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REPORT
Regional Council

For Information

DATE: December 24, 2010

REPORT TITLE: **OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**

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

OBJECTIVE

The objective of this report is to provide Council with an overview of the reserves and an update on overall reserve sustainability.

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 reserves
- Peel has adopted a portfolio approach to both tax supported capital and working fund reserve management
- Working fund reserves are used as a tool to mitigate short term tax pressures and were used to help offset recessionary pressures in the 2009, 2010 and 2011 Budgets
- Reserves provide financial flexibility to meet long term financing requirements for the state of good repair of existing assets, service enhancements and growth
- Reserve level (liquidity) is an important factor in Peel's AAA credit rating
- In addition to the debt forecasted in the 2007 Development Charges (DC) Background study, analysis of non-DC capital reserves shows that over the next 10 years the current level of contribution to capital reserves will result in Peel having shortfalls of $463 million in non-DC Tax Supported Capital Reserves and $208 million in non-DC Utility Rate Supported Capital Reserves
- To address these shortfalls, as part of the 2011 and future budgets, Council will need to consider increasing reserve contributions, issuing debt and/or reducing the non-DC Capital Plan.

DISCUSSION

1. Background

The objective of this report is to provide Council with an overview of the reserves and an update on overall reserve sustainability.

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, Specialty Funds and Development Charge Reserve Funds. Appendix I: Relationship between Capital Financing and Capital Plan provides an overview of the relationship between the various sources of capital financing including Capital Reserves and the Capital Plan.

In the fall of 2007 staff presented Council with a perspective of the Region's tax supported non-growth related capital financing utilizing a portfolio approach to reserve management. This approach assesses reserve adequacy at a Regional level as opposed to an individual program level and allows healthy reserves to offset program areas with weaker reserve levels before overall reserve contributions levels are increased. This approach also recognizes that reserve requirements can be driven by forces that could contradict each other (i.e. inflationary versus recessionary). Council adopted the strategy proposed in the report to increase reserves by one percent tax rate over a period of ten years for capital financing purposes as a first step to achieving financial sustainability.

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 per cent annually. This strategy was adopted by Council as part of the 2009 budget.

In 2007 Council adopted Development Charge (DC) By-law 115-2007. Since then, development revenue within the Region of Peel has not materialized as forecasted. The Region of Peel has experienced a significant revenue shortfall in regards to DC's. This shortfall was anticipated due to Peel's requirement to have infrastructure in place to support future development and was further exacerbated by global economic downturn. In the fall of 2010, staff presented Council with a report that provided a statement of the Development Charge (DC) Reserve Funds for fiscal 2009. The report highlighted that the DC cash balance before commitments transitioned to a deficit position ending the year with a negative cash balance of $228 million.

In May 2010, Council approved the issuance of $400 million in debt to mainly to support the DC related growth capital plan. Reserve levels, while important in directly financing capital projects, are also important as they are an indicator of liquidity which has a significant influence on Peel's AAA credit rating.

2. Working Fund Reserves

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 Working Fund Reserve is an integral tool for tax management as it provides funding for one-time, allows significant pressures to be phased in and is also used to address program pressures where there is some degree of uncertainty. The Region of Peel has generally two types of Working Fund Reserves; Tax Supported Working Fund Reserves and Utility Rate Supported Working Fund Reserves.

a) Tax Supported Working Fund Reserve

The FCBL which requires the balance of the Working Funds Reserve be maintained within a range of a minimum of five per cent and maximum of ten 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. This healthy reserve has provided Council with the flexibility to stabilize the impact of the global recession on Peel's programs.

Staff project the Working Fund Reserve will have a year-end balance of $140 million which is the equivalent of 10.2%, slightly above the recommended 10% maximum in the FCBL. Planned recession related reserve draws through 2013 will reduce the balance to within the FCBL requirements. Following the recession, staff will continue to assess the Working Fund Reserve on an annual basis.

b) Utility Rate Supported Working Fund Reserve

The FCBL also requires the balance of the Utility Rate Supported Working Fund Reserve be maintained within a range of a minimum of five per cent and maximum of ten per cent of the total budget for the utility programs (e.g. Water, Wastewater etc.). Due to the impact of Harmonized Sales Tax (HST) and increased energy costs in combination with decreased average water consumption, there has been significant pressure on the Utility rate working fund balance over the past few years.

Staff are currently developing a longer term plans to bring the balance of the Utility Rate Supported Working Fund reserve within the range in the FCBL and will bring forward options for Council's consideration in the 2011 Budget.

c) GO Liability

The 2011 budget does not include Peel's outstanding liability to GO Transit of $31.1 million, which includes the September 2010 year-to-date amount for the 2007 through 2010 fiscal years. This represents an unfinanced liability due to Peel Regional Council's decision to limit funding for GO Transit to the growth capital plan funded through development charges.

3. Capital Reserves

The Region of Peel's capital plans are financed through capital reserves, DC reserves, internal borrowing, external funding and debt.

Capital Reserves provide financial flexibility to meet long term financing requirements. Capital reserves are used to fund the state of good repair of existing assets and to fund service enhancements (e.g. new paramedic stations and Long Term Care facility) and non-DC growth related capital work.

a) Asset Management

The Region of Peel is committed to maintaining the services it provides at the most affordable costs. Quality services and good infrastructure promotes economic prosperity and healthy communities for Peel's residents and businesses. To support that commitment, Peel is moving toward a more comprehensive approach for long range, strategic planning of Peel's infrastructure requirements. An asset management program was begun in 2007 to develop transparent processes and tools that support senior staff and Council with making informed decisions on the needs and priorities of the organization's existing infrastructure. While the asset management program is still evolving, its core strategies have been used to inform decisions around this year's capital plan.

b) Determining the Cost of Future Capital Liability

i) Replacement Cost

The Region of Peel uses the Replacement Cost methodology to estimate the future capital liability. Replacement cost recognizes that the cost to repair and ultimately replace an asset is often significantly different from its historical cost.

For example, a pumping station in Streetsville cost $3.9 million to build in 1979 would cost an estimated $13.3 million to build today. The increase in cost is driven by the increase in the cost of the raw materials (concrete, steel etc.) and the increased labour cost. Appendix II provides additional details of the increase in the costs of construction from 1977 to 2010.

ii) Impact of Growing Construction Costs

One of the variables that significantly impacts the cost of assets such as buildings, roads and watermains is inflation. For capital work, there is a specific index that is often used called the Construction Cost Index (CCI). The CCI reflects the cost of materials such as concrete, steel, asphalt and labour which tend to increase at a rate faster than general inflation (see Appendix II for a chart that illustrates the impact of the Construction Cost Index).

iii) Service Level Pressures

There is increasing pressure for additional capital investment due to regulatory changes (e.g. changes to water processing), demand to improve service levels of existing Regional programs (e.g. more social housing required to address increasing wait list), and other community changes (e.g. need to increase road width for public transit). Currently these pressures are being addressed using a combination of internal reserves, debt and external funding. As internal reserves are drawn down to address the state of good repair, other financing sources will need to be used in order to implement service enhancements.

c) Tax Supported Capital Financing

The Region's tax supported Ten Year Capital Plan (2011 – 2020) has a gross total value of $2.2 billion and requires $1.6 billion within the next ten years from internal reserves, external sources and/or debt. The plan includes capital projects to address the state of good repair, service enhancements and growth.

During the 2008 Budget process, staff brought forward a report in regards to the sustainability of the Region's longer term capital financing for the tax supported program. Council adopted the strategy proposed in the report to increase reserves by one percent tax rate over a period of ten years for capital financing purposes as a first step to achieving financial sustainability. This program was temporarily suspended in the development of the 2010 Budget due to the depressed economy.

Current reserve levels and contributions are not sufficient to address the Region's tax supported capital plan. Staff project a shortfall of $463 million by the end of year 2020 (see

Appendix III for details of the reserve shortfall). Council will need to consider the following options as part of the 2011 and future budgets to address the shortfall;

- Increasing reserve contribution levels
- Issuing debt for non-DC related growth
- Reducing the capital plan

d) Utility Rate Supported Capital Financing

The Region's utility rate supported Ten Year Capital Plan (2011 – 2020) has a gross total value of $2.7 billion and requires $1.2 billion within the next ten years from utility reserves, external sources and/or debt. The plan includes capital projects from programs such as Water and Wastewater and includes capital work that predominantly addresses the state of good repair. Generally speaking, assets in these programs have an average life span of 60 to 70 years.

Current reserve levels and contributions are not sufficient to address the Region's utility rate supported capital plan. Staff project a shortfall of $208 million by the end of year 2020 (see Appendix III for details of the reserve shortfall). Based on preliminary work under the asset management program mentioned earlier, staff project a shortfall in excess of $6.5 billion in today's dollars when these assets ultimately need to be replaced over the next 60 years. Council will need to consider the following options as part of the 2011 and future budgets to address the shortfall;

- Increasing reserve contribution levels
- Issuing debt
- Reducing the capital plan

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 per cent annually. This strategy was adopted by Council as part of the 2009 budget but was temporarily suspended in the development of the 2010 Budget due to the depressed economy and significant Infrastructure Stimulus Funding received.

4. Development Charge (DC) Reserve Funds

In 2007 Council adopted Development Charge (DC) By-law 115-2007. Since then, development activity within the Region of Peel has not materialized as forecasted. The Region of Peel has experienced a significant revenue shortfall in regards to DC's which can be attributed largely to the global economic downturn.

The 2007 Background Study recognized that the Development Charge Reserve Balances would be in a deficit position before the next update. The Development Charge cash balance at the end of 2009 was in a net deficit position of $228.4 million. While the deficit had been temporarily funded from internal borrowings, there was a need to consider undertaking external borrowing as a long term strategy to manage debt. In May 2010, Regional Council approved the authorization for debenture issuance not to exceed $400 million mainly for growth related infrastructure. In June 2010, debt was issued for DC related projects in the amount of $254 million. As part of a funding strategy it is anticipated that debt will continue to be issued until such time that DC reserves will be able to sustain growth related infrastructure. The 2007 DC Background study forecast that $1 billion in debt would be required to fund the growth program over the next few years.

Council will recall from the 2007 DC By-law update that staff would proceed with the issuance of debt under the philosophy that it be used to fund the growth capital until Development Charge revenues were collected to pay off the debt. The development charge rate set at that time included the debt financing costs.

Staff are currently developing the process and timetables necessary to update the current DC By-law and rates which expire October 4, 2012. The 2011 Capital Budget and Capital Plan will form the basis for the DC Background Study.

CONCLUSION

Prudent past actions by Council have created working fund reserve levels sufficient to finance short term tax pressures such as those caused by the economic recession. However, staff analysis project that capital reserves for state of good repair, service enhancements and growth will not be sufficient to meet Peel's longer term capital requirements. Staff will propose options for Council's consideration in the 2011 Budget that include increasing capital reserve contributions, issuing debt or reducing the capital plan.

for Norma Trim
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c. Legislative Services

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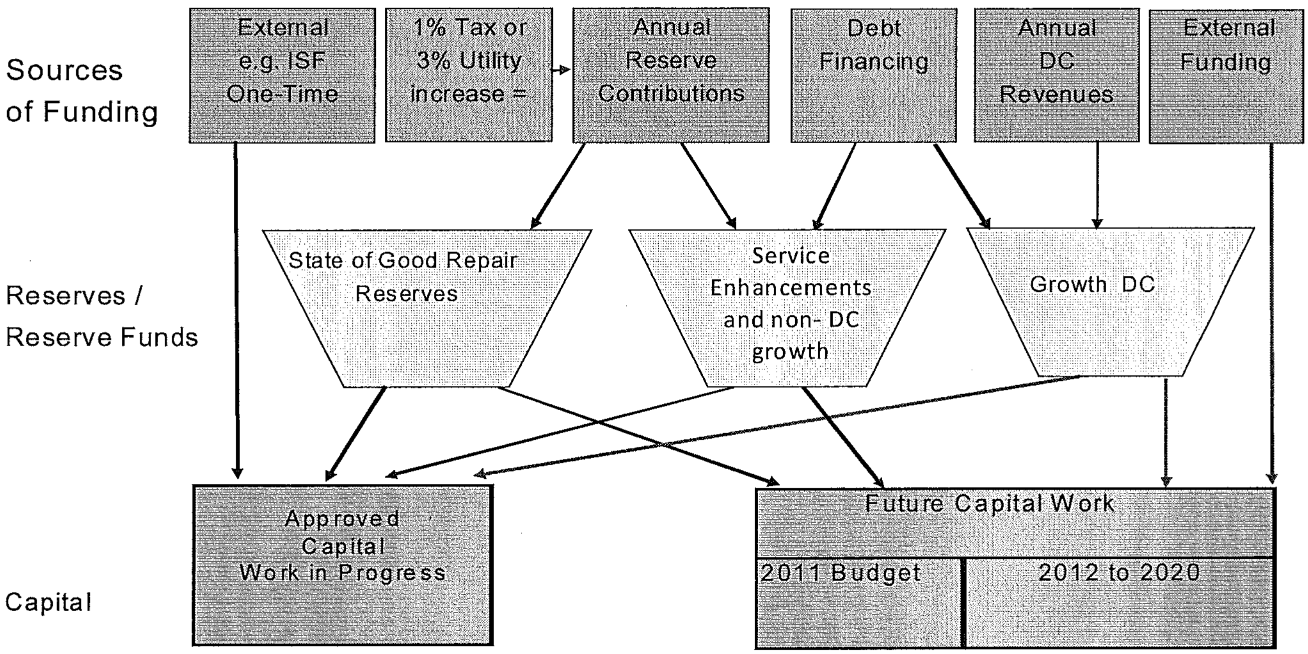
APPENDIX I - RELATIONSHIP BETWEEN CAPITAL FINANCING AND CAPITAL PLAN



The diagram above illustrates the relationship between the various forms of capital financing and the capital work. The state of good repair is generally financed from capital reserve Contributions. Service Enhancements and non-DC growth are currently funded from capital reserve contributions too which puts additional strain on those reserves. More recently, Council approved the purchase of the new 7120 Hurontario building financed through debt. This non-DC growth related project will allow the Region to save on leases and leave Peel with a valuable asset after the debt has matured.

Development Charge (DC) related growth is funded directly by DCs for which debt has been issued to address cash flow issues. External funding, such as the one-time Infrastructure Stimulus funding, usually specifies for which type of capital work it can be used and may have time or other restrictions.

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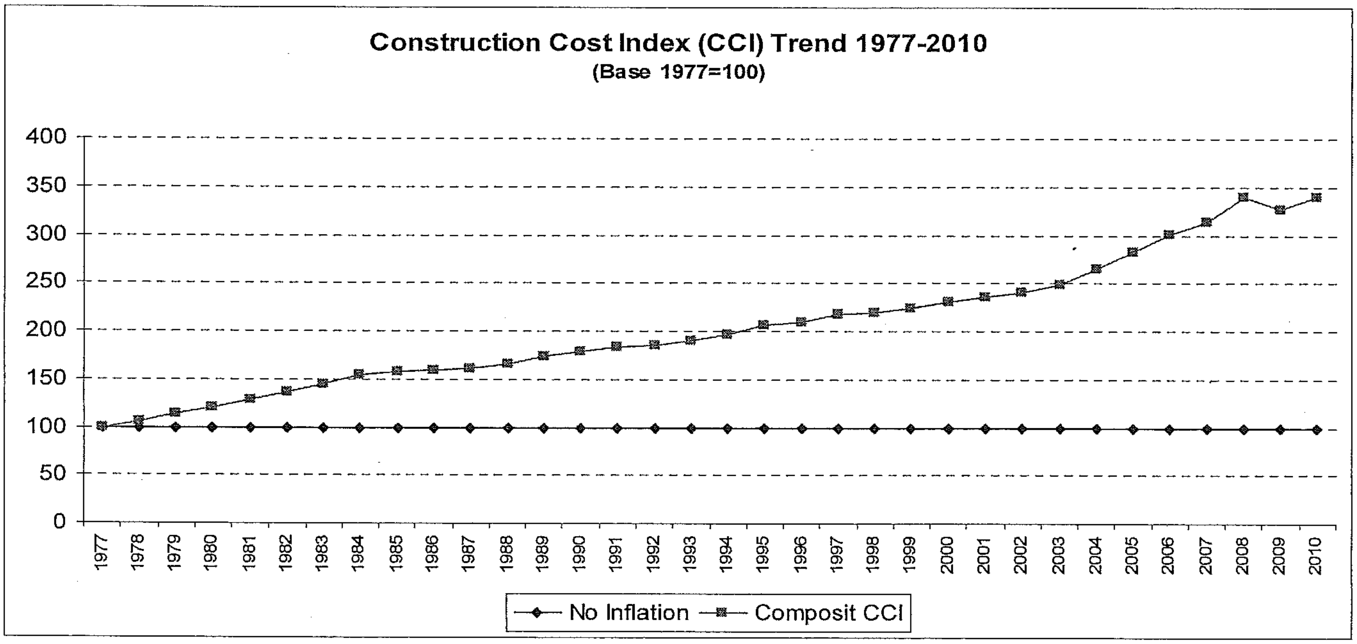
APPENDIX II - IMPACT OF CONSTRUCTION COST INDEX ON CAPITAL WORK



The above chart illustrates the impact of CCI on an asset that was purchased in 1977 for $100 K. By year 2010, the cost to replace the same asset would be $340 K which is 3.4 times higher than the historical cost.

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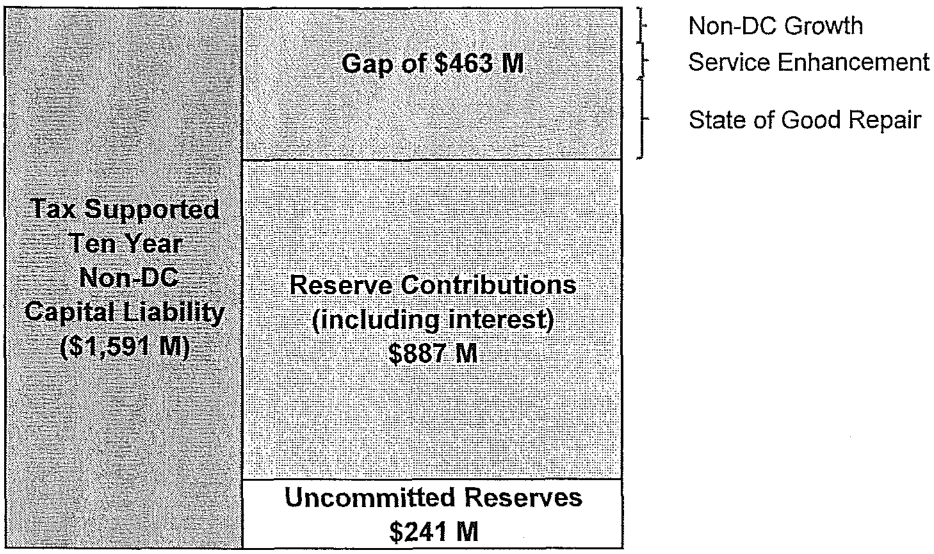
APPENDIX III - PROJECTED FINANCING REQUIREMENTS FOR TEN YEAR CAPITAL PLAN

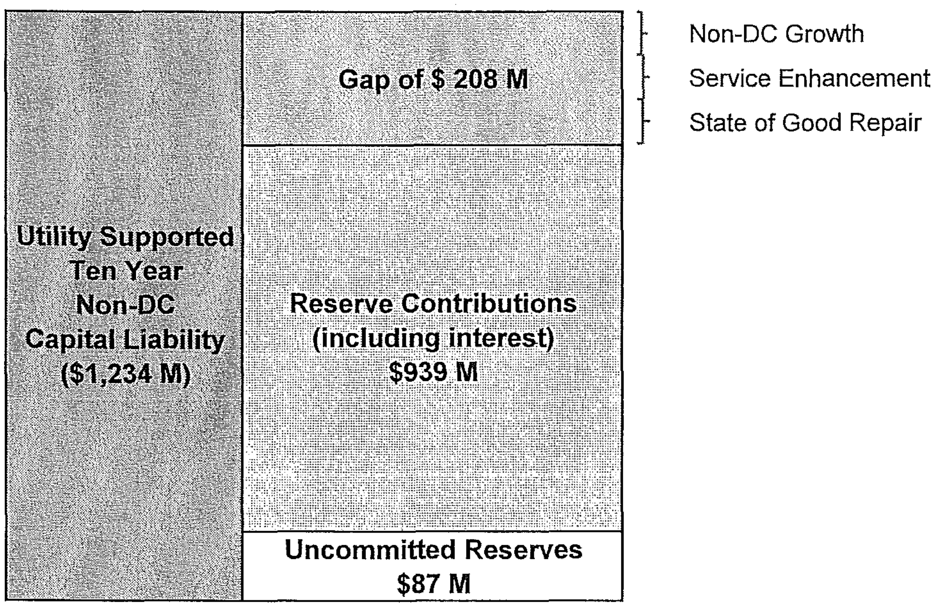
Tax Supported Capital Plan Financing Requirements*

(2011 - 2020 Capital Program)



Utility Supported Capital Plan Financing Requirements**

(2011 - 2020 Capital Program)



* Assuming the current Tax Supported Ten Year Capital Plan, staff forecast the Tax Supported Capital Reserves will be depleted by the year 2015

** Assuming the current Utility Rate Supported Ten Year Capital Plan, staff forecast the Utility Rate Supported Capital Reserves will be depleted by the year 2016