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REPORT
Meeting Date: 2020-07-23
Regional Council

REPORT TITLE:	**Financial Risk Management Strategy of the Regional Capital Program**
FROM:	Stephen Van Ofwegen, Commissioner of Finance and Chief Financial Officer Andrew Farr, Interim Commissioner of Public Works

RECOMMENDATION

That the proposed capital deferral strategy as outlined in the report from the Commissioner of Finance and Chief Financial Officer and the Commissioner of Public Works, titled "Financial Risk Management Strategy of the Regional Capital Program" be endorsed.

REPORT HIGHLIGHTS

- The COVID-19 pandemic has resulted in a slowdown of the global economy and the start of an economic recession.
- Due to the pandemic and resulting economic downturn, growth is expected to slow in the coming years.
- Given the economic changes and slowing of growth, Development Charge (DC) revenues are expected to be lower than forecast over the next several years and the expected loss of revenue will cause overall cash flow and financial flexibility challenges for the Region of Peel (Region).
- A review of the Region's 2020 capital program is underway to ensure it is aligned with our evolving economic circumstances, protecting the Region's liquidity and reducing cash flow pressures.
- Based on the most recent development data, staff have developed a strategy to defer or slow capital projects based on an assessment of legal risk, safety risks, regulatory requirements, as well as reputational risks to the Region.
- This deferral will offset some of the anticipated near-term financial impacts of COVID-19 and the economic downturn on Peel's future borrowing requirements, while balancing the potential service impacts of not proceeding with the current capital plan.
- Targeting a reduction of capital expenditures of approximately $600M to $700M over next five years to align with growth expectations.
- These measures support the Region's Long-Term Financial Planning Strategy's objectives of maintaining financial flexibility and sustainability while minimizing the potential service impacts through the *Plan and Manage Growth* Council priority.

Financial Risk Management Strategy of the Regional Capital Program

DISCUSSION

1. Background

The Region has been on the frontlines of the COVID-19 crisis. Since the Regional emergency was declared in March, staff have focused on protecting the health of residents and promoting the economic well-being of the people and businesses that make up our community. As the health risks of the virus begin to recede, our focus has now shifted to reopening the economy with an eye towards sustaining services for the residents of Peel.

As a result of the pandemic and subsequent shut down of business and services across the province, a significant portion of the Region's construction is continuing safely but at a slower pace.

A Capital & Construction Task Force was established early as part of the Regional Emergency Operations Centre to address the impacts of the pandemic on the Region's capital program. In the early part of the emergency, the task force addressed Provincial orders related to construction and health and safety matters, ensuring compliance and safety of staff, contractors and the community. Most of the Region of Peel's capital initiatives were deemed essential and have continued, but at a slower pace as the industry adopts physical distancing requirements given the provincial construction guidelines.

As the emergency progressed, and the implications of the pandemic began to be realized, the task force was mandated to review the financial and program risks of the capital program with a focus on cash flow and the Region's borrowing program. It is assumed that 2020 property and utility revenue will be collected therefore 2020 reserve funded projects will continue – this will be reviewed again as part of the 2021 budget.

Development Charge growth infrastructure relies heavily on the development charge revenue collections as the primary funding source. This report will provide an assessment of the impacts of COVID-19 and the economic recession on Peel, and the resulting risks to the DC funded capital program, both from a service and financial perspective

2. Analysis and Findings

(a) Financial Impact of Change in Growth Projections

Over the past five years, the Region has narrowed the DC revenue and expenditure gap by aligning growth requirements to expenditures. This has resulted in lower debt issuance than expected based on the 2015 DC Background Study. As a result of the pandemic and impacts on the economy, expectations for growth within the Region have changed. In collaboration with demographic and real estate experts (Cushman and Wakefield, Hemson Consulting Limited) staff arrived at the following conclusions:

- Although recovery is expected to begin immediately following the emergency, growth is not expected to return to pre-recession levels until after 2024.
- Single and semi-detached units expected to experience the greatest residential impact in the short and medium term.
- Retail sector expected to be most significantly impacted in the non-residential sector, followed by office with industrial least impacted.

- Impacts vary across each local municipality, depending on the residential unit type and employment projected.

Due to the changes to the growth projections and the resulting impact on development within Peel, staff reviewed the impact to DC revenues, incorporating the Region's experience during the 2008/2009 financial crisis. It is estimated that the DC collection for the fiscal periods 2020 to 2024 are projected to be approximately $600 million to 700 million less than forecast compared to the 2015 DC Background Study. It is assumed that revenues will start to recover in 2022 and return to the previous levels of development growth after 2024.

Based on an analysis of the adjusted DC revenues and projected expenditures over the period 2020-2024, if the capital program proceeds as originally planned prior to the COVID-19 crisis and the subsequent recession, additional debt requirements would reduce financial flexibility and put increased pressure on the Region's credit rating. Prior to the recession, to build out infrastructure to support future growth, Peel expected to issue $1,500 million of debt. This was manageable and did not pressure the Region's financial flexibility.

With the recession and lower expected DC revenue, the additional debt financing for a revised total of $2,100 million would put the Region's financial flexibility and credit rating at significant risk. This creates significant financial risks to the Region increasing cash flow pressures to service debt in future years.

(b) Impact on Service Levels

Given the projected reductions in DC revenue and having an early understanding of how the COVID-19 pandemic may affect the development industry, staff reviewed current capital projects planned within the approved capital budgets and their impact on service levels. Staff considered both projects in progress and those identified in the 10-year capital plan.

The deferral strategy carefully considered many current capital program areas across the Region, but focused primarily on key program areas in water, wastewater and transportation, which represent more than 95 per cent of DC related expenditures.

Service level impacts were compared against the potential to defer projects. Where impacts were low to moderate, staff deferred servicing projects. Some of the deferred projects had already reached a stage where the design was complete and the project was ready to tender.

As part of the strategy, staff maintained a status quo investment approach on projects where capacity challenges have higher risk and where service level impacts would be excessive. As an example, a companion report is included in the July 9 Council agenda for one such project. This report recommends additional funding for the G.E. Booth Wastewater Treatment plant expansion to support the Inspiration Lakeview development.

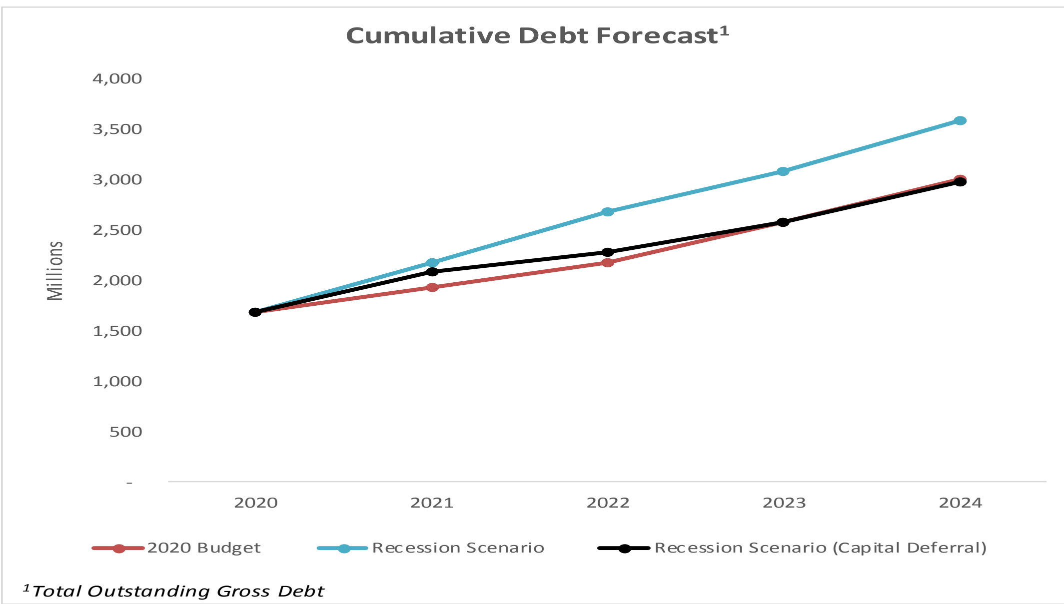
Additionally, staff has noted that overall production rates for construction have been reduced due to the need to abide by new provincial health and safety guidelines. A process to monitor the implications of such is considered in the strategy.

3. Capital Review Strategy

The primary objective of the capital review is to ensure the Region's capital program is aligned to our evolving economic circumstances and the principle that "growth pays for growth." Mitigating the risks of the evolving economic circumstances will enable staff to protect the Region's liquidity and reduce cash flow pressures.

Based on the analysis, and the long-term impact to the Region's financial flexibility and sustainability, staff developed a strategy to re-position project timelines to more closely match post-COVID-19 growth needs and DC revenues. Staff propose a multi-year deferral strategy to more closely align adjusted growth projections to expenditures. This will reduce DC cash flow pressures as DC revenues begin to recover while mitigating the potential service risks of not proceeding with the current capital plan.

Based on current projections, staff propose targeting a reduction of capital expenditures of approximately $600 million to $700 million over the next five years to align with growth expectations and DC revenue forecasts. These measures support the Region's Long-Term Financial Planning Strategy's objectives of maintaining financial flexibility and sustainability while minimizing the potential service impacts through the *Plan and Manage Growth* Council priority.



Timelines for on-going projects required to meet present servicing requirements and service levels based on growth that has already occurred remain the same, as do ongoing construction activities. A summary of deferred program areas and deferral timelines is as follows:

Capital Program	Program Area	Deferral Timing	Capital Budget Deferred
Water	Facilities (pumping stations and reservoirs)	1-year	$55M
Water	Linear Pipelines	1-year	$374M
Wastewater	Linear Pipelines	1-2 years	$135M
Wastewater	Inflow & Infiltration – Diversion and Local Improvement	1-2 years	$45M
Transportation	Road Improvements	1-2 years	$205M

The table summarizes multiple underlying projects within the program area to achieve the deferred capital budget. Estimated cash flow deferrals for 2020 are $65M. The deferred projects in the program areas will assist in reducing annual cash expenditures in 2021-2024 through the 2021 budget process.

The review will be revisited on a regular basis in order to reflect changes in the development outlook and consequently DC revenue collections. Staff recommend that the capital programs be aligned to meet the projections and should growth trend upwards or downwards, or should additional population and employment be allocated to Peel, the Capital Plan will be re-evaluated, and the construction budgets of needed infrastructure will be advanced or deferred further.

The iterative process will also monitor to ensure that savings associated with deferrals of capital works are not offset by increased costs elsewhere (such as state of good repair costs). This ongoing adjustment exercise will be essential throughout the economic recovery. In addition, a variety of information will be re-evaluated regularly to inform decisions about further project deferral or advancement, such as factors that impact project delivery (e.g. status of land acquisitions), service levels, legislative requirements, coordination with local municipalities and state of good repair requirements.

On June 22, staff consulted with the Peel BILD Chapter discussing various inputs into this report; namely the growth forecasts and community planning analysis in relation to impacts on the Region's capital program. There is a commitment to continue discussions with the Industry and further explain staff's rationale and decision-making principles that balance expectations to deliver infrastructure in a timely manner without taking on undue financial risk. Additional consultation has been scheduled throughout the summer and input will be considered and brought forward in future reports.

Cash flow estimates beyond 2020 have reduced certainty and will require continual review on a regular basis to ensure accuracy. Staff recommend that capital projects continue to be advanced, namely staff complete design work to bring projects to a "shovel ready" state in order to be ready for growth related changes and possible economic stimulus funding. As design activities typically represent 5-10% of the cost of a capital project, this approach allows staff to respond quickly to development related changes without incurring significant financial risk.

RISK CONSIDERATIONS

With the recession and lower expected DC revenue, the additional debt financing for a revised total of $2,100 million would put the Region's financial flexibility and credit rating at significant risk. This creates significant financial risks to the Region increasing cash flow pressures to service debt in future years.

The proposed mitigation strategy aims to align capital program spending with lower than expected DC revenues while addressing the financial and service risks of deferring capital projects.

A common set of risk criteria were used to review each project including:

- Legal risk
- Safety risk
- Regulatory compliance risk
- Service level risk
- Reputational risks to the Region.

Deferred projects will increase in cost over time (inflation, property costs, etc.), and take longer to complete if construction guidelines related to COVID-19 continue or become more stringent.

The deferral strategy may also place additional pressure on existing infrastructure. This includes both stressing infrastructure beyond its capacity or beyond its life cycle. To mitigate these risks, staff will closely monitor asset condition, service level impacts and capacity utilization over time to reduce potential impacts. As an example. deferral of some program area work such as Inflow and Infiltration projects may result in basement flooding during significant rainfall events until such time as deferred projects are advanced to construction.

The intent of the deferral strategy is that no specific in-progress development be delayed. It is therefore acknowledged that some deferred projects may subsequently need to be advanced once the true pace of development is known over the next year or two.

FINANCIAL IMPLICATIONS

At this point, there are no financial implications to the DC reserve fund as the proposed strategy mitigates the risk to the reserve fund. There are also no implications to the capital reserves at this point.

Not proceeding with the proposed deferrals could risk increased debt which, if left unchecked, could eventually impact liquidity, pressuring the Region's strong credit ratings. This could lead to future credit rating downgrades, resulting in increased financial risks for the Region.

CONCLUSION

Strategic deferral of capital projects is the recommended approach to address a projected slowdown in development growth post-COVID-19. Although there are servicing risks, staff believe the decreased risk to Peel's financial flexibility deems the deferrals necessary.

For further information regarding this report, please contact Julie Pittini, Director, Treasury Services, Ext. 7120, julie.pittini@peelregion.ca.

Reviewed and/or approved in workflow by:

Department Commissioners and Division Directors.

Final approval is by the Chief Administrative Officer.

Nancy Polsinelli

N. Polsinelli, Interim Chief Administrative Officer

Risks to the Capital Program and Financial Flexibility from COVID 19

Adrian Smith, Interim Chief Planner and Director of Regional Planning and Growth Management

Anthony Parente, (Acting) General Manager, Water/Wastewater

Julie Pittini, Director, Treasury Services

July 23, 2020

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Overview

- Impact of COVID-19 on:
  - planning and growth
  - development charge revenues
- Capital program and service level risks
- Risks to cash flow and financial flexibility
- Actions to mitigate risks
- Summary

Growth Expected to be Slower

Assessing Development Impacts

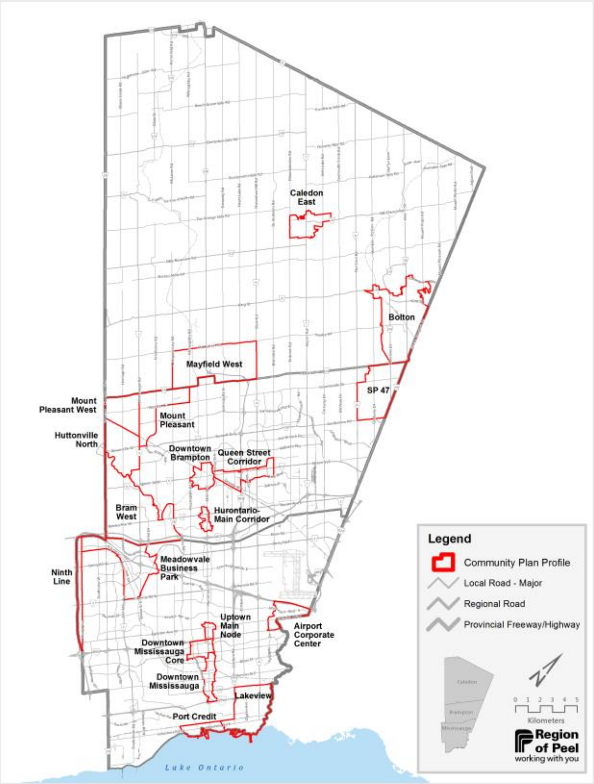
Growth Forecast

CUSHMAN & WAKEFIELD — *Potential Impact Of Covid-19 Crisis On New Non-residential Development In Peel Region*

HEMSON — *Residential and non-residential unit / floor space growth forecasts, 2020–2030*

- Recovery beginning 2021 with growth normalizing to pre-recession levels after 2024
- Single and semi-detached units to experience the greatest impact
- Retail sector to be most significantly impacted (reduced by 14 to 34%) followed by office (reduced by 7-24%) with industrial least impacted (reduced by 2-15%)
- Local municipal impacts vary depending on residential unit type and employment type

Community Level Analysis



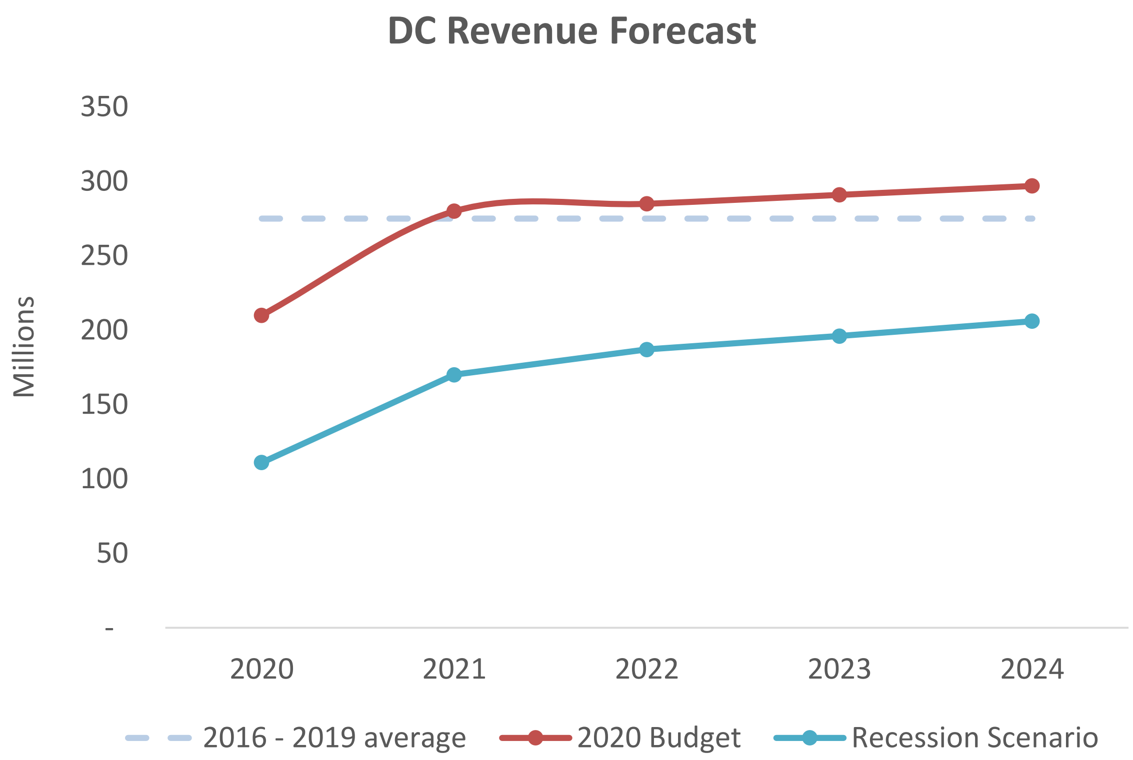
150 Total Community Planning Areas in Peel

20 Community Planning Areas selected in this review

- Non-residential growth is at risk of not meeting forecast target
- Designated greenfield areas are trending below forecast, while built-up areas are more closely aligned with forecast

Impact of COVID

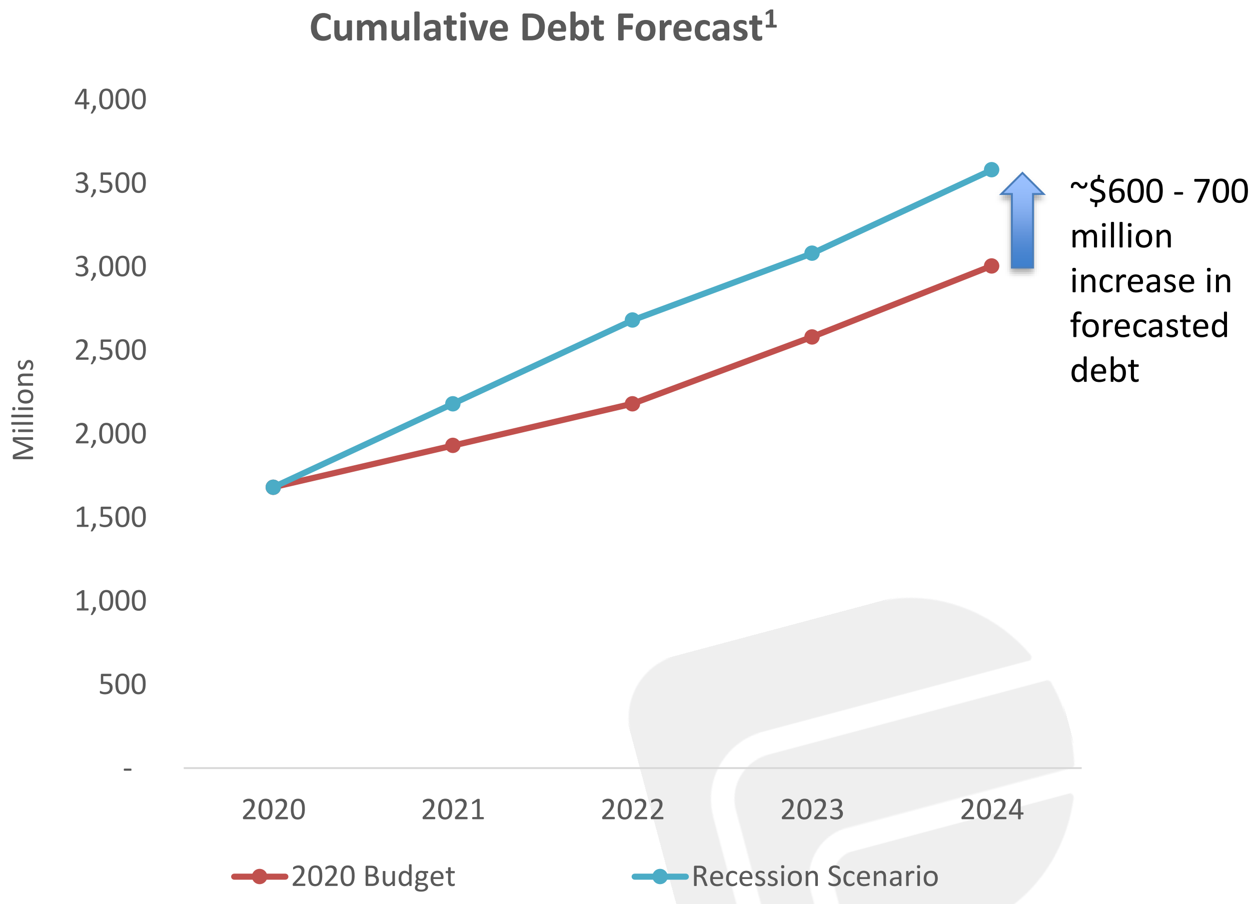
Forecasted Decrease of $600-700 million in DCs



- Reduced DC revenues due to impacts of COVID-19 – $600-700M reduction from 2020-2024
- Impact more significant in 2020 and 2021
- Revenues expected to normalize to pre-recession levels after 2024

Financial Flexibility Risks

- With no change to planned annual expenditures, coupled with lower DC revenues increases debt requirements
- Pressure on cash flows
- Increased debt requirements reduce financial flexibility and sustainability
- Pressure on the Region's Triple A credit rating



[1]*Total Outstanding Gross Debt*

Impact of COVID

Aligning Spending to the DC Forecast

- Took an in-depth look at what could be deferred without impacting the community
- Aimed for a balance between financial need and service risk
- Will continue to closely monitor growth and infrastructure and adapt deferrals to suit

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Capital Program Risks

RISKS of current deferral strategy

1. Plan assumes that some development ***will*** be delayed.
2. Deferrals may result in existing infrastructure operating close to, or above capacity.
3. Some deferrals allow for "just in time" delivery
4. Some key strategic improvement work will be deferred ex. *Inflow and Infiltration*
5. Coordination with local municipalities requires review

Any additional deferrals ***could*** lead to:

- Service level impacts which are not acceptable
- Requiring a cancelation of active construction projects

Summary

- Staff propose expenditure reduction of $600-700M between 2020-2024 to align to expected DC revenues and reduce impact on debt
- Overall objective is to maintain the Region's financial flexibility and ensure growth pays for growth
- Capital review will be revisited regularly as more information is obtained on economic recovery

Questions