid Waste	187,000	97,000	-	-	1,300,000	1,196,644	1,088,120
Water	8,672,500	9,366,500	10,547,800	21,602,854	24,640,436	39,303,313	42,007,427
Sanitary Sewers	19,929,500	21,673,500	20,805,200	23,014,856	21,198,572	51,149,971	49,697,123

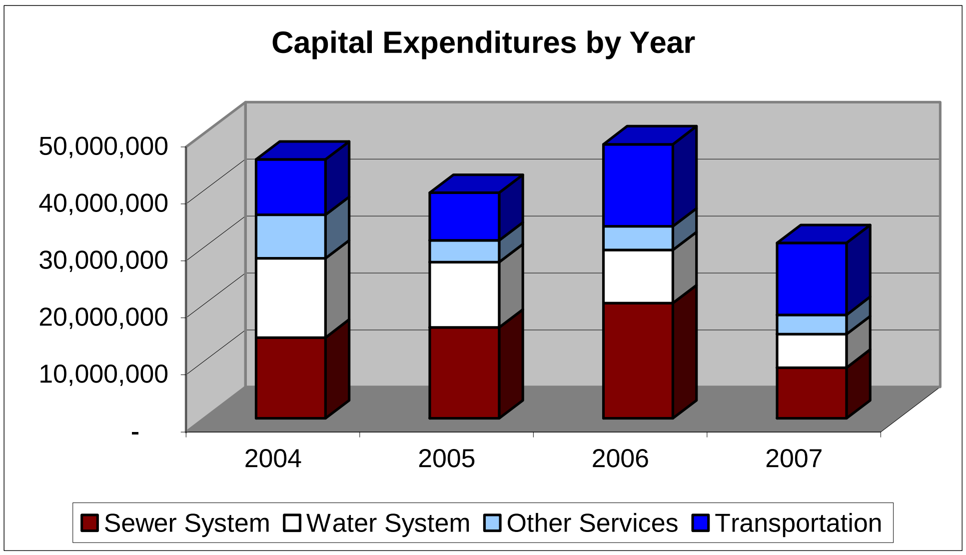
Managing Our Legacy Together

The increase in the debt level is attributed to the financing of new construction, upgrades and replacement of water and sewer infrastructure. Between 2006 and 2007 total debt outstanding at the end of the year increased by $43.9 million dollars. The increase is due to $48.3 million in debt issued for projects as listed in the following table, less $4.4 million in principal repayments in 2007.

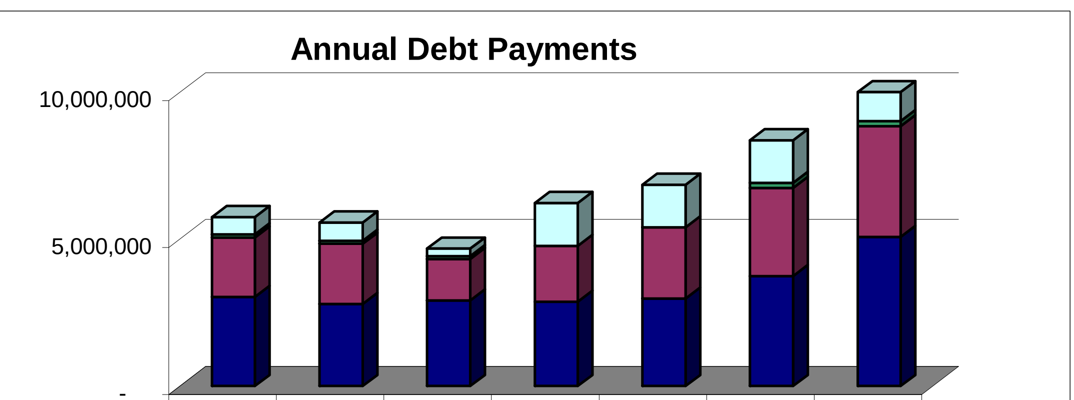
		Debt Issued ($)				
By-law	Project	2004	2005	2006	2007	Total
Water						
2004-57	Watermains Huntsville & Gravenhurst	1,078,000				1,078,000
2005-7	WTP Beach Rd Gravenhurst		7,000,000			7,000,000
2005-35	Watermains Huntsville & Gravenhurst		3,167,000			3,167,000
2005-36	Watermains Huntsville & Bracebridge		1,378,000			1,378,000
2005-61	Watermains Gravenhurst		260,000			260,000
2006-51	Waterworks Bracebridge			300,000		300,000
2006-51	Watermains Gravenhurst, Bala, MacTier & Huntsville			2,370,000		2,370,000
2006-51	WTP Bala / MacTier			630,000		630,000
2006-51	Kirby Beach WTP Improvements			1,200,000		1,200,000
2007-18	WTP Bala & MacTier				770,000	770,000
2007-18	Watermains Gravenhurst				300,000	300,000
2007-83	Watermains Bracebridge, Port Carling, Bala & Huntsville				952,000	952,000
2007-83	WTP MacTier				1,400,000	1,400,000
2007-83	Waterworks Huntsville				3,790,000	3,790,000
2007-84	Waterworks Hanes Road Huntsville				1,010,000	1,010,000
		1,078,000	**11,805,000**	**4,500,000**	**8,222,000**	**25,605,000**
New Systems						-
2007-3	Baysville Water & Sewage Works				6,692,000	6,692,000
2007-4	Baysville Water & Sewage Works				5,000,000	5,000,000
2007-4	MacTier Water & Sewage Works				8,679,000	8,679,000
2007-82	Sewage Works MacTier				3,300,000	3,300,000
2007-82	Sewage Works Baysville				1,248,000	1,248,000
2007-83	Waterworks Baysville				1,900,000	1,900,000
		-	**-**	**-**	**26,819,000**	**26,819,000**
Sewer						-
2004-57	Sewage Works Huntsville	1,300,000				1,300,000
2005-35	Sewage Works Huntsville & Gravenhurst		2,987,000			2,987,000
2005-61	Sewer Mains Huntsville, Gravenhurst & Bracebridge		890,000			890,000
2007-18	STP Huntsville				400,000	400,000
2007-18	Sewer Mains Bracebridge				450,000	450,000
2007-19	STP Gravenhurst				5,000,000	5,000,000
2007-82	Sewage Works Bracebridge				1,700,000	1,700,000
2007-82	Sanitary Sewers Bracebridge, Huntsville				210,000	210,000
2007-82	Sewage Works Gravenhurst				4,500,000	4,500,000
2007-82	Sewage Works Huntsville				1,000,000	1,000,000
		1,300,000	**3,877,000**	**-**	**13,260,000**	**18,437,000**

By-law	Project	2004	2005	2006	2007	Total
				Debt Issued ($)		
<u>Solid Waste</u>						
Internal debt	Land Purchase Solid Waste			**1,300,000**		**1,300,000**
<u>Tax Supported</u>						
2004-60	Pines Home for the Aged	**7,077,000**				**7,077,000**
	Total Annual Debt Issued	**9,455,000**	**15,682,000**	**5,800,000**	**48,301,000**	**79,238,000**

Water and sewer systems have accounted for 60% of the total capital expenditures over the last 4 years and 90% of the debt increase. Transportation is the second largest area of capital expenditures at 27% and has no debt associated with the capital program. The Roads program is 100% financed by reserves, which are in turn financed through the annual tax levy or through development charges.



The result has been a significant increase in annual debt payments within the water and sewer systems as reflected in the following graph.



	2002	2003	2004	2005	2006	2007	2008 Budget
Homes for the Aged	594,580	624,065	254,847	1,454,931	1,454,230	1,452,990	1,453,306
Solid Waste	103,610	104,110	102,748	-	-	168,356	168,356
Water	2,017,903	2,041,966	1,400,847	1,897,090	2,411,896	2,998,380	3,770,768
Sanitary Sewers	3,032,709	2,794,524	2,915,153	2,872,690	2,981,528	3,740,961	5,073,068

Not surprisingly there has been a corresponding increase in user rates and special urban service area charges as these systems cope with having to finance these annual debt payments. Debt payments and related reserve contributions to finance capital projects account for over 50% of the operating costs. Since 2004 the average residential customer on combined service has experienced a 58.9% or $36.39 per month increase in their utility bill and a 44.6% or $17.76 per month increase in their urban service area charge. The combined effect of these increases is an additional $650 in the annual costs for those users on water and sewer services and has given The District Municipality of Muskoka one of the highest, if not the highest water and sewer rates in the Province.

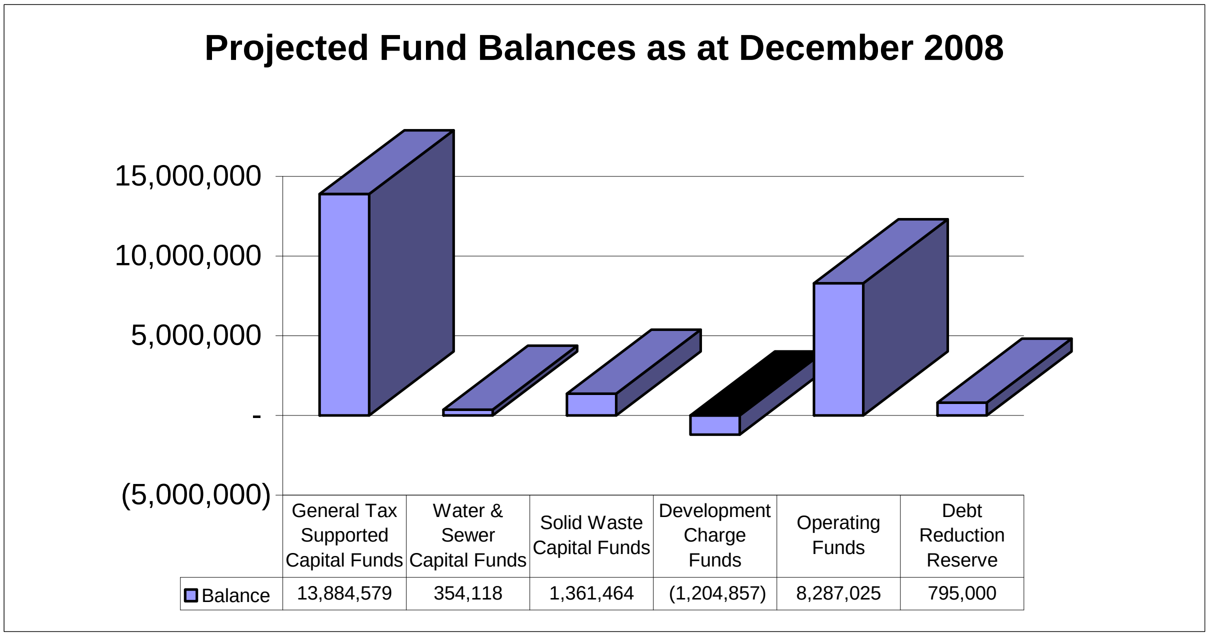
Despite this, Muskoka's annual credit limit has not altered significantly over the years.

Year	Limit ($)	% Used
2003	17,076,900	32.6%
2004	17,890,013	31.3%
2005	19,803,904	31.4%
2006	21,192,876	32.3%
2007	23,668,495	35.3%

The concern is not one of overall corporate fiscal capacity to issue debt, although The District Municipality of Muskoka is not as fiscally strong as some of its peer municipalities, but the concentrated use of debt as it relates to water and sewer systems. The interest charges on the outstanding debt accounts for $4.4 million of the annual operating costs for these two systems. Avoidance of the interest charge would reduce overall user rates by $30 per month or 19%. By contrast the general tax levy incurs $1.5 million in annual debt charges of which $.9 million is interest and is offset by a $.6 million grant. The net result is an annual debt charge of $.9 million.

Although the District does not have an issue in terms of the Provincial credit limit, there are still issues in terms of the District's overall financial strength in comparison to other municipalities.

Annually the Ministry of Municipal Affairs, based on each municipality's annual Financial Information Return (FIR), prepares key financial performance indicators and compares them to peer municipalities. In their 2006 review they indicated that Muskoka's relatively low reserve fund balances were a high risk factor and that Muskoka's debt levels were a moderate risk factor, and that was prior to the $48.3 million debt issue in 2007. The projected uncommitted reserve fund balances held by The District Municipality of Muskoka at December 2008 totaled $22.6 million.



As shown in the above graph, any available reserve fund balances are in General Tax Supported activities. Rate Supported reserve fund balances are either minimal or are over committed.

In a Municipal Study, conducted by BMA Management Consulting Inc., the firm compared water and sewer reserves as a percentage of operating expenditures. The study included key indicators from 79 Ontario municipalities, representing in excess of 80% of Ontario's population. In that study, the median balance of reserves as a percentage of expenditures for water and sewer was 47.4% for water and 57.6% for sewer versus The District Municipality of Muskoka's 3% and 22%. To reach the average the District would have to maintain $5.1 million in its water reserves and $6.8 million in its sewer reserves.

The District Municipality of Muskoka's overall credit rating is Aa2, which is reflective of a strong fiscal position, however, in the 2007 rating Moody's echoed similar findings to those observations made by The Ministry of Municipal Affairs.

Modest Reserve Levels
Although the report indicated that reserves were up over 2007 they referenced that future operating surpluses, along with an ongoing review of the District's development charges, will likely enhance Muskoka's reserve levels and capacity to rely more heavily on pay-as-you-go financing for future capital projects.

Debt Burden Forecast to Peak in 2008
The rating was also hinged on the fact that the debt burden based on the 2007 Capital Budget and Forecast was going to peak in 2008 and that debt as a percentage of operating revenues was high but was declining. Moody's considers forecast debt issuance, stemming from the District's capital plan, to be manageable in the current fiscal framework.

Governance and Management Factors
Moody's also expects that The District Municipality of Muskoka will continue to display strong governance and management characteristics through multi-year capital planning, based on a ten-year capital plan, and a record of generating operating surpluses. It also referenced management's conservative debt and investment practices that limits exposure to market-related risks and helps to ensure smooth debt servicing costs.

The implications are that if reserve levels do not continue to increase, if debt burden does not peak in 2008 and if management and Council do not continue to be vigilant in their financial management, the credit rating may be at risk.

ANALYSIS

The remainder of the report outlines potential strategies to reduce overall debt levels and/or avoid debt in the future.

Increase Funding

Infrastructure funding from Senior Levels of Government

The District Municipality of Muskoka has sought out funding from senior levels of government on a continual basis and will continue to do so. The concern and issue of the funding programs to date is that they cannot be relied upon in order to prepare a capital and financial plan with any degree of confidence. These programs are characterized by:

- Funding commitments that vary from year to year
- Eligible costs for projects that vary from year to year
- Approvals of funding on a project by project acceptance with limited documented information as to what the success / approval criteria are and how projects were scored
- Unrealistic time constraints as to when expenditures have to be incurred which are often in conflict with local priority and or prudent management
- Eligible costs under the funding problem not being reflective of total project costs
- Arduous application and approval process

A case in point is the Lagoon Lane Sewage Treatment Plant in Bracebridge as shown in the following table. The District Municipality of Muskoka applied on several different occasions for funding under previous COMRIF releases and was not successful. When finally approved, the eligible costs were set at $21 million versus an estimated cost of $30 million required to complete the project. In addition, the program required the expenditures or construction to be completed by March 2009, which effectively means for a project of this size and complexity that Muskoka cannot receive its full funding as approved.

Note: At the time of writing this report we have received notice that the extension has been approved.

The following table shows programs over the past several years where the District has been successful in receiving a total of $26 million in senior government funding.

Project	Project GL Code(s)	Ministry	Total Project Expenses To-Date ($)	Total Eligible Expenses ($)	Provincial Share ($)	Federal Share ($)	Maximum Financial Assistance
COMRIF Bracebridge Sewer Plant Lagoon Lane Proj #15092	**02.410.759**	Ministry of Agriculture, Food And Rural Affairs Rural Investments Branch	1,604,605.58	21,505,810.00	7,168,603.00	7,168,603.00	14,337,206.00
OSTAR MacTier Sewer Plant Proj #6116	**02.414.750/705**	Ministry of Agriculture, Food And Rural Affairs Rural Investments Branch	22,551,872.98	19,671,365.00	6,557,777.38	3,192,721.33	9,750,498.71

GMEF GMF520 Biosolids Composting Study	**02.440.578**	Green Municipal Enabling Fund FCM Federation of Canadian Municipalities	803,560.14	777,777.77	350,000.00	350,000.00
RIII Rural Infrastructure Investment Initiative 6181	**Various**	Ministry of Public Infrastructure Renewal				952,000.00
FedNor Prof #842-496439 Norwegian-Airport Terminal	**02.816.597**	Industry Canada-FedNor	1,102,052.93	871,180.00	435,590.00	435,590.00
FedNor Proj #837-481317 Norwegian-Non Capital Component	**02.816.589**	Industry Canada-FedNor	254,786.79	252,915.00	126,458.00	126,458.00

In March 2007, the Association of Municipalities of Ontario (AMO) stated the following in a Backgrounder Bulletin entitled "Provincial - Municipal Fiscal Gap".

> "*Municipal councils continue to be forced to divert billions of dollars in municipal property tax revenues away from infrastructure investment and other services to pay their bills to the Province - investments that would otherwise have gone toward local priorities such as roads, bridges, sewer and water systems, transit, and parks.*
>
> ***Why has AMO identified an upload of the Ontario Disability Support Program (ODSP) as something that could be uploaded immediately?***
>
> *Uploading ODSP is an obvious choice. Municipalities are required to collect $600 million in property taxes (and growing) a year to hand over to the Province for the ODSP program. ODSP is a provincial program that is designed and delivered by the Province. Municipalities have nothing to do with it. Property tax payers are even required to pay half the cost of the salaries of provincial public servants who design and deliver the program! It's unaccountable.*
>
> *Municipal cost sharing for the ODSP is a case study in bad public policy. It would be difficult to find anyone who would disagree.*"

To the Province's credit they approved the uploading of ODSP costs over a 4-year period commencing in 2008.

In The District Municipality of Muskoka's case, based on the 2008 budget the following projected "savings" will accrue from the uploading of the ODSP program.

Year	"Annual Savings"
2008	$685,000
2009	$935,000
2010	$2,342,000
2011	$3,749,000

In 2008, the savings were used in part to finance an increased contribution to the Environmental Reserve Fund. This additional funding reestablished the annual contribution to its targeted level after adjusting for inflation as shown further on in this report.

In 2008, Council established a Debt Reduction Reserve Fund for payment of such principal and interest charges on debentures issued by The District Municipality of Muskoka and to fund capital projects directly or indirectly through internal loans. The initial contribution of $795,000, as approved in the 2008 General Tax Supported Operating Budget, was earmarked to repay a portion of the balloon debenture on debt related to the new Pines facility. A list of the balloon debentures held by the corporation is listed in the following table. The table shows the by-law, the purpose for which the debenture was issued and the amount and year of the principal outstanding that must be paid or refinanced for each debenture.

By-law	System	2009	2010	2011	2027	Total
99-54	Sewer	$ 673,000				
99-54	Water	$127,000				
2000-69	Sewer		$ 659,000			
2000-69	Water		$1,650,000			
2001-72	Sewer			$1,027,800		
2001-72	Water			$ 64,200		
2001-72	Pines			$4,422,000		
2007-19	Sewer				$2,500,000	
	Total	$800,000	$2,309,000	$5,514,000	$2,500,000	$11,123,000

There is little opportunity to refinance existing debt. The District's debt is issued through debentures that have a fixed duration. The majority of the investors who buy the debt hold them to maturity. Occasionally investors sell the debentures on the open market but this is rare and provides little opportunity for true savings in terms of interest gains. The best opportunities occur when the debenture needs to be refinanced. Over the next four years, by using the uploading savings from the ODSP program, the District has the opportunity or the obligation to pay $11 million in debt.

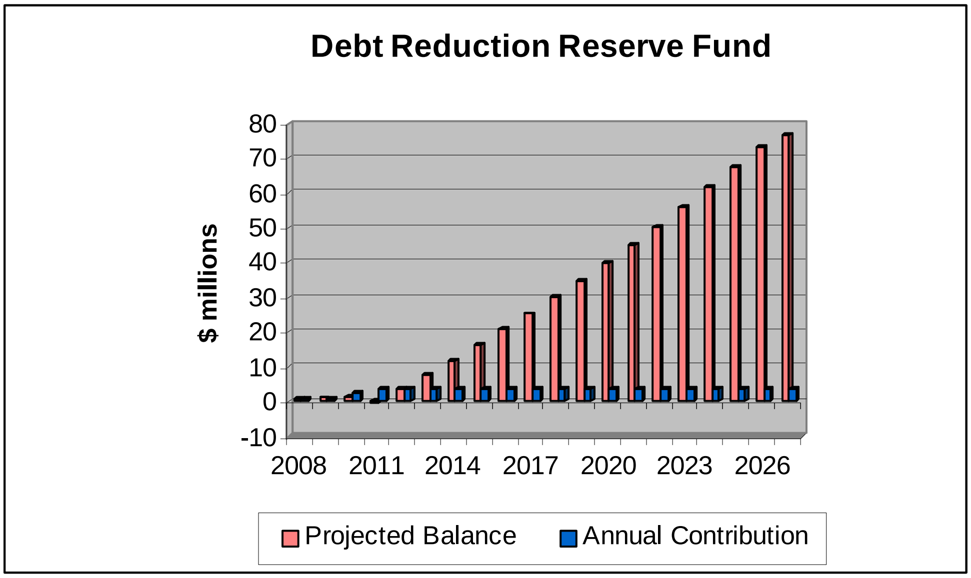
In addition, by earmarking these funds exclusively for either debt reduction or debt avoidance, future savings through reduced annual debt charges will accrue to The District Municipality of Muskoka. If these funds were taken into the general operating budget to reduce taxes there may be a tendency to lose the savings to year-over-year budgetary increases rather than providing future cost benefits through reduced financing costs (*annual savings in debt charges from paying off the balloon principal at maturity is $1.4 million or $17 on a typical residential property*).

> *Note: The ODSP savings to an average residential property owner in 2008 was $8. In 2011 the savings would equate to $44.*

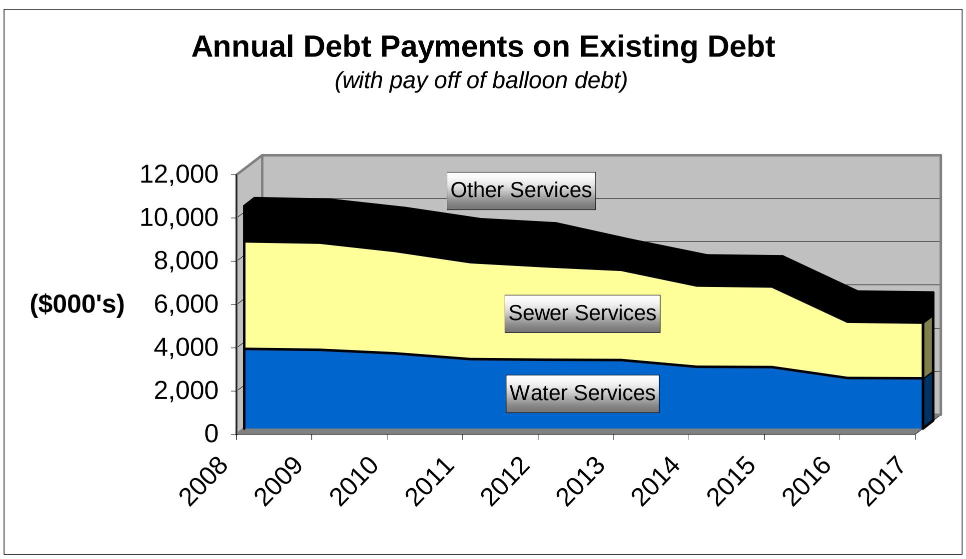
By using the additional ODSP savings above the initial savings of $685,000 as identified in 2008 to top up the annual contribution to the Debt Reduction Reserve Fund of $795,000, this fund could accumulate a significant balance over time. The adjusted annual contributions would be:

Year	Contribution ($)
2008	795,000
2009	1,045,000
2010	2,452,000
2011	3,859,000 and for all subsequent years

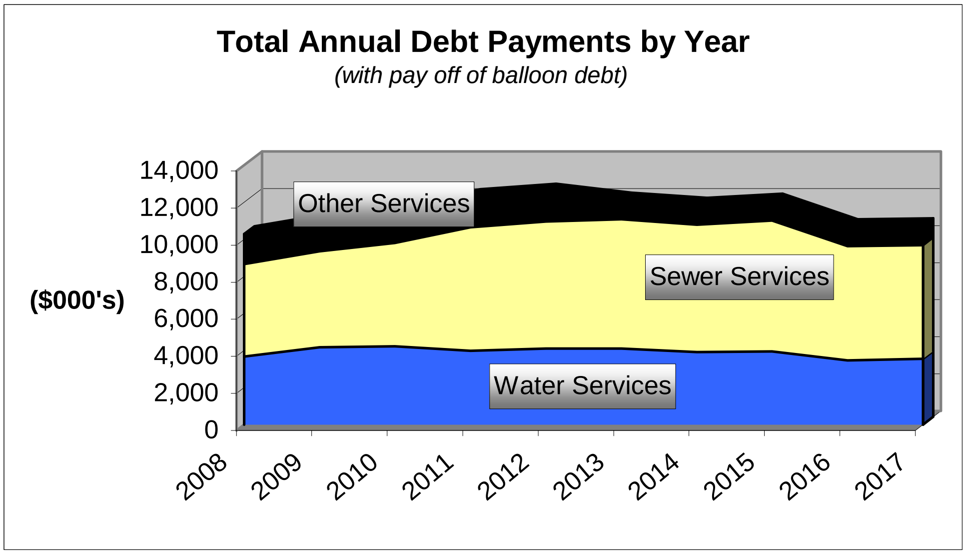
Based on those annual contributions, this fund could pay off the $11 million in scheduled balloon debt payments, as well as provide a source of internal loans to finance capital projects. The following graph shows the potential for the growth in the accumulated balance within this fund.



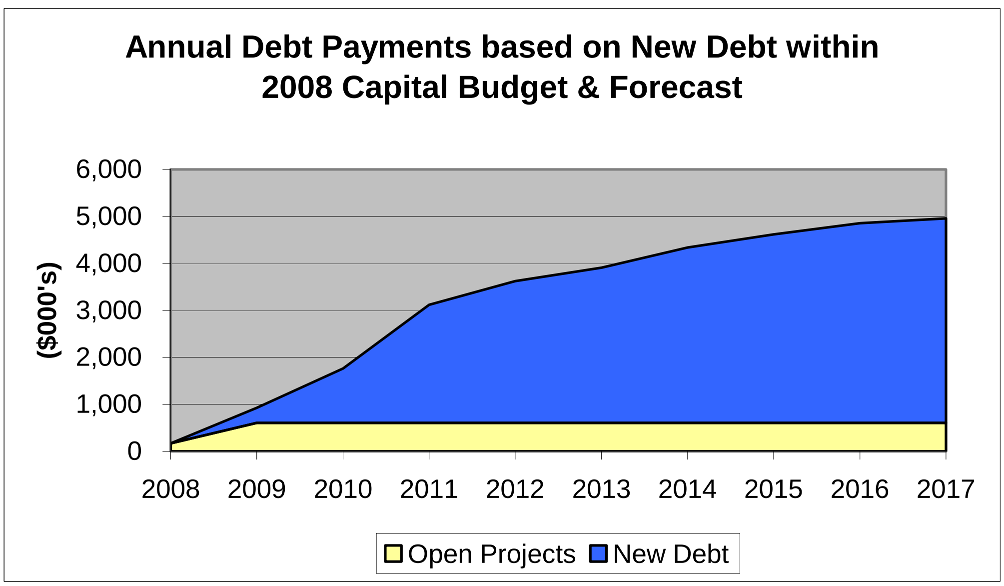
The following graph shows the annual debt charges on existing debt assuming that the principal portion of the balloon debt will be paid off upon maturity.



Despite the decline in existing debt, projected annual debt charges as shown in the following graph remain fairly constant.



The reason for the minimal decline in the annual debt charges is due to the requirement for new debt to finance current projects and to finance future forecasted capital infrastructure. The following graph shows the annual debt payments on new debt based on the 2008 Capital Budget and Forecast and on an increase in the development charge rates.



Based on the 2008 Capital Budget and Forecast The District Municipality of Muskoka is projected to issue between $46 to $106 million in debt over 10-years, depending on growth related revenues from development charges (*a table of the most significant projects is contained later on in this report*). By critically reviewing its capital projects within the capital program and through the establishment of the Debt Reduction Reserve Fund much of the external debt could be avoided.

By using the savings from the ODSP uploading to contribute to the Debt Reduction Reserve Fund, the fund can be used to issue internal loans to finance the capital projects at zero or minimal interest rates. The establishment of scheduled repayment plans would ensure that those functional areas remain responsible for paying for the cost of the infrastructure related to the provision of those services. Those annual repayments would in essence create a revolving loan fund that in turn could be used to issue future loans.

Initially the fund would not be able to provide all of the required financing. In incidences where funds are not available, the District would issue balloon debentures with varying maturity dates. The maturity dates would be designed to match the available funds within the Debt Reduction Reserve Fund to internalize the debt upon their maturity.

In order to ensure that this fund has an adequate balance to be of immediate benefit it is recommended that $2 million of uncommitted funds from the General Capital Reserve Fund be transferred to the Debt Reduction Reserve Fund.

Recommendations:
That $2 million be transferred from the General Capital Reserve Fund;
That the principal due upon maturity of the balloon payments outlined in this report be financed from the Debt Reduction Reserve Fund;
That ODSP savings above the initial savings of $685,000 as identified in 2008, be used to top up the annual contribution to the Debt Reduction Reserve Fund of $795,000; and
That the Debt Reduction Reserve Fund be used to issue internal loans to finance capital projects at zero or minimal interest rates.

Federal Gas Tax Funding

The Federal Gas Tax Fund was announced in the 2005 Federal Budget and committed approximately $1.9 billion to Ontario municipalities for environmentally sustainable infrastructure over a five-year period (2005-2010). The 2007 Federal Budget committed to extending the Fund by an additional five years (2010-2014).

Year	Funding Level ($)
2005	515,962
2006	515,962
2007	687,873
2008	859,785
2009	1,719,569
2010	1,719,569*
2011	1,719,569*
2013	1,719,569*
2014	1,719,569*
Total	**$11,177,427**

*Indications are that the annual funding will be maintained, at its current level. Within Ontario the $575 million, representing Ontario's share in 2009, is allocated on a per capita basis. The inherent risk is if Muskoka's population decreases as a percentage of Ontario's total population, the grant will decrease accordingly. Currently those funds have been allocated, almost exclusively, to collection and treatment of sewage.

Recommendation:
That The District Municipality of Muskoka continue to use the Federal Gas Tax Funding to finance sewer related capital projects until such time as the debt levels are stabilized and reserve fund balances are at viable levels.

Increase contributions to the Environmental Reserve Fund

When The District Municipality of Muskoka was created in 1970, the enabling legislation (i.e. The District Municipality of Muskoka Act) required that a Pollution Control Fund be established and that it be financed by a one quarter of a mill levy across the whole of Muskoka. The fund was to be used for sewage works (including treatment facilities for septage generated by private, rural sewage systems), waste management facilities and other projects that might improve Muskoka's natural environment through the control of pollution.

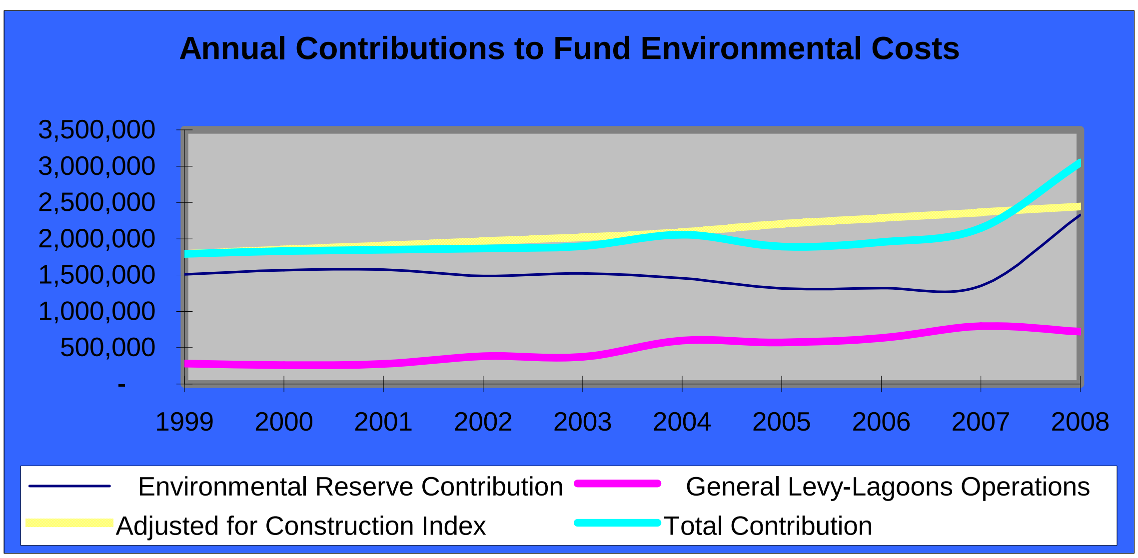
> *Note: This fund is financed through The District Municipality of Muskoka's general levy and is therefore paid for by both rural and urban residences. On a $200,000 assessed residential home this equates to $36 or 5% of the general levy.*

In 2006, the Environmental Reserve Fund superseded the Pollution Control Fund and the septage treatment facilities (rural lagoons) were for clarity purposes shown separately within the Tax Supported Budget. In real terms, the amount of the annual contribution to this fund has diminished substantially over time up until 2008 when an additional $900,000 contribution was budgeted for in order to meet the projected capital financing requirements for septage lagoons and sewer projects.

At first, The District Municipality of Muskoka was not provided with jurisdiction over urban drinking water systems. That responsibility did not come until the mid 1970's when, in response to some significant water supply issues, the Muskoka Act was amended. The Act was also amended to permit the Pollution Control Fund to be used for waterworks projects. By 1997 the one-quarter-mill rate requirement was no longer applied and the total contribution was $1.7 million versus the $2.1 million that would have been raised through the one-quarter-mill rate.

The following graph shows the annual contributions from 1999 to 2008. The graph shows the lagoons operations, which are raised from the net levy and included in the original Pollution Control allocation, and the contribution to the then Pollution Control Reserve Fund. The top line shows what the annual contribution should be as adjusted by inflation from the 1999 base of $1.8 million.

> *Note: Even adjusting the 1997 base to the $2.1 million and adjusting for inflation, the amount required in 2008 would be $2.6 million, which is below the $3.0 million amount contained in the 2008 operating budget. However, if the equivalent tax rate of one-quarter-mill rate was levied in 2008, the operating budget would be $4.9 million versus the $3.0 million.*



Over the years, the fund has financed a variety of capital projects depending on the needs of the day. These have ranged from water studies and landfill improvements to water, sewer and lagoon capital projects. Due to an ever-increasing regulatory environment and to related infrastructure requirements, the use of the fund has been primarily used for sewer and lagoon capital projects.

The general tax levy has always funded the septage lagoon operations directly and/or through the then Pollution Reserve Fund. Similar to the water and sewer systems, regulatory requirements in this area have increased both the operating and capital costs for this function. Since 1999 both capital and operating costs have doubled and now account for $1.3 million of the $3.0 million levied for Environmental Services in 2008.

> *Recommendation:*
> *That the 2008 base for Environmental Services of $3,050,439 as approved in the 2008 General Tax Supported Budget be maintained and that this base be increased annually to maintain its purchasing power by the Southam Construction Price Index.*

User fees finance 20% of the operating costs associated with lagoons and none of the capital costs associated with the lagoon operations *($550,000 annually is expended on capital costs related to septage lagoons*). User fees, based on 2007 septage volumes, would have to increase from the current $33 / 1,000 gallons to $158 / 1,000 gallons to finance just the operating costs. Although this increase is not feasible, a more realistic target of 50% of the operating costs ($80 / 1,000 gallons) could be achieved if phased in over time.

> *Recommendation:*
> *That lagoon haulage charges be set at $40 for 2009 and increased by $10 each year until the 50% target is achieved.*

<u>Review of current Development Charge Study</u>

The District Municipality of Muskoka commissioned C.N. Watson & Associates to prepare a review of the current development charge rates and by-law. The report is now in draft form and is scheduled to be presented to Council on July 21st. The aim is to have a new by-law in place by the end of October 2008.

A series of public meetings and final adoption by Council is required before the rates come into effect. During this period, decisions as to the amount of charge, phase-in considerations and exemption and incentives within the by-law need to be addressed. Preliminary costing, at the time of writing this report, would see the rates increase substantially for water and sewer services. The following table shows tentative proposed rates for a single detached residential home.

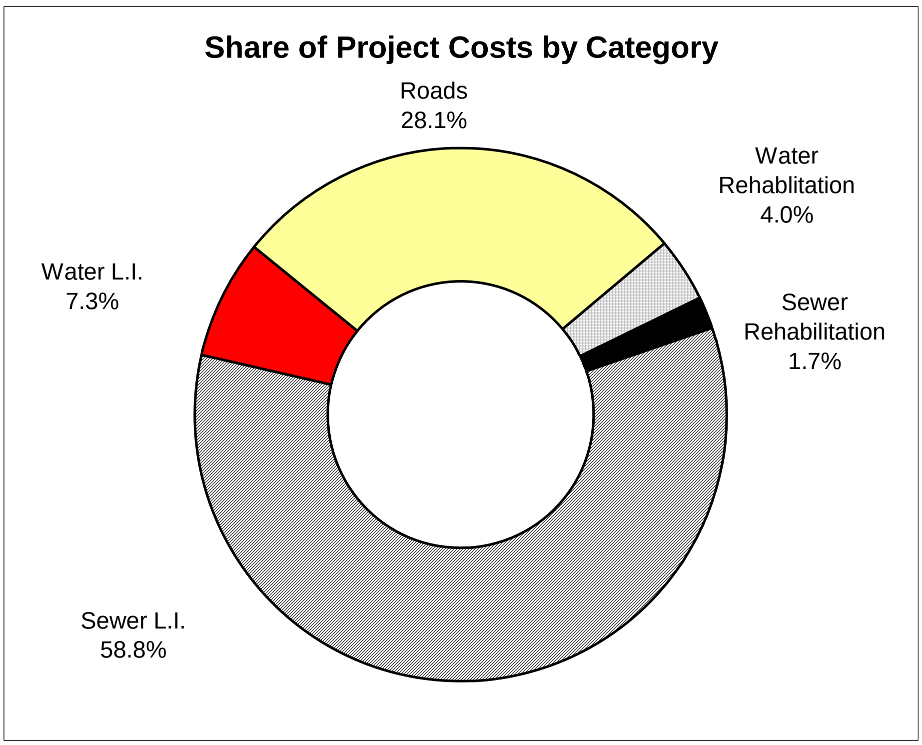
Service	**Current Rate ($)**	**Proposed Rate ($)**
Urban		
Roads	5,068	5,300
Water	1,994	6,600
Sewer	3,342	7,800
Other	0	200
Total	**$10,404**	**$19,900**
Rural		
Roads	5,068	5,300
Septage	391	600
Other	0	
Total	**$5,459**	**$5,900**

Within the Treasurer's report which accompanied the 2008 Water and Sewer Budget, a warning stated that "If the development charge is not increased, growth does not occur as projected and the growth related projects as outlined in the 10-year forecast proceed as planned, deficits within the respective Development Charge Reserve Funds will balloon to $12.3 and $38.0 million respectively for water and sewer. At that time the only recourse will be to issue debentures to finance these projects."

> *Recommendation:*
> *That Council, when considering the development charge study, adhere to the principle that growth pays for the cost associated with the necessary infrastructure to accommodate new development. By doing so existing users will not be further burdened with the cost of growth, debt level increases will be curtailed and the ongoing financial viability of these reserve funds will be maintained.*

<u>Review of current connection charges for Local Improvements</u>

Staff has reviewed costs and revenues of local improvement projects completed over the past 3 years. In total 11 projects were reviewed, 8 sewer and 3 water. In reviewing the projects in more detail, it was soon discovered that not all of the project costs were related exclusively to the local improvements themselves but included rehabilitation work on adjacent mains and pumping stations and a significant amount of road upgrades and replacement associated with the project.



Once you factor out these expenditures the proposed increased is not as great as originally thought. The accompanying graph shows the percentage share of the costs for the sample projects selected.

Of the total costs of $25.2 million only 66% or $16.6 million related to the local improvement projects themselves. Another $8.6 million related to other system costs and road works.

As expected, total costs for sewer local improvements varied significantly from project to project, from a low of $10,886 / connection to a high of $62,630 / connection. Removing the costs associated with adjacent rehabilitation work on the mains and roadway upgrades and replacement this range narrowed from a low of $7,984 / connection to a high of $51,297 / connection. Taking out the low and high cost projects, the average cost per connection is $31,922 and the median is $29,463 based on total project costs. Backing out the rehabilitation work and the roadway upgrades and replacement the average dropped to $20,721 / connection and the median dropped to $17,524. Using a weighted average of $18,820 / connection a break-even connection charge would be $9,700. This charge would raise enough revenue to cover off the local improvement cost component of the project. A break-even connection charge to cover off total project costs would be $17,500.

Staff conducted a similar exercise on water local improvements and the findings were similar, but with only three projects the variability in the data was greater due to a smaller sample size. The average break-even connection charge on total project costs was $17,187. The break-even connection charge to cover off the local improvement portion was $4,563.

Based on the above break-even connection charges for the local improvement costs only and after adjusting the costs for inflation to reflect 2008 dollars, an increase in the connection charge is warranted. The following table outlines the existing local improvement connection charges and the proposed 2008 connection rates to be used on future local improvement projects. The proposed rates in this table are recommended on the assumption that costs related to rehabilitation work and to road work should be financed from another source other than connection fees.

Connection	Existing Charge	Proposed Charge
Water	$3,760	$ 4,900
Sewer (gravity connection)	$7,520	$10,400
Sewer (low pressure connection)	$3,760	$6,900

A primary survey was conducted on the capital cost of the alternative service for a private owner (installing and maintaining private wells and septage systems) and although the costs can vary significantly depending on the property topography, the rates are comparable. The initial capital cost for installing a water well service is approximately $8,000 - $10,000 and for a septage system is $11,000 to $17,000. In the case of municipal services there is ongoing user fees, however, in the case of private systems there are ongoing maintenance costs and also replacement costs.

Recommendation:
That the proposed charge be used in all subsequent local improvement projects starting in 2008 and that the rate be increased annually by the Southam Construction Price Index; and That a detailed review of the connection charges be conducted every two years to ensure the charge continues to reflect the cost of providing service.

Mandatory Connections

Since May of 2007 approximately 621 notices have been sent to property owners identified as being required to connect to municipal water and/or sewer services. To date 55 Appeal Requests have been received in writing of which 50 have been reviewed by the Appeal Committee. Eight Appeal Requests have been declined, 14 were granted extensions, 28 were granted temporary exemptions and the remaining requests are pending further investigation.

Since the implementation of the Mandatory Connection By-law 2007-24 property owners have proceeded with connecting to municipal services. A total of 178 properties have been connected to-date. A significant portion of this increase is related to mandatory connection efforts of the corporation.

The addition of these customers, based on average residential consumption, has added $70,000 to the water system and $90,000 to the sewer system user fees revenue. This additional revenue was realized at no cost by using the existing system infrastructure.

Muskoka provided property owners with a financing option in order to assist them in paying for the costs of connecting their property to the municipal water and/or sewer systems. To date 7

Loan Applications have been approved. Out of the 7 applications, 6 have requested the 10-year repayment option and one has requested the 5-year repayment option.

> *Recommendation:*
> *That the mandatory connection program continue as scheduled.*

<u>Reduce Costs</u>

<u>Restrict new local improvement programs to those that are financially viable</u>

In reviewing completed local improvement projects over the last several years it became evident that a considerable portion of the cost of these projects related to road replacement and upgrades. Included in the costs for roads are such items as paving, curbs, culverts, drainage, excavation of road base and granular material to replace/rebuild base.

In some cases, the road improvements were financed by the respective road budget but not in all cases. In effect, water and sewer rates have been used to finance improvements to The District Municipality of Muskoka and Area Municipal road inventory. The respective Roads Budget should rightfully finance these costs, especially where there has been an increase in the useful life of the asset or where there has been an improvement in the road standard.

The following table summarizes the findings of the review for the sample projects selected.

Project Name	Water or Sewer Portion ($)	Roads Portion financed through Rates ($)	Roads Portion as a percentage of total project costs
Brobst Forest (sewer)	1,947,974	401,092	21%
Westvale (sewer)	955,254	269,152	28%
Muskoka Road 18 (sewer)	6,200,391	707,010	11%
May Lane (sewer)	158,350	34,333	22%
Townline Road (sewer)	492,549	150,725	31%
Townline Road (water)	528,082	161,598	31%
Mactier (sewer)	8,426,784	2,904,920	34%
Muskoka Road 11 (water)	1,791,609	1,110,613	62%
Muskoka Road 38 (sewer)	528,421	104,720	20%
Baysville (sewer)	2,296,845	612,288	27%
Baysville (water)	1,843,480	620,370	34%
Totals	**$25,169,739**	**$7,076,821**	**28%**

In total, $7 million of Roads' related costs were or are being financed through user rates. In most cases these costs were financed through debentures and represent approximately $617,000 in annual debt charges.

<u>PSAB 3150</u>

Under the new financial reporting requirement for tangible capital assets the delineation between water, sewer and road works is mandatory. In this example, the value of upgrade or replacement must be recorded in the books of the municipality that owns the asset regardless or whether they paid for the asset or not. If the asset was assumed at no charge, the value of the asset must be shown as a gift or revenue to that municipality from the developer or in this case The District Municipality of Muskoka. The asset would then be amortized over its useful life and the annual amount of the amortization would be reflected as an expense against their operating budget.

Recommendation:
Water and Sewer Systems should only finance road related replacements and/or upgrades associated with water and sewer projects to the extent that it replaces the road in the same condition it was in immediately prior to the project initiation.

To the extent that there is an increase in the useful life of the asset and/or an increase in the service standard, those costs associated with the "betterment" should be funded independently from the Water and Sewer Systems and financed from those functional areas charged with providing that service (i.e. roads, traffic control, sidewalks, storm water management, etc.).

Reduce scheduled rehabilitation program

In 2008, staff recommended, in report PW–6–2008-11, to reduce the 2008 rehabilitation program by $1 million or half of the original budget and is currently investigating alternate methods to reline the mains as opposed to replacing them. This initiative, if successful, will reduce costs and minimize disruption as a result of road reconstruction associated with these projects.

Evaluate Capital Program

The objective is that all projects prior to proceeding must undergo an analysis to determine if the project is financially viable and/or essential for program delivery. To this end, staff has begun to introduce the concept of net present discounted costs that will accompany any recommendation to either proceed or cancel a project before it is initiated. The following table highlights the major system expansions contained within the 10-year forecast period. To date, although there has been significant planning and some preparatory work done, no construction tenders have been awarded for the projects highlighted below.

System	Project	Gross Cost ($)	External Funding ($)	Development Charges ($)	System Costs ($)
Bracebridge Sewer	Lagoon Cleaning	1,890,000			
	Lagoon Lane Plant	29,090,659			
	Subtotal	**30,980,659**	**13,232,206**	**6,412,550**	**11,335,903**
Huntsville Sewer	Forcemain Coveside Dr Golden Pheasant	2,562,500			
	Main-Mountview Trunk	3,075,000			
	Church Street Pumping Station	2,047,500			
	Coveside Dr Pumping Station	3,077,500			
	Mountview STP Improvements	2,420,000			
	Golden Pheasant Plant Expansion	24,298,875			
	Subtotal	**37,481,375**	**0**	**18,740,687**	**18,740,688**
Port Severn Water	Water Treatment Plant	4,100,000		4,100,000	0
Port Severn Sewer	Sewage Treatment Plant	4,100,000		4,100,000	0
Port Carling Sewer	Sewage Treatment Plant	8,600,000		4,300,000	4,300,000
	Total	**$85,262,034**	**$13,232,206**	**$37,653,237**	**$34,376,591**

These five projects constitute a large portion of the 10-year capital budget and forecast. They account for 46% of the gross expenditures, 65% of the required development charge revenues and 74% of the forecasted debt. These projects can have significant positive and/or negative impacts on the financial viability of the water and sewer systems and must therefore be analyzed in detail before any commitment is made.

Bridge Financing

The District Municipality of Muskoka allocates interest to major capital and local improvement projects that span more than one year and require financing beyond the reserve fund contribution for any current year expenditure. The interest rate applied is prime less .25%.

The allocation and capitalization of interest charges is at the discretion of the municipality. If the interest is not allocated to these capital projects, the cost of financing is absorbed by the operating fund and is recognized as either an expense or is recognized through reduced investment income as any idle cash would be used to cash flow the unfinanced expenditures within these projects.

The only accounting policy related to the recognition of interest is that interest allocated to capital projects can only be capitalized up to the time the asset goes into production. Once the project is in production (being used for the function it was designed for) the interest must be charged to operations.

Over the last two years the only projects that have fallen into this category are water and sewer projects. All other projects are funded directly by the tax levy or indirectly through reserves or reserve funds. The following table reflects the amount of interest allocated to projects within those service areas.

Function	2006	2007
Water	$270,610	$361,222
Sewer	$616,769	$750,622
Total	**$887,379**	**$1,111,844**

It should be noted that during 2006 and for a portion of 2007, two significant projects accounted for the bulk of the interest charges, those being the Baysville water and sewer projects and the MacTier sewer system. In 2008, there is no project on a similar scale. The next project of significant size that would attract interest charges is the Bracebridge sewage treatment plant.

> *Recommendation:*
> *That the practice of allocating interest charges to unfunded capital projects during construction before they are brought in service be discontinued.*

Criteria for the Issuance of Debt

Municipal services are capital intensive, especially as it relates to roads and water and sewer operations. The District Municipality of Muskoka has invested over $650 million in infrastructure over the years. To replace these assets at today's costs could easily be over $2 billion. In that context $106 million in outstanding debt is not unreasonable, however, prudent management requires planning.

General replacement and upgrades of road works, distribution and collection systems are fairly predictable and consistent from year to year. These amounts should either be paid for through the annual budget and/or through annual reserve contributions.

New assets and major infrastructure projects, such as water and sewer treatment plants and new roadways are of such magnitude that by necessity they need to be financed through debt.

These projects also have a useful life that extends well into the future and therefore benefit not only the present property owners and system users but also future property owners and users. Debentures can be used to better match the benefactors of the infrastructure investment to the cost of acquiring those assets.

ALTERNATIVES

None of these options come without risk. Council may consider all or none of the above options in an attempt to moderate the forecasted rate increases while weighing these options against the risks and against the wider community interests.

The ability to tailor financial instruments to achieve the above objectives and goals is to a large extent dependent on the financial strength and flexibility of the municipality. Those municipalities that have relatively low reserve balances and limited ability to increase operating budgets and user fees have limited options. Without those fundamental components in place, the municipality's only option may be to issue debt, despite adverse interest market conditions.

The establishment of a debt reduction plan, increasing reserve fund balances, restricting expenditures to financially viable projects and in essence living within your means is the first step in achieving this financial flexibility.

STRATEGIC PRIORITIES

Approval of a debt reduction plan also adheres to two main goals outlined in the District's Strategic Priorities document. Those being:

> "2.1 Strengthen the overall financial position by adopting and implementing a set of clearly defined financial objectives, including reducing the capital debt associated with sewer and water capital projects. Prepare a financial business case analysis with each new major capital project being considered by Council."
>
> "2.2 Increase sewer and water revenue by enforcing the mandatory connection by-law, avoiding or delaying new capital costs where possible and utilizing the existing system capacities for new growth. Limit extensions to the service areas until sufficient growth demands support the return on investment. Investigate a non-urban tax levy contribution to water and sewer costs."
>
> "2.3 Adopt a debt reduction plan and build stronger capital reserve funds on an annual basis thereby reducing the future amount of debenture debt required. Budget room created by the uploading of costs to the Province and other means should be applied to debt reduction."
>
> "4.4 Prepare a detailed 10-year capital investment plan for all water and sewer projects for examination and prioritization by Council. Complete the Lagoon Lane (Bracebridge) and Port Carling sewage treatment plants as new facility priorities."

Corporately, The District Municipality of Muskoka has some financial flexibility, however, current financial policies and practices have constrained this flexibility and have the potential of negatively impacting the financial strength of the corporation as a whole. Applying the recommendations in this report will be a major step in ensuring The District Municipality of Muskoka has the financial strength and resilience to meet an ever-increasing demand and ever-increasing costs of maintaining its critical infrastructure.

Respectfully submitted,

Stephen Cairns
Commissioner of Finance and
Corporate Services