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REPORT
General Committee

For Information

DATE: October 28, 2009

REPORT TITLE: **RESERVE SUSTAINABILITY**

FROM: Norma Trim, Chief Financial Officer and Commissioner of Corporate Services

OBJECTIVE

The objective of this report is to provide Council with an update on the overall sustainability of working funds and capital non-growth related reserves as well as to provide Council with potential actions to ensure future financial viability.

REPORT HIGHLIGHTS

- Peel's Financial Control By-law establishes the framework for managing reserves
- Reserves include: Working Funds, Capital Financing, Capital Construction, Specialty Funds and Development Charge Fund reserves
- In 2007 Peel adopted a portfolio approach to reserve management
- Reserves provide financial flexibility to meet long term financing requirements and maintain Peel's debt free status
- Analysis demonstrates adequate working fund reserves are available to offset recessionary impacts driving 2009 operating deficit and the 2010 Budget
- Analysis of the capital reserves and Capital Plan supports the continued requirement for one percent tax rate increase for tax supported capital reserves
- Rate supported non-growth related reserves – due to infrastructure funding stimulus, previously suggested three percent annual rate increase for reserves can be suspended for 2010 budget but would be required again in 2011 Budget

DISCUSSION

1. Background

On June 3, 2004, Council authorized a Financial Control By-law (FCBL) establishing financial controls related to the Current Budget, Capital Budget and reserve management of the Regional Municipality of Peel. The by-law defines Reserves as unrestricted accumulation, at the discretion of Council, of appropriations from net revenues. Reserves include Working Funds, Capital Financing, and Capital Construction.

In the fall of 2007 staff presented Council with a perspective of the Region's tax supported non-growth related capital financing needs utilizing portfolio approach to reserve management. The report highlighted the need to substantially increase reserve contributions in order to continue to sustain both the state of Region's capital infrastructure and its debt free status. The report proposed one per cent tax rate increase over a period of

ten years for capital financing purposes as a first step to achieving financial sustainability. The strategy was adopted by Council as part of the 2008 and 2009 budget.

In the fall of 2008 staff presented Council with a report outlining the need for increasing utility rate to finance the expanding state of good repair budget and mitigate debt financing. The long-term modeling of capital financing forecast predicted the need to immediately increase utility rates by a minimum of three percent annually. The strategy was adopted by Council as part of the 2009 budget.

On June 5, 2009, the Region was awarded $98.6 million in Infrastructure Stimulus Funding (ISF). The Region is committed to fund 1/3 or $50.7 million of the total eligible project cost as well as all ineligible project costs. Peel's share will be made available from a number of reserve funds, non growth related capital financing reserves as well as working funds thus impacting the reserve balance.

The status of Development Charge Reserve Funds will be addressed in a separate report. The analysis also excludes a review of specialty funds (e.g. WSIB reserves)

2. Working Fund Reserves

a) Overview

Working fund, as defined in the FCBL, is a reserve arising from the operation of programs funded from property taxation to minimize annual fluctuations in property tax rates. The Chief Administrative Officer (CAO) is authorized to make contributions to or withdrawals from working fund reserves to adjust a surplus or deficit in tax supported programs at the end of the current year with a purpose of reducing or eliminating changes in future property tax rates which would otherwise result from an adjusted surplus or deficit. In addition, the CAO is authorized to approve contributions to or withdrawals from the Working Funds Reserve of a Department of up to $250,000 as transitional funding to meet an unanticipated expenditure pressure or a revenue receipt that was not budgeted. Given this, working fund reserves allow for added flexibility and prudent financial planning. Following are some specific examples of past utilizations of working fund reserves:

- In order to deal with recessionary impacts on Human Services' clients, in May 2009 Council endorsed utilizing working fund reserves in the amount of $7.2 million to address increasing caseload and $2.1 million for expansion of current program service levels and new service delivery initiatives.
- In September 2009 Council approved a draw from working fund reserves of up to $1.65 million to provide interim funding for the costs associated with pandemic preparedness and response for pandemic (H1N1).
- In October 2009 Council directed staff to utilize working fund reserves in the amount of $1.2 million to increase funding of Senior's Low-Income Dental Program in 2010 to address a large program wait list.

In order to exhibit more flexibility and promote fiscal responsibility, just as with the tax supported capital financing reserves previously presented to Council, staff also adopted a portfolio approach to the working funds reserve management. With a portfolio approach, reserve adequacy and compliance with the FCBL is assessed at the Regional level as opposed to individual reserve level. This allows healthy reserves to offset the ones with lower balances before overall reserve contributions are increased.

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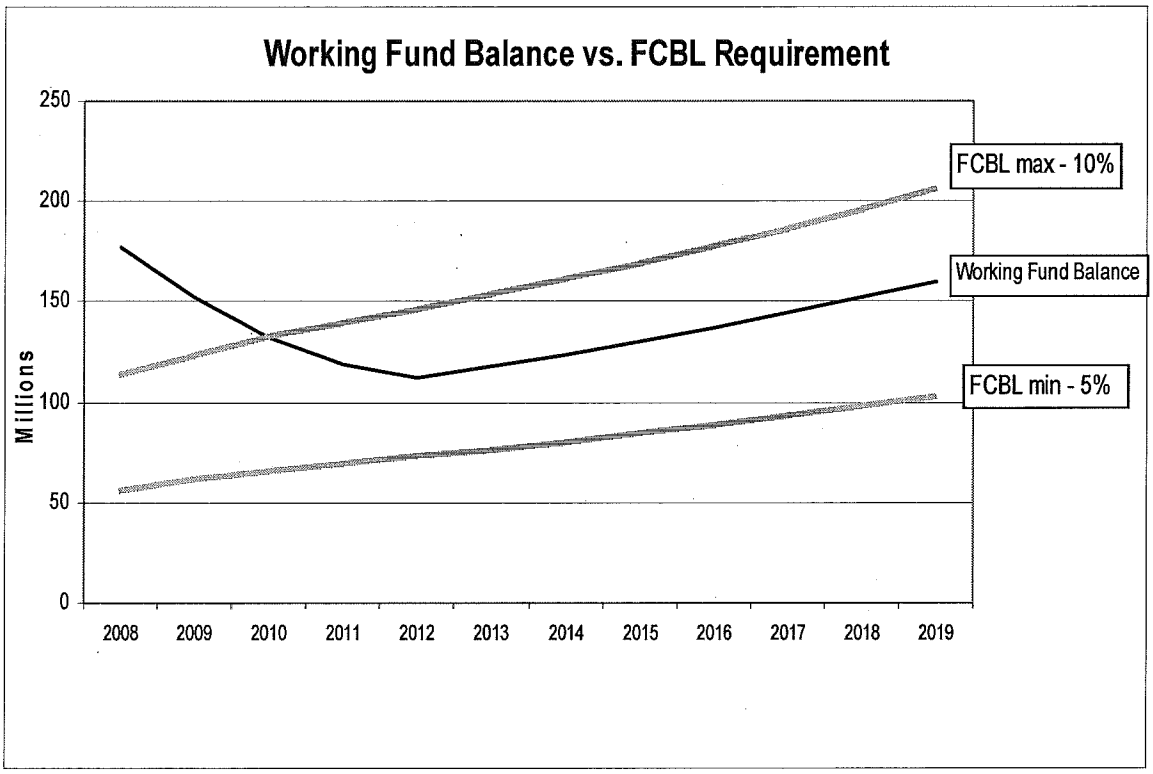
b) Analysis

The FCBL which requires the balance of the Working Funds Reserve be maintained within a range of a minimum of 5 per cent and a maximum of 10 per cent of the total budget for programs funded from property taxation. Due to past prudent financial decisions, Council built a healthy working fund balance over the years. A healthy working fund balance provides Council with flexibility to stabilize the impact of the global recession on Peel's programs. The graphs below outlines the financial position of the working funds reserves in relation to the stipulated range of 5 – 10 per cent.



Staff anticipate the recessionary impacts will extend into year 2012 at which point the cumulative recessionary impact since year 2009 will be approximately $53 million. The model assumes that the conditions will improve beyond 2012 and as such doesn't build any future budget draws beyond this point. The following table shows anticipated recessionary reserve draws.

Year	Amount of Draw (in millions)
2009	$10
2010	$18
2011	$15
2012	$10
Total	**$53**

Assumptions utilized in the above analysis may understate a number of risks to Peel. For example, Ontario Works caseload forecast included in the 2010 Budget is based on

information available to-date. Given the nature of the information, it is fairly difficult to predict the actual impact on Peel; as such, staff used fairly conservative estimates. In addition, the assumptions do not incorporate potential municipal costs associated with Peel's response to H1N1 nor does it account for possible Provincial and Federal initiatives to address burgeoning provincial and federal deficits, that may result in reduced transfers to Peel. In addition, the analysis does not incorporate an unfunded liability to GO Transit in the range of $17.7 million.

c) Summary

Based on the above analysis the working fund reserve balance will decline from current levels to approximately 7.6 per cent by 2012; levels still within the FCBL limits. If required, staff will utilize the balance to offset additional risks (outlined above). During better economic times, operating surpluses can be utilized to replenish working funds reserves.

3. Region's Tax Supported Non-growth Related Capital Reserves

a) Overview

During the 2008 Budget process, staff brought forward a report in regards to the sustainability of Region's longer term capital financing for the tax supported program. Based on this report, the 2008 budget included an annual increase to reserve contributions equivalent to one per cent tax increase in each of the next 10 years which was expected to provide over $400 million in additional funding for the tax supported capital program. This was recognized to be the first step toward achieving financial sustainability. Additional tactics such as continued advocacy with the provincial government were recognized to be an integral part of the plan in order to facilitate long term financial viability of the tax supported reserves.

During 2009 Budget, Council acknowledged continued need for the "1 per cent solution" and included the additional contribution within the overall approved budget

As indicted above, in order to exhibit more flexibility and promote fiscal responsibility, tax supported capital financing reserves are managed through a portfolio approach. The net available balance is summarized as follows:

	In Millions ($)
Portfolio Reserve Balance	$599.8
Outstanding Commitments	(379.4)
Net Available Balance	**$223.3**

Since Capital Asset Management Initiative (CAM) for tax supported non-growth related capital assets is in the process of being developed, as an interim step, staff utilized the following assumptions to predict future capital commitments: long term inflation at 2% (Bank of Canada target for core inflation) and 1.5% annual growth in assets, in order to come up with a reserve status and future reserve requirements. Historically, the first three years of Peel's 10-Year Capital Plan have been reasonably accurate however, years four to seven have been understated. In future CAM will better inform Peel's capital planning requirements. The modeling utilized is not capable of including complex factors which will drive the costs and regional commitments in the future and as such may provide a fairly understated picture.

Aside from future asset replacement costs, which ensures Peel's assets are maintained in a state of good repair, there are other drivers. As technology becomes more complex and sophisticated, environmental sustainability becomes more central, regulations change and become more stringent (e.g. Places to Grow intensification requirements) and as Peel's services evolve and improve, there will be added pressures to enhance the infrastructure base to accommodate these changes. These enhancements to the existing infrastructure base will compound the pressure to increase contributions to the reserves to meet the many known and unknown challenges ahead.

In the future, once CAM is complete, staff will be able to provide longer range modeling including better assessment of financial needs.

b) Analysis

The model incorporates funds received through the ISF which resulted in a net benefit to the tax supported reserves of $6.8 million. Since future works will be completed under CAM, the current reserve model only extends for a period of ten years, a timeline consistent with working fund reserve model.

The graph below displays future commitments related to tax supported regionally controlled programs (bars) compared to uncommitted reserve balance under two scenarios (lines); one with the continued "1% Solution" and the other with "1% Solution" foregone in 2010. The graph takes into consideration net available reserve balance of $223 million (as per summary table above). The graph demonstrates the impact of foregoing the "1% Solution" in 2010.

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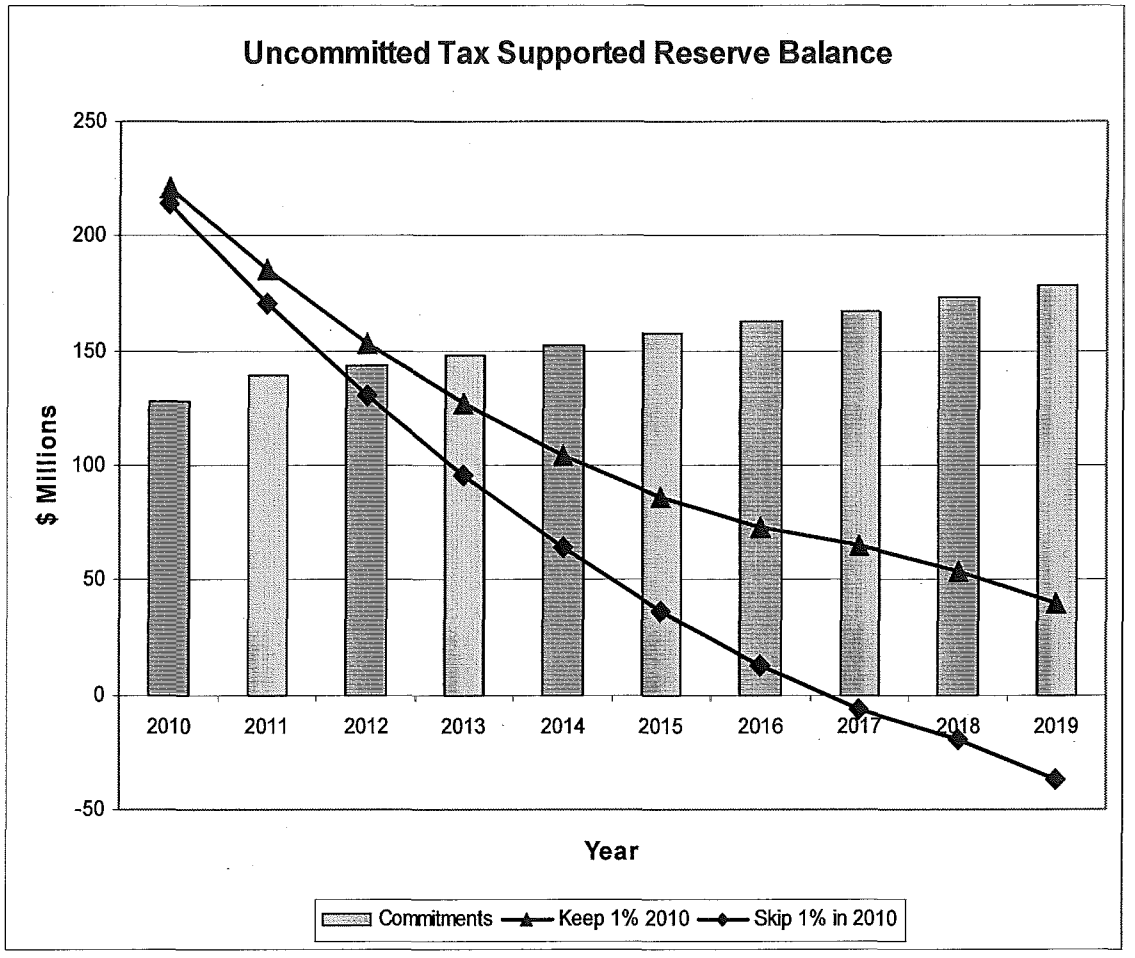


Based on the assumptions the chart above demonstrates the negative impact a one-year suspension of the "1% Solution" will have on the uncommitted reserve balance. As the economic recovery takes hold, commodity prices will begin to increase and may return to pre-recession levels, having a further negative impact on the uncommitted reserve balance. Although work is progressing on CAM, true replacement costs for existing assets is not fully understood. These are potentially significant risks and need to be better understood prior to changing course. As a result the recommendation is to continue to apply the "1% Solution" as the planned commitments are not yet fully understood.

c) Summary

Suspending the additional reserve contribution for one year will have a cumulative impact of $95 million over the next 10 years. Peel's future financial flexibility will be a greater risk and may result in the need to issue debt for future capital works. Based on the above analysis, staff proposes that Council continues to support the "1% Solution" in the upcoming 2010 Budget in order to ensure long term financial sustainability of the tax supported programs.

4. Region's Rate Supported Non-growth Related Capital Reserves

a) Overview

In the fall of 2008 staff presented Council with a report outlining the need for increasing utility rate to finance the expanding state of good repair budget, findings identified through CAM. The long-term modeling of capital financing forecast predicted the need to immediately increase utility rates by a minimum of three percent ("3% Solution") in order to ensure financial viability of rate supported reserves.

The rate supported reserve analysis also uses a portfolio approach. The net available balance is summarized as follows:

	In Millions ($)
Portfolio Reserve Balance	$385.8
Outstanding Commitments	(319.6)
Net Available Balance	**$66.3**

The summary indicates that majority of the reserve balance (83 per cent) has been committed to finance previously approved projects. Only $66 million of the existing reserve balance is available to fund future needs of the Region's aging utility system with a 2008 replacement cost in the range of 12.3 billion.

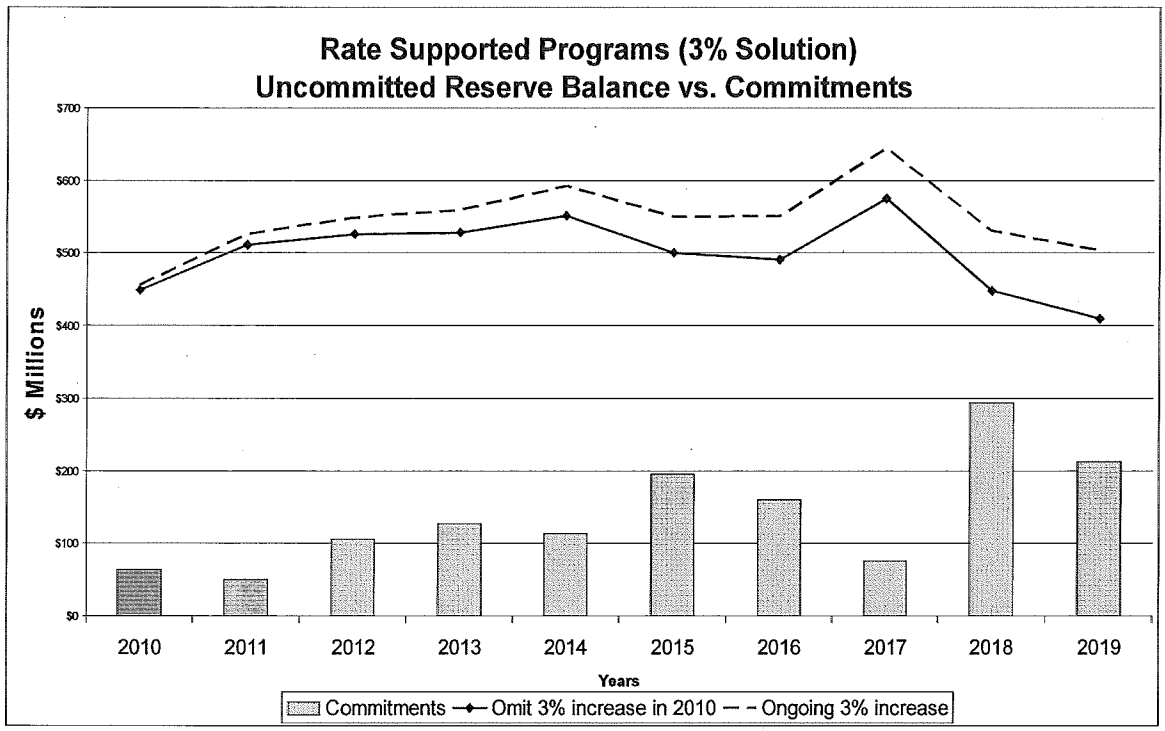
The rate reserve sustainability analysis benefits from and builds on year-to-date preliminary results obtained through CAM.

b) Analysis

The model incorporates funds received through the ISF which provide a significant net benefit of $45.4 million to the rate supported programs.

The graph below displays future commitments related to rate supported regionally controlled programs (bars) compared to uncommitted reserve balance under two scenarios (lines); one with the continued "3% Solution" and the other with "3% Solution" suspended in 2010 but re-introduced in 2011. The graph takes into consideration net available reserve balance of $66.3 million (as per summary table above).

The graph indicates that even though the uncommitted reserve balance remains positive, the cumulative impact of the suspension of the "3% Solution" in 2010 will translate into approximately $94 million reduction in reserve balance over period of ten years. This impact can be compared to ISF funding of $45.4 million.



As reported to Council in a report on the utility rate process staff continue to explore other approaches which will result in alleviating pressures from Peel's rate payers. Past efforts have included bulk purchasing, energy saving process improvements and an improved contract with OCWA to allocate risk and reduce future operating costs. Over the next year, Public Works and Finance will partner on a more thorough Utility Rate Study. Results of the rate study will be brought forward to Council at a later date.

In addition, staff continues to diligently work through CAM, to ensure that Peel's $12 billion worth of aging utility infrastructure is maintained in a state of good repair.

C) Summary

The above analysis indicates that the suspension of the "3% Solution" in 2010 will not jeopardize Peel's long term financial flexibility in the near future. In future, the amount required to sustain reserves will be reassessed to take into account changing economic conditions, evolving program infrastructure requirements as well as will incorporate results of the Utility Rate Study.

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CONCLUSION

Past actions of Council have provided today's Council with financial flexibility to withstand pressures such as currently experienced by the global recession and H1N1 preparation efforts underway. Staff will continue to monitor changing economic conditions to assess Peel's reserves and financing requirements to sustain both the state of Region's capital infrastructure and its debt free status.

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