
For Information

DATE: November 6, 2019

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

FROM: Stephen VanOfwegen, Commissioner of Finance and Chief Financial Officer

OBJECTIVE

To provide an overview of the reserves and an update on the overall sustainability of Regionally Controlled reserves, with focus on the rate stabilization reserves, capital reserves and specialty reserves.

REPORT HIGHLIGHTS

- The Region of Peel's (Region) Long Term Financial Planning Strategy, Financial Management By-law and Reserve Management Policy establish the present framework for managing reserves.
- Reserve adequacy is an important factor in the Region's overall financial condition as it impacts both financial sustainability and financial flexibility.
- Reserves are used as a tool to mitigate short term tax pressures and to meet long term financing requirements for the state of good repair of existing assets, service enhancements and non-Development Charge Growth.

Operating Reserves

- Tax Supported and Utility Rate (Water and Wastewater services) Supported Stabilization Reserves are currently sufficient to adequately maintain the Region's financial flexibility to mitigate service volatility.

Capital Reserves

- Analysis of Tax Supported Capital Reserve and Utility Rate Supported Capital Reserve shows that maintaining the reserve contribution at the current levels will result in a total shortfall of \$3.2 billion by the end of 2039 (Tax: \$1.8 billion, Utility Rate: \$1.4 billion).
- Actions to address the shortfall in Tax and Utility Rate Supported Capital Reserves will be brought forward for consideration as part of the 2020 Budget.
- Bill 108 may increase the pressure on capital reserves

Specialty Reserves

- Review of the Specialty Reserves indicates that the Specialty Reserves are at appropriate levels given the current risk environment with the exception of the Housing-Contingency Liability Reserve.
- Staff continue to assess the shortfall in the Housing-Contingency Liability Reserve, which will be addressed through the management of overall reserves.

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DISCUSSION

1. Background

This report provides an annual overview and update on the status of the Region's reserves. The management of reserves is an important factor in the Region's overall financial condition, as it impacts both financial sustainability and financial flexibility. The credit rating agencies have acknowledged the Region's highly liquid reserves and reserve funds and its moderate level of debt as major attributes helping it to achieve the Triple A (AAA) credit rating. Maintaining a high credit rating ensures Peel's access to capital markets at very competitive rates, benefiting the Region and the local municipalities, and is critical to the long term financial sustainability of Regional services. The Region's current Reserve Management Policy was established by Council on November 14, 2013 through the report "Implementation of the Long Term Financial Planning Strategy – Phase II".

The Reserve Management Policy supports two key principles in the Long Term Financial Planning Strategy, "Ensuring the capital plan is sustainable" and "Maintaining the flexibility to mitigate the volatility in rates". Reserves, reserve funds and specialty reserves are managed within larger pools like investments, where the overall pooled risk is lower than the separate individual risks. Pooling similar reserves into a portfolio enables Council to easily deploy the funds to areas of greatest need. The policy classifies reserves into four major categories: Operating Reserve, Capital Reserve, Specialty Reserve, and Reserve Funds.

2. Operating Reserves

The Rate Stabilization Reserves, as defined in the Reserve Management Policy, are the reserves arising from the operation of Regional programs. The Region has two Rate Stabilization Reserves: Tax Supported Rate Stabilization Reserves and Utility Rate (Water and Wastewater services) Supported Rate Stabilization Reserves. 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 rate by providing funding for one-time costs, allowing significant pressures to be phased-in and addressing program pressures when there is some degree of uncertainty. Appendix I provides a summary of the status of the Rate Stabilization Reserves as at August 31, 2019.

a) Tax Supported Rate Stabilization Reserve

The Reserve Management Policy requires that the balance of the Tax Supported Rate Stabilization Reserve be maintained within a range of a minimum of five per cent and a maximum of ten per cent of the total budget for programs funded from property taxation. Due to prudent financial decisions, Council has built a healthy rate stabilization balance over the years. The reserve has provided Council with the flexibility to stabilize the impact of economic volatility on the Region's programs.

As at August 31, 2019 the balance of Tax Supported Rate Stabilization Reserve is at \$138 million or 9.3 per cent of the 2019 Tax supported total operating budget. The balance is within the range of five to ten per cent as prescribed in the Reserve Management Policy and is sufficient to provide financial flexibility to address one-time pressures and volatility within the Tax Supported operating budget. The Tax Supported

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Rate Stabilization Reserve will be also used to partially address the potential GO Transit liability which totals \$229 million at the end of August 2019.

b) Utility Rate Supported Rate Stabilization Reserve

The Reserve Management Policy also requires the balance of the Utility Rate Supported Rate Stabilization Reserve be kept within the range of a minimum five per cent and a maximum ten per cent of the total Utility Rate supported operating budget. As at August 31, 2019, the Utility Rate Supported Rate Stabilization Reserve has a balance of \$44 million, which represents 8.3 per cent of the 2019 Utility Rate supported total operating budget, which is in compliance with the Reserve Management Policy and provides financial flexibility to address volatility within the water and wastewater services.

3. Capital Financing

The Region's capital plans are financed through capital reserves, Development Charges (DC) reserve funds, 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 the Region's assets. They finance the state of good repair requirements of the existing assets and other capital work not eligible for DC funding.

The capital financing sources used are largely dependent on the type of capital project. For example, DC funding can only be used for eligible growth related projects. A separate report titled "Regional Development Charges Update-2018" was provided to Council in April 2019, that detailed the status of development charge revenues, the growth related capital expenditure, the associated risks along with the mitigation measures and the adequacy of Development Charges Reserves. 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.

a) Asset Management

As detailed in the companion report titled, "Enterprise Asset Management" November 14, 2019, the Region owns and operates \$29.6 billion in infrastructure. Maintaining these assets in a state of good repair is essential to the provision of Regional services and in turn to the overall success of the Region. Consequently, the Region has established a goal of maintaining an overall infrastructure status of "Good". This goal allows the Region to balance prudent investment in infrastructure to support efficient and reliable community services while maintaining affordable tax and utility rates.

The purpose of the Enterprise Asset Management Update report is to provide Council with an infrastructure status update and identify priority initiatives. The report concludes that the levels of investments proposed in the 2020 Capital Budget and Forecast are required to maintain the Region's infrastructure at Council's level of service targets. The report also indicates that Peel's asset portfolio is currently rated "Good" in relation to Council's targets.

OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**b) Determining the Cost of Future Capital Liability****i) Maintain Existing Service Level**

Inflation is one of the variables that significantly impact the cost of maintaining or repairing assets such as buildings, roads and watermains. For capital work, there is a specific index that is often used known as 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 CCI on replacement costs).

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

ii) Service Demand

There are increasing pressures for additional capital investment due to regulatory changes (e.g. changes for environmental protection), demand to improve service levels of existing Regional programs (e.g. more social housing required to address the waitlist), and other community changes due to population growth (e.g. need to increase road width for public transit, expand Paramedics to respond to call volume growth). These pressures contribute to the increases to the 20-year Tax and Utility Rate Supported Capital Plans, which put strain on the capital reserves that are used to fund the increased requirements.

iii) Term of Council Priorities

The Term of Council (ToC) priorities for the term of 2018-2022 were approved by Council on June 13, 2019. The ToC priorities include seven priorities such as “Transform housing service delivery”, “Expand community mobility” and “Build environmental resilience”. Examples of work underway include Peel Housing Master Plan, Sustainable Transportation Strategy, Long Range Transportation Master Plan, Accessible Transportation Master Plan, Inflow & Infiltration Strategy and Asset Management Plan. The 20-year Tax and Utility Rate Supported Capital Plans reflect the capital requirements driven by the ToC priorities. These additional capital requirements have increased pressures on the capital reserves which are the major funding sources.

c) Funding

Funding for non-DC capital projects is generally provided from reserves that can be broken down into two major categories: Tax Supported and Utility Rate Supported capital reserves.

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In the fall of 2007, Council adopted a strategy to increase reserves by one per cent tax rate each year for capital financing purposes to achieve long term financial sustainability. By 2019, Tax Supported capital reserves have been enhanced by an additional amount of \$563 million since its implementation in the 2008 Budget which helped to fund the capital work required since that time.

Staff also presented Council with a report in 2008 outlining the need for increasing the utility rate to finance the expanding state of good repair budget and mitigate debt financing. Since 2009, utility rate increases in range of three – seven per cent have been implemented in annual budgets to strengthen Utility Rate Supported capital reserves resulting into an additional amount of \$618 million in reserves by end of 2019.

The benefit of the increased reserve contributions will continue to grow over time ensuring Peel's assets are adequately maintained and the capital program is sustainable.

i) Tax Supported Capital Financing

To meet the Region of Peel's long term capital requirements while maintaining financial stability, staff use a twenty year capital forecast to assess the adequacy of Tax Supported capital reserves. Based on the evaluation of the capital plan to address Tax Supported state of good repair, service enhancement and non-DC growth requirements, it is estimated that approximately \$5.2 billion is required over the next 20 years for Tax Supported Regionally Controlled services and for the state of good repair of the affordable housing stock in Peel (inflation adjusted). Based on the most recent assessment, keeping the Region's affordable housing stock in the state of good repair requires an investment of \$235 million over the next ten years (see section 4 – Specialty Reserves).

Current reserve levels and contributions are not sufficient to address the Region's 20-year Tax Supported Capital requirements. Staff are projecting a shortfall of \$1.8 billion by the end of year 2039 (see Appendix IV for details). To mitigate the gap, it is proposed that a one per cent infrastructure levy increase be included in the 2020 Budget and in each of the next 6 years till 2026.

ii) Utility Rate Supported Capital Financing

Similar to Tax Supported services, staff use a twenty year capital forecast to assess the capital reserve adequacy for Utility Rate Supported services. It is estimated, based on the evaluation on the state of good repair capital requirements, that approximately \$5.9 billion is required over the next 20 years for Utility Rate funded services including Water and Wastewater (inflation adjusted).

Current reserve levels and contributions are not sufficient to address the Region's 20-year Utility Rate supported capital plan. Staff are projecting a shortfall of \$1.4 billion by the end of year 2039 (see Appendix IV for details). In 2017, staff had forecast that a 5 per cent infrastructure levy would be needed for 5 more years. In the 2020 Budget, it is proposed that the Council continue with the 5 per cent infrastructure levy increase and implement it each year for two more years till 2022.

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This estimate may change as the overall financial sustainability of the utility rate program is being reviewed.

iii) Infrastructure Funding

There has been an increased focus on infrastructure funding from the Federal government in municipal infrastructure areas. In August 2016, Phase I of the Federal Government's Investing in Canada Plan was launched. The plan dedicates over \$180 billion in infrastructure funding over twelve years. Funding is being allocated to municipalities in two phases. In 2017, during the Phase 1 of the infrastructure funding program, the Region received \$104 million under the Clean Water and Wastewater program to support the rehabilitation of key Regional infrastructure assets.

The Region provided feedback to the Federal government on Phase 2 funding as early as September 2016. The first Provincial Stream, Rural and Northern communities, was open in March 2019 (the Region was ineligible for this stream). Staff have been reviewing the funding eligibility criteria and are in the process of applying for funding where applicable. The proposed 2020 10-year capital plan reflects the utilization of infrastructure funding. Future infrastructure funding may be significant and would reduce the long term pressure of rising infrastructure levies.

4. Specialty Reserves

The Reserve Management Policy provides for a categorization of reserves referred to as Specialty Reserves. This category includes reserves for specific and defined purposes that fall outside of the broader requirements for capital financing and rate stabilization. As required by the Reserve Management Policy, a review of these specialty reserves was performed. The results indicate that all specialty reserves are at appropriate levels given the current risk environment except for the "Housing-Contingency Liability Reserve" – R1919, which is expected to have a \$235 million shortfall.

The "Housing-Contingency Liability Reserve" R1919 was established to fund the expected gap in the state of good repair funding of Affordable Housing buildings in the Region. The housing stock contains approximately 20,000 units/homes, owned and managed by Peel Living and external housing providers. The reserve is used to provide capital grants or loans to service providers as a means to address the deficit in their sources of funding when fulfilling state of good repair requirements, and is also funded as part of the one per cent infrastructure levy due to Region's mandate as Service Manager in ensuring a safe and adequate supply of Affordable Housing (also see Section 3.c.i – Tax Supported Capital Financing).

5. Risks and Pressures

Reserves, reserve funds and specialty reserves ensure the capital plan is sustainable as well as provide flexibility to mitigate volatility in tax and utility rates. The evolving environment the Region is facing has resulted in increasing risks and growing pressures on service levels and hence on reserves, reserve funds and specialty reserves that are established to support service delivery to Peel residents and businesses. The risks and pressures include the following:

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Rate Stabilization Risks:

- Provincial funding reduction: as reported to Council in 2019 through reports related to provincial funding, the Province of Ontario introduced funding changes to municipalities including a change in cost share for Public Health, the introduction of a discretionary cost share for Child Care and overall reductions in funding for municipally-provided and provincially mandated services including Long Term Care. Peel is facing significant provincial funding decrease from 2020 to 2022 and a high degree of uncertainty going forward with respect to funding.
- GO Transit liability: the potential GO Transit liability continues to grow, amounting to \$229 million by August 2019.

Capital Reserve Risks:

- Impact of 2015 DC By-law appeal decision: a recent appeal decision will result in a potential decrease of \$31 million in DC funding for capital projects related to Benefit to Existing. This will affect the Tax Supported rate stabilization reserve adversely which is required to fund the shortfall.
- Impact of Bill 108, *More Homes, More Choices Act 2019*; as proposed, would have adverse financial implications and poses risks to the Region. The DC revenue loss would require the Region to take on additional debt or increase property taxes and utility rates to continue with its capital infrastructure investment plan for growth. It would impact the Region's financial sustainability and flexibility over the long term.
- Service enhancements such as infrastructure requirements to achieve increased waste diversion and additional affordable housing to address unmet needs.
- Unanticipated capital work such as emergency watermain repairs.
- Available balance to match Federal & Provincial infrastructure funding.

All of the above risks and pressures require the Region to maintain reserve balances as prescribed in the Region's Reserve Management Policy. This sustains the Region's capital plan and provides flexibility in mitigating the volatility of tax and utility rates.

In addition to maintaining reserve balances to mitigate risk, staff continue to assess and monitor any fiscal pressures on reserves and reserve funds by carrying out the following strategies:

- Ensure service levels are maintained.
- Review service operations and capital infrastructure requirements to meet the changing needs of the community
- Improve processes to identify efficiencies and to prioritize resource allocations
- Utilize external funding whenever possible (examples include Infrastructure Funding, Federal and Provincial Gas Tax funding).
- Explore opportunities to increase revenue (examples include the following):
 - By identifying changes in the development of land use planning; staff have committed to reviewing the fee structure of the applications over the next two years, and;
 - By generating greater financial returns on active investment strategies, staff expect \$6 - \$6.5 million in additional returns in 2019, as reported to Council

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on October 10, 2019 in the report "Establishing a Treasury Risk Appetite Framework".

CONCLUSION

Council's current strategy of funding the Region's capital plan through the one per cent infrastructure levy for tax supported capital as well as infrastructure levy increases for utility rate supported capital have helped to maintain its financial sustainability and flexibility of the capital program.

As indicated in the Long Term Financial Planning Strategy, the reserves are an important factor in the Region's overall financial condition as they impact both Financial Sustainability and Financial Flexibility.

Staff analyses project that capital reserves for state of good repair, service enhancements and growth will not be sufficient to meet the combined \$3.2 billion in funding shortfall associated with the Region's long term capital financing requirements. The proposed 2020 Budget will include capital infrastructure levies for Council consideration.



Stephen VanOfwegen, Commissioner of Finance and Chief Financial Officer

Approved for Submission:



N. Polsinelli, Interim Chief Administrative Officer

APPENDICES

- Appendix I: Rate Stabilization Reserves
- Appendix II: Relationship between Capital Financing and Capital Plan
- Appendix III: Construction Cost Index Trend
- Appendix IV: Reserve Gap Analysis
- Appendix V: Specialty Reserves

For further information regarding this report, please contact Norman Lum @ extension 3567 or via email at Norman.Lum@Peelregion.ca.

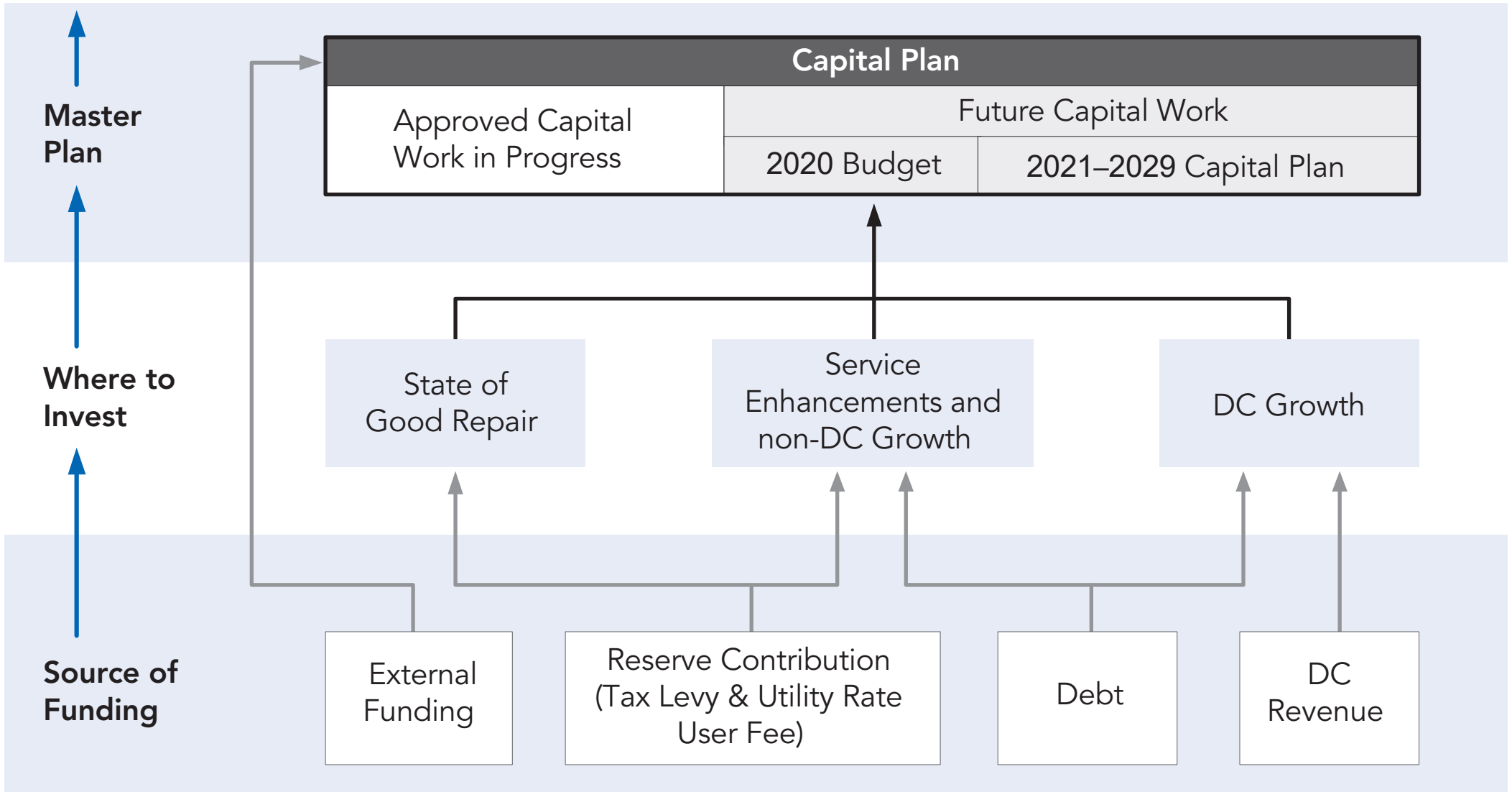
**APPENDIX I
OVERVIEW AND UPDATE ON THE STATUS OF RESERVES**

Rate Stabilization Reserves

	Balance as at August 31, 2019	Status of Reserves as at August 31, 2019
Tax	\$138 million	9.3 % of 2019 Tax Total Operating Budget In compliance with the Reserve Management Policy
Utility Rate	\$44 million	8.3 % of 2019 Utility Rate Total Operating budget In compliance with the Reserve Management Policy

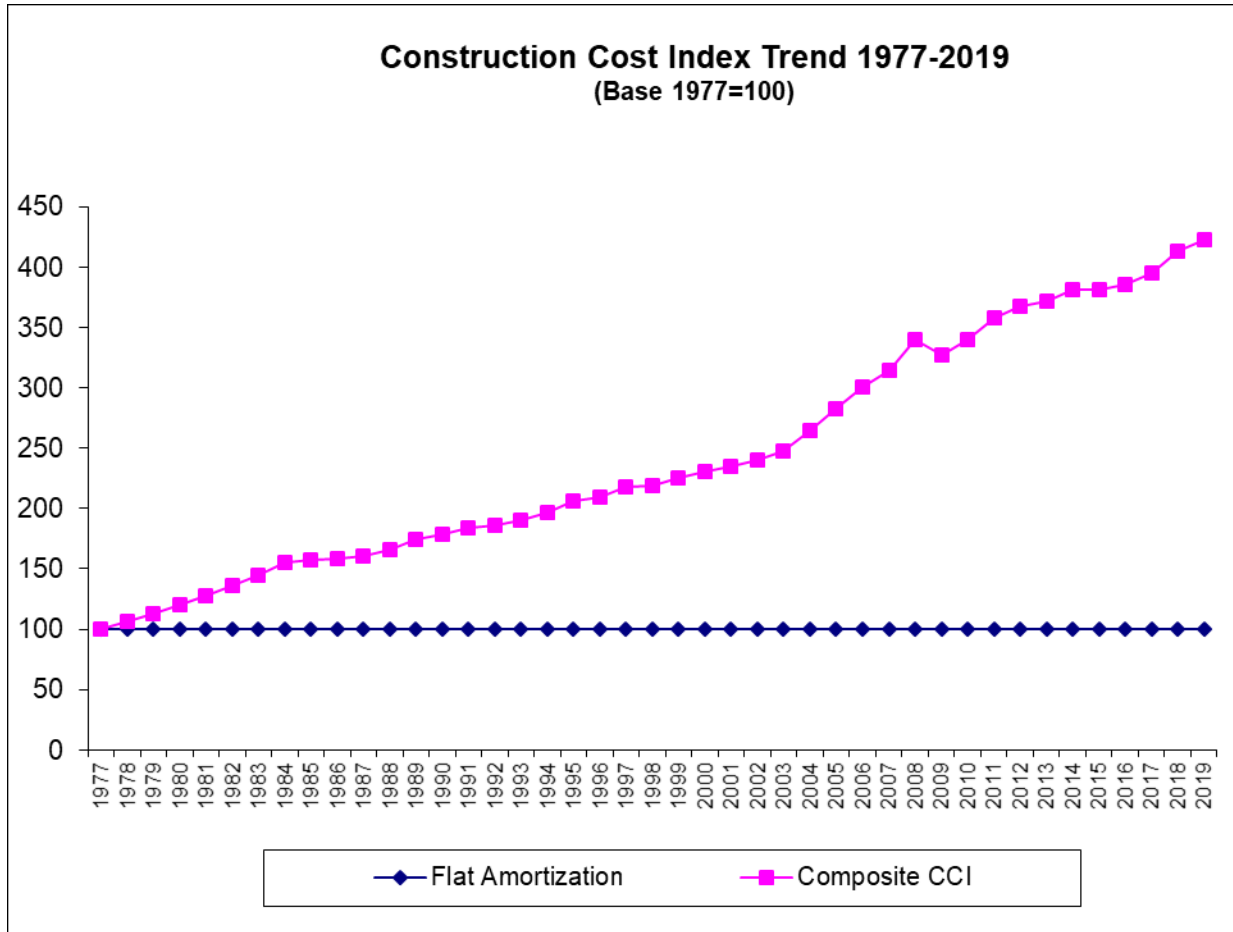
Community for Life

Strategic Plan



APPENDIX III

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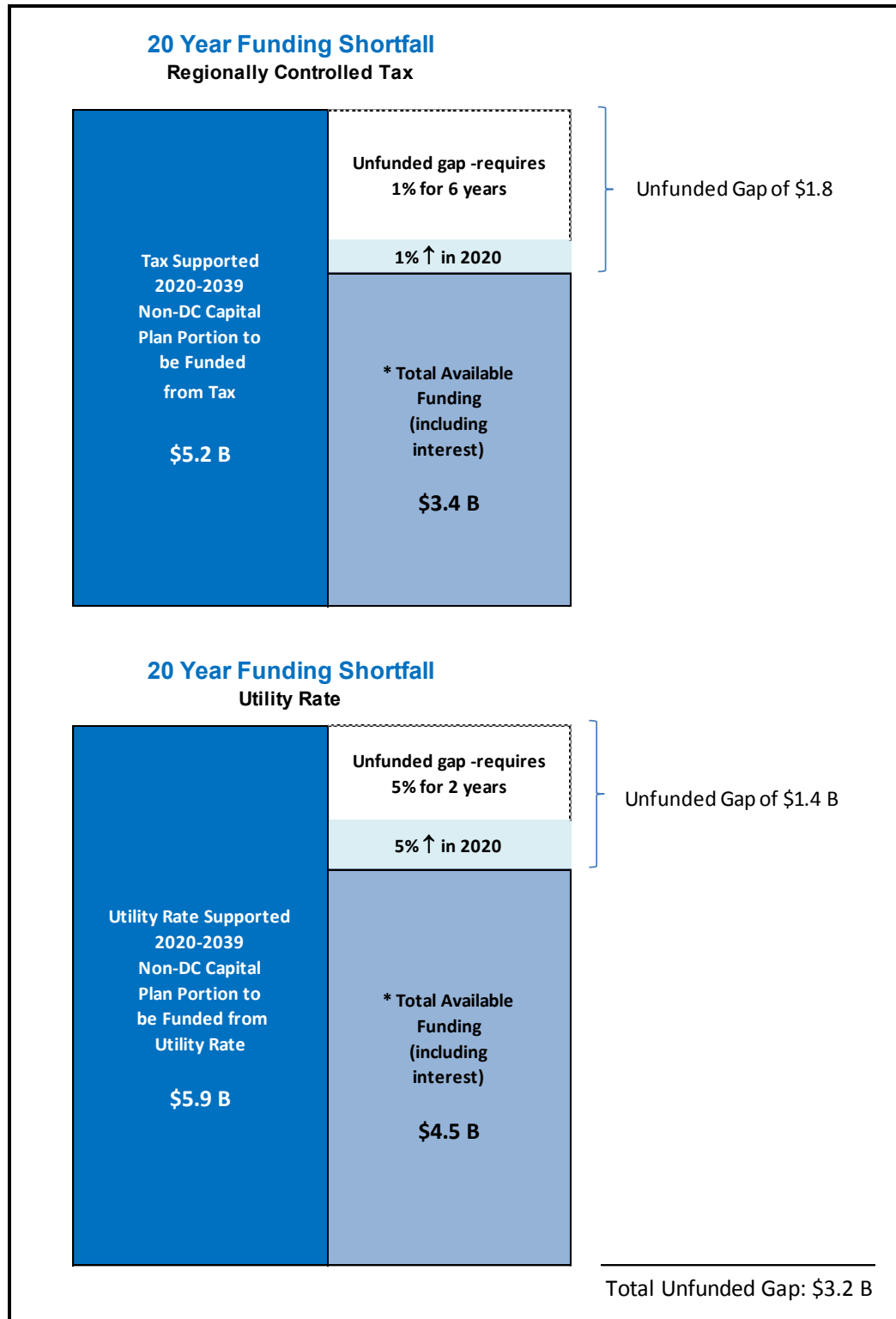


Source: US Department of the Interior, Bureau of Reclamation, Construction Cost Trends

The above chart illustrates the impact of Construction Cost Index (CCI) on an asset that was purchased in 1977 for \$100 thousand. By July of year 2019, the cost to replace the same asset would be \$423 thousand which is 4.2 times higher than the historical cost. The average annual increase over this period was 3.5%.

**APPENDIX IV
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Reserve Gap Analysis



* The available funding comprises of projected opening uncommitted reserve balance in 2020, regular annual contributions, annual estimated interest on reserve balances and council approved infrastructure tax levy and utility rate increases till 2019

APPENDIX V OVERVIEW AND UPDATE ON THE STATUS OF RESERVES

Specialty Reserves

Reserve	Description	Intended Use	Cash Balance August 31, 2019 (\$Millions)	Assessment
R0500	Insurance Stabilization Reserve	To fund any material variances that could adversely impact the Region relating to liability claims or accidental losses.	8.8	Sufficient: Currently held sufficient to reduce the impact of potential unexpected events. Detailed assessment of risk severity and its impact on reserve will be conducted and included in future reporting.
R0520	Administrative Service Only (ASO) Benefit Stabilization	To fund any material unexpected variances in self-insured Extended Health Care (EHC) and Group Life benefit plans	8.3	Sufficient: Currently held sufficient; there is limited impact on reserves due to provision of stop-loss in self-insured EHC and Group plans.
R0880	WSIB Reserve Pensions	To fund the Region's future WSIB liability (self-insured) as determined by the actuaries.	13.9	Sufficient: Reserve balance sufficient to fund current estimate of WSIB unfunded liability at about \$8.5 million.
R1140	Capital Long Term Waste Management Strategy - Energy From Waste Savings	To receive savings from interim landfill operation placed after expiry of third party incineration contract	68.5	Sufficient: Reserve amount will be supplemented by debt issuance to fund 75% 3Rs Target projects approved by Council.
R1919	Housing - Contingency Liability Reserve	To fund the potential gap in the state of good repair reserves faced by affordable housing service providers	84.8	Insufficient : An initial estimate of \$235 million deficit is expected by 2029
R1923	Housing-Advances to Providers	To track loans that the service provider obtains from Region (draw from R1919) that is under \$500 thousand.	0.0*	N/A: Reserve is for tracking of loans issued from R1919; Notional use only, no incremental commitment is expected.
R1924	Housing-Loans to Providers Pre	To track loans that the service provider obtains from Region (draw from R1919) that is over \$500 thousand.	0.0*	N/A: Reserve is for tracking of loans issued from R1919; Notional use only, no incremental commitment is expected.
R1925	Housing- Loan to Providers Post	This reserve is to track repayments which have begun from housing service providers.	0.0*	N/A: Reserve is for tracking of loans issued from R1923/24; Notional use only, no incremental commitment is expected.
R1261A	Human Services Revolving Capital Fund	To support community partner integration and system improvements activities in Human Services Department	0.6	N/A: Reserve is for tracking of loans issued from R1261A; Notional use only, no incremental commitment is expected.
R0221	Capital Finance Stabilization - Greenlands Securement	To provide annual funding of Greenlands capital project which involve securing greenlands by Peel's Conservation Partners	8.1	Sufficient: Currently held sufficient based on recent spending patterns

* Cash balance net of the loan that has been lent out