

For Information

DATE: October 17, 2012

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

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

OBJECTIVE

To provide Regional Council with an overview of the reserves and update on the overall sustainability of reserves with focus on the working fund reserves and capital reserves.

REPORT HIGHLIGHTS

- Peel's Financial Control By-law establishes the framework for managing reserves
- Reserves include: Working Funds, Capital Reserves, Specialty Funds and Development Charge (DC) reserve funds
- 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 as contingencies to address pressures and risks in the 2012 Budget
- Reserves provide financial flexibility to meet long term financing requirements for the state of good repair of existing assets, service enhancements and non-DC growth
- Reserve level is an important factor in Peel's overall financial condition as it impacts financial sustainability and financial flexibility
- 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 shortfall of:
 - - \$213 million in non-DC Tax Supported Capital Reserves (Regionally Controlled programs)
 - - \$471 million in non-DC Utility Rate Supported Capital Reserves.
- In the 2012 Budget Council approved increases to capital contributions (equal to 1% Tax Rate and 6% for Utility Rate) have positively impacted funding shortfalls
- To address these shortfalls, as part of the 2013 and additional future budgets, Council will need to consider increasing reserve contributions, issuing additional debt and/or reducing the non-DC Capital Plan.
- Staff will propose a Reserve Management Policy to Council in 2013 to manage the reserves and reserve funds

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OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**DISCUSSION****1. Background**

The Financial Control By-law (FCBL) establishes financial controls related to the Operating Budget, Capital Budget and reserve management of the Regional Municipality of Peel. The policy defines Reserves as unrestricted accumulation, at the discretion of Council, of appropriations from net revenues. Reserves include Working Fund Reserves, Capital Reserves, Specialty Funds and Development Charge (DC) Reserve Funds. This report will focus on the working fund reserves, capital reserves and DC reserve funds. Appendix I provides a summary of the projected status of the working fund reserves.

In the fall of 2007 staff presented Regional 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 1% tax rate each year for capital financing purposes as a first step to achieving long term financial sustainability. As part of the development of the Long Term Financial Planning Strategy (LTFPS), staff will be proposing a Reserve Management Policy to Council in 2013 which addresses reserve management.

Staff also presented Regional Council with a report outlining the need for increasing utility rate to finance the expanding state of good repair budget and mitigate debt financing in the fall of 2008. The long-term modeling of capital financing forecast predicted the need to immediately increase utility rates by a minimum of 3% annually for the state of good repair. This strategy was adopted by Council as part of the 2009 budget.

In the fall of 2011, staff provided Regional Council with a report on the status of reserves entitled "Overview and Update on the Status of Reserves". In this report, staff highlighted that over the next ten years, shortfalls of \$329 million for tax supported capital reserves and \$451 million for utility rate supported capital reserves were projected. In the 2012 budget, Council approved increases to the contributions to capital reserves the equivalent of 1% net tax levy. In an effort to close the Utility Rate supported capital financing gap more quickly Council approved a 6% utility rate increase to support capital reserves. In addition, as part of surplus management, Council also directed the allocation of \$11.5 million from year-end surplus to the tax supported capital reserves. Council's strategies to improve funding of capital reserves have improved long term sustainability of the Capital program.

The management of reserves is an important factor in Peel's overall financial condition as they impact financial sustainability and financial flexibility. The credit rating agencies have acknowledged the Region's highly liquid reserves and reserve fund levels and its relatively low level of debt as major attributes allowing it to achieve a Triple A (AAA) credit rating. Maintaining a high credit rating is a goal held by the Region which ensures its access to capital markets at very competitive borrowing rates, benefitting the Region of Peel and Area Municipalities, and is critical to the long term financial sustainability of Regional services.

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2. Working Fund Reserves

The Working Fund, as defined in the FCBL, is a reserve arising from the operation of programs. Surpluses from tax supported programs and utility rate supported programs are put into separate reserves. These reserves are used to minimize annual fluctuations in property tax and utility rates as it provides funding for one-time costs, 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 Stabilization Reserves.

a) Tax Supported Working Fund Reserve

The FCBL which requires the balance of the Working Fund Reserves be maintained within a range of a minimum of five per cent and maximum of ten per cent of the total budget 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 slowly recovering global economy on Peel's programs.

Staff project the Working Fund Reserve will have a year-end balance of \$111 million, net of both the Go transit liability and the sinking fund set up for the retirement of the debt issued to finance the 7120 Hurontario Street building purchase. The balance is the equivalent to approximately eight per cent of the 2012 total budget funded from property taxes, in compliance with the FCBL.

b) Utility Rate Supported Stabilization Reserve

The FCBL also requires the balance of the Utility Rate Supported Stabilization 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.). Staff project that the Utility Rate supported stabilization reserve will have a year end balance of \$28 million, which represents approximately 9% of 2012 Utility Rate supported operating budget, in compliance with the FCBL.

3. Capital Financing

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 and help achieve the long term financial sustainability of its assets. They are used to fund the state of good repair of existing assets and to fund other capital work not eligible for DC funding.

The capital financing sources used are somewhat dependent on the type of capital project. For example, DC funding can only be used for growth related projects. Appendix II, "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.

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OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**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. On October 6, 2011, staff presented the corporate asset management strategy to the Audit Committee. The purpose of the strategy is 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. The strategy considers the technical/condition assessments of the assets and compares them with the service levels currently being delivered to develop a risk profile on which Council can make informed decisions on priorities. This strategy was piloted in the 2012 budget in the Long Term Care and Water programs and is being used to inform the development of the 2013 Capital Budget and 2013 – 2022 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 \$14.0 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 over the asset's useful life. Appendix III provides additional details of the increase in the costs of construction from 1977 to 2012.

The replacement costs of new assets not yet approved by Council are excluded from the ten year projections of capital liability.

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 have historically increased at a rate faster than general inflation (see Appendix III for a chart that illustrates the impact of the Construction Cost Index on replacement costs).

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 (e.g. P3 Canada) will need to be used in order to implement other capital work not eligible for DC funding.

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OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**c) Funding****i) Tax Supported Capital Financing**

The Regionally controlled programs' proposed tax supported Ten Year Capital Plan (2013 – 2022) has a gross total value of \$2.7 billion and requires \$1.4 billion within the next ten years from internal capital reserves with the remaining funded from DC, external sources and/or debt. The plan includes capital projects to address the state of good repair, service enhancements and non-DC growth.

Current reserve levels and contributions are not sufficient to address the Region's tax supported capital plan. Staff projects a shortfall of \$213 million by the end of year 2022 (see Appendix III for details of the reserve shortfall). The shortfall of \$213 million excludes the expenditures and reserve contributions required for the new Energy from Waste Facility as staff consider different financing options including the issuance of debt and P3 funding. Going forward, Council will need to consider the following options as part of the 2013 and future budgets to address the shortfall;

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

ii) Utility Rate Supported Capital Financing

The Region's utility rate supported Ten Year Capital Plan (2013 – 2022) has a gross total value of \$3.1 billion and requires \$1.6 billion within the next ten years from utility reserves with the remaining funded from DC, 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 projects a shortfall of \$471 million by the end of year 2022 (see Appendix IV for details of the reserve shortfall). Council will need to consider the following options as part of the 2013 and future budgets to address the shortfall;

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

iii) Development Charge (DC) Reserve Funds

The 2012 Background Study recognized that the Development Charge Reserve Balances are in a deficit position and that there would be a need for additional debt issuance. To date, debentures have been issued in the amount of \$1,023 million, mainly for growth related infrastructure. It is anticipated that debt will continue to be issued to a maximum of \$2.6 billion, or until such time that DC reserves will be able to sustain growth related infrastructure. Assuming the projected DC revenue forecast to 2031, it is expected the debt issued to cash flow the timing differences between the DC expenditures and DC revenue will be fully funded by the end of 2031.

Increased monitoring of DC revenues and expenditures will be carried out on an annual basis in order to determine the adequacy of existing development charges. Review of

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the Capital Plan and ongoing DC project cost pressures would factor into the decision as to whether a DC update is warranted prior to the expiry of the new by-law and, Council would be advised accordingly.


CONCLUSION

Council's current strategy of funding the sustainability of the Peel's capital plan through the 1% Property Tax infrastructure levy and 6% Utility Rate infrastructure increase have helped to maintain its overall liquidity. Reserves are an important factor in Peel's overall financial condition as they impact two critical areas; financial sustainability and financial flexibility.

Staff analysis projects that capital reserves for state of good repair, service enhancements and growth will not be sufficient to meet Peel's longer term capital financing requirements. Staff will propose options for Council's consideration in the 2013 Budget that include Peel's continued investment in longer term assets.



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Approved for Submission:

D. Szwarc, Chief Administrative Officer

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c. Legislative Services

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Overview and Updates on the Status of Reserves
Appendix I

Working Fund Reserves

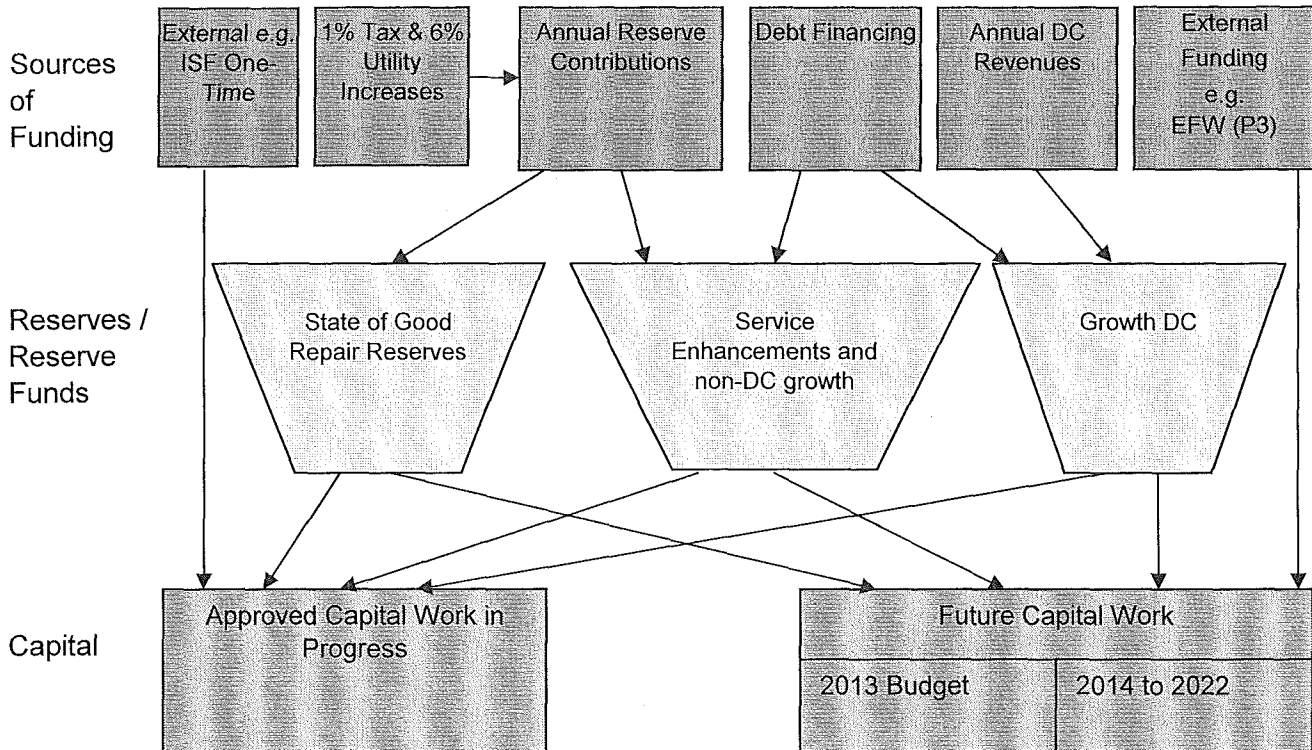
	Projected Balance as at December 31, 2012	Projected Status as at December 31, 2012
Tax	\$111 million	8% of 2012 Tax Operating Budget In compliance with FCBL required range of 5 per cent to 10 per cent
Utility Rate	\$28 million	9% of 2012 Utility Rate operating budget In compliance with FCBL required range of 5 per cent to 10 per cent

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Overview and Updates on the Status of Reserves

Appendix II



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.

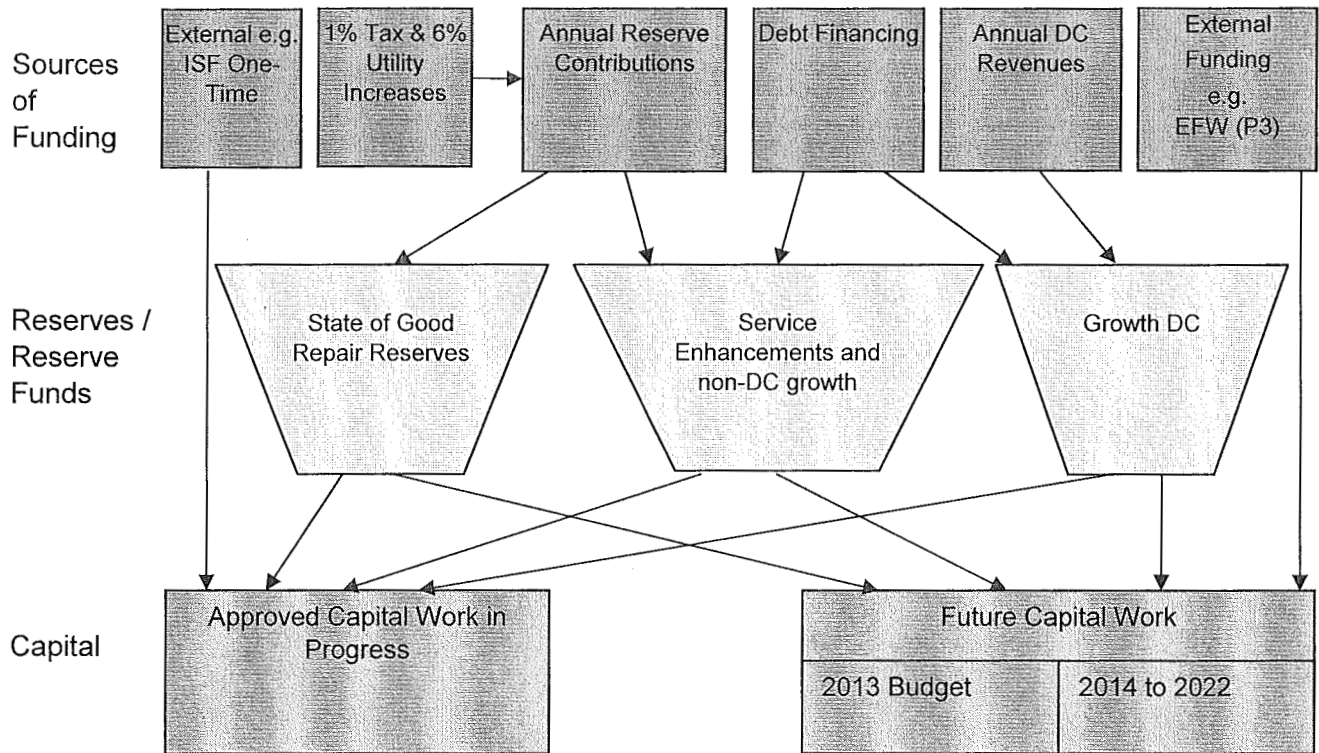
Development Charge (DC) related growth is funded directly by DCs for which debt has been issued to address cash flow issues. External funding, such as the one-time Infrastructure Stimulus funding, usually specifies for which type of capital work it can be used and may have time or other restrictions.

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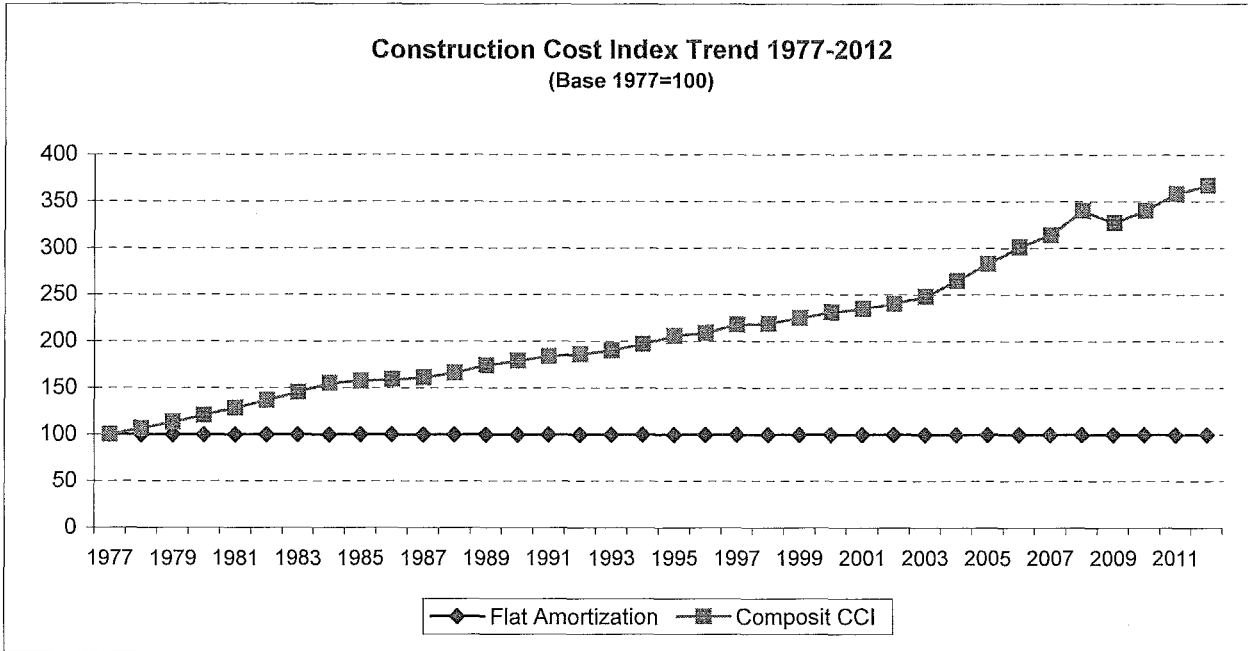
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Source: US Department of the Interior, Bureau of Reclamation, Construction Cost Trends

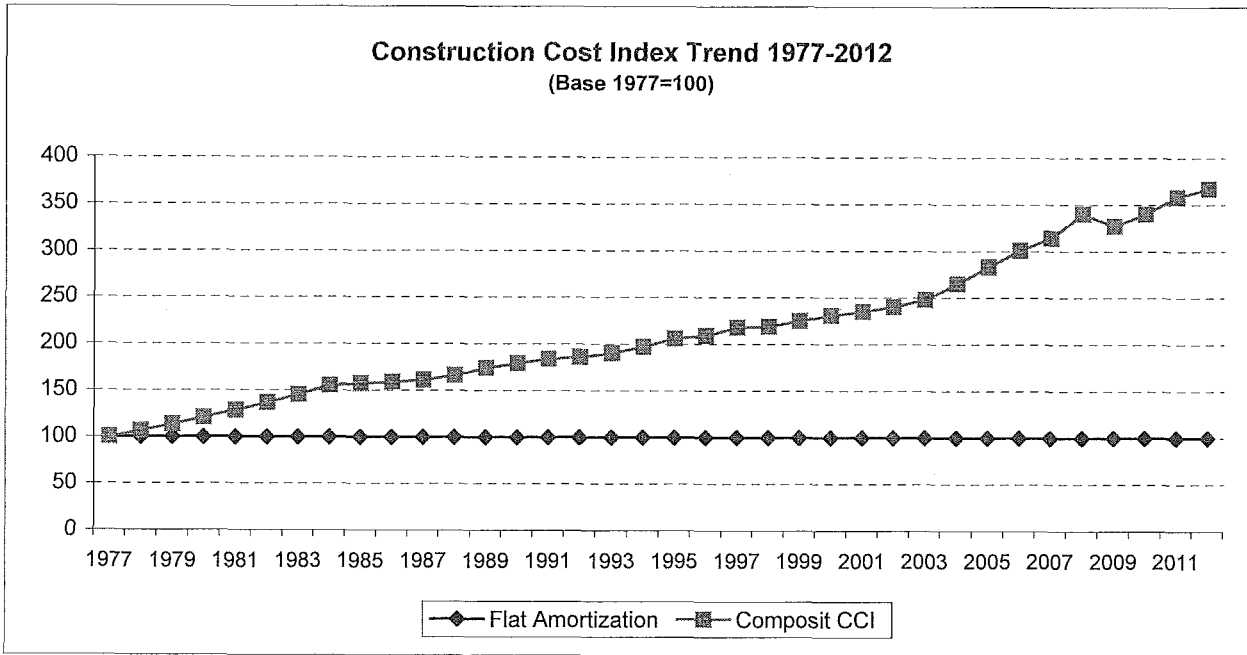
The above chart illustrates the impact of CCI on an asset that was purchased in 1977 for \$100 K. By year 2012, the cost to replace the same asset would be \$367 K which is 3.7 times higher than the historical cost.

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Overview and Updates on the Status of Reserves

Appendix III

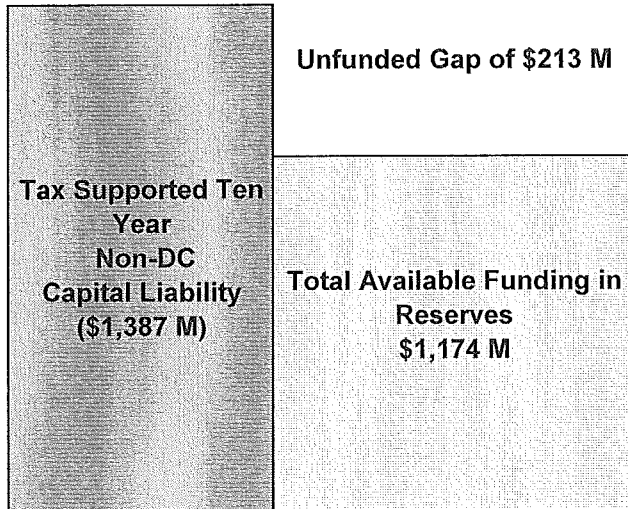


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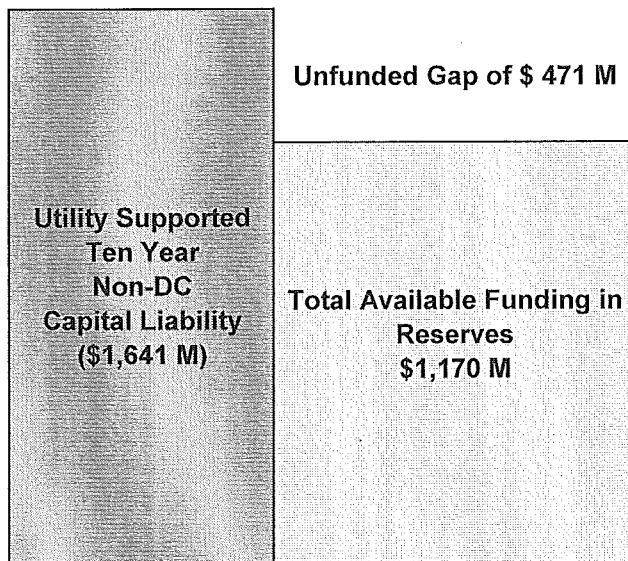
Tax Supported Capital Plan Financing Requirements*

(2013 - 2022 Capital Program)



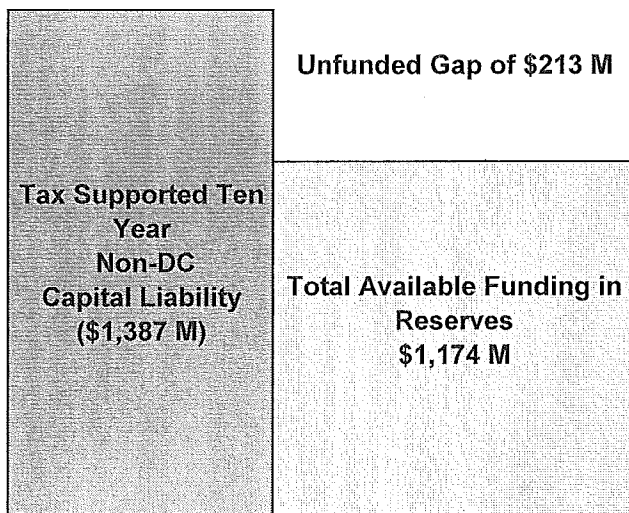
Utility Supported Capital Plan Financing Requirements**

(2013 - 2022 Capital Program)



Tax Supported Capital Plan Financing Requirements*

(2013 - 2022 Capital Program)



Utility Supported Capital Plan Financing Requirements**

(2013 - 2022 Capital Program)

