

Financial Plan 2019-2022 – Water and Wastewater Lines of Service

EXECUTIVE SUMMARY

The financial plan for The City of Calgary's (The City's) Water Treatment and Supply (Water) and Wastewater Collection and Treatment (Wastewater) lines of service was established after a review of the business' historical financial policies in 2011. These two lines of service have historically been referred to as the "Utilities".

The financial plan articulates policies, measures, targets and a timeline for compliance. Adhering to the plan ensures improved financial capacity and sustainability to meet the challenges of maintaining services and responding to growth. These policies are used on an ongoing basis to guide financial management decisions and their targets are used to measure performance within the Financial Plan.

The City's Water Services and Water Resources business units (the Water Utility), operating these lines of service, remain on track to achieve compliance with the financial targets set out in this financial plan, thereby mitigating financial risks and ensuring a financially sustainable future. Maintaining progress towards compliance is contingent on the line of service rate increases to be presented as part of One Calgary planning for 2019-2022.

This report provides an update on and a proposed revision to the financial plan based on the results of a review of the current financial policies, measures, targets and timelines in relation to the goal of financial sustainability as well as in response to changes in economic circumstance. This revised financial plan for the Water and Wastewater lines of service is in alignment with the planning for One Calgary, and the development of indicative rates for the 2019 to 2022 business cycle. An update on the assessment of financial risks and recommendations is included as Attachment 1 and specific changes recommended to policies, measures and targets are summarized in Attachment 2.

ADMINISTRATION RECOMMENDATION:

That the Standing Policy Committee on Utilities and Corporate Services recommends that Council approve the recommended financial plan policies, measures and targets for the Water and Wastewater lines of service for 2019 – 2022 as shown in Attachment 2.

And further, that Report UCS2018-0223 be forwarded as an item of Urgent Business to the 2018 March 19 Combined Meeting of Council.

PREVIOUS COUNCIL DIRECTION / POLICY

At the 2011 June 28 meeting, Council received Report C2011-66 (Utilities Financial Plan and Indicative Rates) and approved the recommended Utilities financial policies. Council also directed Administration to incorporate a Cost of Service Study for the Utilities and Drainage in the 2012-2014 business plan.

2014 March 17, Council received UCS 2014-0021 Water and Wastewater Utilities 2012-2017 Financial Plan update for information.

2014 May 05, Council approved 2015-2018 Utilities Indicative Rates (C2014-0103) directing Administration to incorporate a Cost of Service Study and an evaluation of financial policies and

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targets for 2019-2022 in the 2015-2018 Action plan, and to report back no later than 2016 June with an update on the Utilities Financial Plan progress and any necessary Utility rate adjustments, including any adjustments required to reflect the new Standard Development Agreement.

2016 May 25, Council received UCS 2016-0413 Water and Wastewater Utilities Financial Plan Progress Report with updates on the Utilities' Financial Plan progress towards achieving the financial targets and maintaining compliance with the financial policies set out in the Utilities Financial Plan.

2016 September 19, Council received C2016-0688 Utilities Indicative Rate-Revised for 2017 and 2018. Council directed a reduction in the increase from a blended rate increase of 8.3 per cent per year to an increase of 2.5 per cent per year. This was a zero per cent per year increase for the water line of service and a 5.1 per cent and 4.9 per cent increase for the wastewater line of service for 2017 and 2018 respectively. Council also directed Administration to report back in 2017 Q1 with revision to the Utilities Financial Plan that integrates industry best practice and the change to the timeframe in building the sustainment reserve balance.

2017 February 22, UCS2017-0175, Council further directed Administration to report back with revisions to the Utilities Financial Plan no later than 2018 June.

BACKGROUND

The City's Water Utility operates Calgary's Water and Wastewater lines of service under a utility business model. In this model, the Water Utility is self-supported, requiring revenues to cover all the costs of providing services. In addition to operating within relevant Council and Administrative policies, these lines of service do maintain financial policies specific to their operations. These policies, their associated measures, targets and the established timelines for compliance are key focuses of the financial plan.

The rate increases for the Water and Wastewater lines of service were approved by Council as part of Action Plan with a blended 8.3 per cent increase per year, and then reduced to 2.5 per cent per year for 2017 and 2018. This reduction in the rate increases required deferring the timeframe for compliance with financial policies and targets. Specifically, the target of achieving the sustainment reserve balance of 10 per cent of revenues by 2018 deferred to 2022.

The revised Off-Site Levy (OSL) Bylaw and rates for 2016-2020 were approved in 2016 January (C2016-0023). This increased the financial risk for the Water and Wastewater lines of service, as 100 per cent growth related infrastructure costs were to be recovered through OSL, and a larger proportion of revenue tied to development. The risk associated with this change materialized with growth in 2016 being much lower than expected, putting significant upward pressure on utility rates.

With rising capital investment required to maintain highly reliable Water and Wastewater systems, meet regulatory requirements, protect the watershed and environment, and be resilient to environmental and economic changes, a revision for existing financial plan and financial policies is necessary.

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INVESTIGATION: ALTERNATIVES AND ANALYSIS

The structure of the financial plan includes policy statements, measures, targets, and the timeline for achieving targets. Review of the financial plan for these lines of service is necessary to ensure it is current and relevant in terms of reflecting industry best practices to retain resiliency under changing environmental and economic conditions, while also meeting Council and citizen expectations.

Self-supported

The Water and Wastewater lines of service operate under a self-sustaining, public utility model, where rate revenues, OSL and sources other than the municipal tax shall cover all the operating and capital costs incurred to provide Water and Wastewater lines of service, as well as comply with the financial targets set out in the financial plan and achieve financial sustainability.

Revenue

The Water and Wastewater lines of service are funded primarily by revenue, which is based on Council-approved rates for utility services, and Council-approved OSL rates that recover costs associated with growth. The OSL bylaw (C2016-0023, Bylaw 2M2016) approved by Council on 2016 January 11 included levy rates that will fund the full cost of infrastructure investments for development of new and existing areas. The full recovery of costs associated with growth results in an increase in the proportion of revenue tied to development and recovered from OSLs.

The forecasted revenue from OSLs in future years is still uncertain due to the current economic climate.

Cost of Service Study

Since 2012, the Water Utility has committed that a Cost of Service Study shall be carried out in each of The City's multi-year business cycle to ensure costs are being recovered appropriately by each customer class and that the right mix of fixed and volumetric charges are in place to support long term sustainability. The goal of the Cost of Service Study is to balance fairness and equity to customers, financial sustainability of the Utilities, as well as water resource management. A Cost of Service Study is currently underway to inform the 2019-2022 rates for the Water and Wastewater lines of service.

Capital Investment

The nature of utility services is capital intensive, requiring ongoing capital investment in treatment, distribution and collection systems. These lines of service manage long term capital requirements through their collective ten-year Water Infrastructure Investment Plan (WIIP). Investment is required to meet the increasing demands on the Water and Wastewater systems in response to regulatory and environmental protection requirements and Calgary's environmental, economic and demographic changes. Optimum levels of services also require maintenance of the existing and growing system. There are also ongoing programs to evaluate, monitor and identify infrastructure in the water distribution and wastewater collection systems

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that requires repair, replacement or upgrading. These programs ensure high levels of service to customers are maintained.

The City of Calgary has a Water Approval to Operate and a Wastewater Approval to Operate that specify regulatory requirements under the Government of Alberta's Environmental Protection and Enhancement Act. Ongoing investments will continue to be required to ensure continued compliance to regulations. The Wastewater Operating Approval requires renewal in 2018 through negotiations with Alberta Environment and Parks.

The capital investments within the WIIP are categorized using four investment drivers as shown in the table below. Each driver addresses one of the factors identified as placing additional pressure on the infrastructure programs.

Investment Driver	Objective	Percentage of WIIP
Maintain assets	Maintaining, protecting and extending the life of infrastructure investments.	20% - 25%
Regulatory & Environmental Protection	Continuing to meet increasingly stringent regulatory and environmental protection requirements.	15% - 20%
Service	Continuing to provide reliable and high quality services to meet the needs of citizens.	10% - 20%
Growth	Providing infrastructure to meet the needs of a growing city.	45% - 60%

Financial Plan Revisions

A financial review within the Water and Wastewater lines of service, was completed by a utility sector financial consultant in 2016 March and examined the magnitude of financial risk in the business, as well as the adequacy and consistency of policies, measures and targets with industry best practice. The work done by this consultant has been considered, and informs the recommended revisions in this financial plan for 2019-2022.

The recommended changes include removing the debt limit of \$2 billion as well as the debt servicing limit of a maximum of 40 per cent of revenues, but continuing to effectively manage the level of debt in the business by introducing a Debt Service Coverage Ratio and associated target to apply to each line of service. It is also recommended that 120 days of annual operating expenditures be used as a target for the sustainment reserve.

Except for a revision to the debt term policy statement, the financial plan 2019-2022 aligns with historical financial policies statements. The revisions to the financial plan for 2019-2022 timeframe are summarized below and provided in Attachment 2.

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Policy Area	Measure	Revision
Debt and Cash Financing	Debt limit	Remove Maximum \$2.0 billion Debt limit
Debt and Cash Financing	Debt Service to Revenue Ratio	Remove Maximum debt servicing 40 per cent of revenues
Debt and Cash Financing	Debt Service Coverage Ratio	Minimum 1.75 times in Debt Service Coverage Ratio in each line of service in Water and Wastewater for 2019-2022
Debt to Equity	Debt to equity ratio	Debt to equity ratio will be monitored annually and reported on periodically
Debt term	Length of debt term	The Water and Wastewater lines of service will employ up to a 25 year debt term on major projects.
Sustainment reserve	Sustainment reserve balance	120 days of annual operating expenditures

Management of Water and Wastewater lines of service debt

Debt Service Coverage Ratio is a measure of the Water Utility's ability to pay debt service obligations. The Debt Service Coverage Ratio, recommended to replace the current \$2 billion debt ceiling and maximum 40 per cent of revenues for debt servicing, can better measure the ability to meet debt servicing requirements. A minimum target of 1.75 times will be maintained for the Debt Service Coverage Ratio for each line of service in Water and Wastewater. This represents how many times principal and interest payments can be made, once operating expenses and payments to The City have been made. Further, for 2023-2026, it is recommended that the Debt Service Coverage Ratio target be increased to 1.80 times. This will function as capital contingency to ensure some debt capacity is maintained for unexpected capital requirement. This new mechanism for managing debt, will maintain overall debt levels within the historical \$2 billion debt ceiling.

In alignment with OSL rate calculation, Water and Wastewater lines of service will use a 10-year debt term for growth investments for treatment plants. It is recommended to change the wording of the debt term policy from "25 year" to "up to 25 year" in financial plan 2019-2022.

Reserve

The sustainment reserve has the purpose of serving both operating and capital, and has a current target of 10 per cent of revenue, by line of service. Industry best practice indicates the reserve target should be tied to operating expenditures. As such, a target of 120 days of annual operating expenditure is recommended to be achieved by the end of 2022. In terms of the sustainment reserve balance to be achieved and maintained, the 120 days operating expenditures is slightly higher than the previous 10 per cent of revenues target.

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Stakeholder Engagement, Research and Communication

The Water Utility and Finance have undertaken the work to review progress on compliance with the financial plan. This work is overseen by a combination of operational, financial and strategic staff, and has been completed leveraging expertise across business units, as well as independent financial consultants. Financial benchmarking data was also reviewed, which compared The City's Water and Wastewater lines of service to those in other municipalities across Canada.

Strategic Alignment

A focus on the financial capacity and sustainability of Water and Wastewater lines of service enables The City's Utilities and Environmental Protection (UEP) Department to deliver its commitment on three Council Priorities:

- To support a city of inspiring neighbourhoods, the Water Utility provides the infrastructure needs of a growing city, enhances The City's ability to prepare for and respond to natural disasters, and builds resiliency to flooding.
- Contributing to a healthy and green City, the Water Utility, and UEP, lead by example to protect public health and the environment, and ensure regulatory compliance.
- The financial discipline demonstrated through the Water and Wastewater lines of service's performance within their financial plan is an example of commitment to a well-run city.

Strengthening the financial capacity and sustainability of Water and Wastewater lines of service aligns with The City's Long Range Financial Plan and the Municipal Development Plan. Ensuring that there is sufficient funding available to support growth, operate and maintain the systems, and expand and upgrade the plants also aligns with The City's 2020 Sustainability Direction, and the Corporate Growth Management Framework.

Social, Environmental, Economic (External)

The Water and Wastewater lines of service provide fundamental services to the community and the larger watershed. Achieving the financial plan will ensure that the social, environmental and economic goals of Water and Wastewater lines of service are delivered under sound and sustainable financial policies.

Financial Capacity

Current and Future Operating Budget:

The Water Utility has reviewed progress on the current financial plan with the financial targets set out in the plan, to ensure a financially sustainable future and to manage operating pressures facing the business. A course of revision of financial policies statements, measures, targets and timelines for compliance is required to ensure a sustainable future and to manage operating pressures facing the business. Implementing Zero Based Review recommendations and other efficiencies is expected to have future benefit in Water and Wastewater lines of service and will ultimately mitigate some of these pressures on the operating budget.

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Current and Future Capital Budget:

In response to the continuously changing economic situations, the Water Utility has adjusted the capital budgets 2016-2018 for the Water and Wastewater lines of service through the corporate capital budget recast. The Stage Gating process implemented in 2016 also provides the Water Utility additional controls to ensure that budget is allocated to the highest priority projects at the time when projects are ready to proceed and with the most accurate cost projections.

Risk Assessment

Achieving compliance with the financial targets set out in Water and Wastewater lines of service financial plan will ensure a financially sustainable future for the Water and Wastewater lines of service and mitigate financial risks due to environmental and economic changes and potential financial pressure due to uncertainty of OSL revenue.

REASON(S) FOR RECOMMENDATION(S):

This report provides updates on the Water and Wastewater lines of service financial plan and summarises proposed financial policy revisions for financial sustainability.

Confirming any changes to financial policies in 2018 March will be an important step prior to establishing the next four years' operating and capital budgets as is completing the Water and Wastewater lines of service Cost of Service Study to inform the utility rates for 2019-2022.

ATTACHMENT(S)

1. Attachment 1 – Financial Plan 2019-2022 Water and Wastewater Lines of Service
2. Attachment 2 – Revisions to Water and Wastewater lines of service financial plan for 2019-2022