

2016 Reserves & Reserve Funds Report

EXECUTIVE SUMMARY:

The purpose of this report is to provide Council with an overview of the balances in the reserve and reserve funds at December 31, 2016.

Overall, the consolidated reserve and reserve funds have decreased \$5.4 Million from \$166 Million to \$160.6 Million during 2016.

In summary, the following are the highlights:

(in millions)	2016
Balance: January 1, 2016 (non consolidated)	\$164.9
Add: Interest	2.8
Less: Net transfers from Operating	2.5
Net transfers to Capital	(11.0)
Balance: December 31, 2016	159.2
Add: Reserves of Consolidated Entities	1.4
Balance: December 31, 2016 (consolidated)	\$160.6

The non consolidated balances consist of:

(in millions)	2015	2016
Reserves	8.2	7.1
General Reserve Funds	58.1	54.3
Capital Financing and other Capital Reserve Funds	98.6	97.8
Total Reserve and Reserve Funds	\$164.9	\$159.2

BACKGROUND:

Please see Appendix A for tables illustrating the trends in reserve and reserve funds over the past five years.

Please see Appendix B and C which provides a more detailed explanation of each of the City's reserves and reserve funds as well as examples of projects within the committed balances at the end of 2016.

Reserves and reserve funds are generally set aside for significant future purchases, to replace major capital infrastructure, are accumulated to meet a growing future liability, or are simply accumulated to provide a buffer for significant unanticipated

expenditures beyond the control of Council.

The main difference between a reserve and a reserve fund is that a reserve does not earn interest, whereas a reserve fund is in a separate fund and is credited, on a monthly basis, with the interest it has earned.

As outlined in the BMA study, reserves and reserve funds are a critical component of a municipality's long-term financing plan. The purpose for maintaining reserves, as outlined in the report, is to:

- Provide stability of tax rates in the face of variable and uncontrollable factors (consumption, interest rates, unemployment rates, changes in subsidies)
- Provide financing for one-time or short term requirements without permanently impacting tax and utility rates
- Make provisions for replacements/acquisitions of assets/infrastructure that are currently being consumed and depreciated
- Avoid spikes in funding requirements of the capital budget by reducing their reliance on long-term debt borrowings
- Provide a source of internal financing
- Ensure adequate cash flows
- Provide flexibility to manage debt levels and protect the municipality's financial position
- Provide for future liabilities incurred in the current year but paid for in the future

Reserves offer liquidity which enhances the municipality's flexibility, both in addressing unplanned operating requirements and in permitting the municipality to temporarily fund capital projects internally. The level of reserves and reserve funds is a key measure of the financial health of a municipality. Compared to other municipalities in Ontario, the City is below the median as it pertains to reserves and reserve funds as a percentage of total taxation, as identified in the 2016 BMA municipal study which is based on statistics for 2015. The ratio used is total reserve and reserves funds (excluding water/wastewater) as a percentage of taxation revenues. In 2015, 39 of 102 participants in the study have a lower percentage than Sudbury. The results across the survey range from a low of -5% to a high of 207% in 2015. In 2015, the City increased to 57% from 54%.

2016 Reserves and Reserve Fund Balances

The reserve balance as of December 31, 2016 of \$159.2 million includes \$7.1 million in reserves, \$54.3 million in general reserve funds and \$97.8 million in capital financing reserve funds. The 2015 reserve and reserve fund balances included \$8.2 million in reserves, \$58.1 million in general reserve funds and \$98.6 million in capital financing and other capital reserve funds for a total of \$164.9 million. The primary difference between the 2016 forecast and actual year end results are the delay in spending funds set aside (or "committed") for capital projects as these are completed over several years and estimated spending was based on the budgeted amounts.

Of the total balance of \$159.2 million, there are reserves and reserve funds which are included in a "committed" reserve fund for a specific project or program which accounts for approximately \$96.3 million. Refer to Appendix B and C which provides additional information on these committed reserve funds.

The annual operating and capital budgets as approved by Council include draws from reserves and reserve funds in order to fund various expenses such as capital projects which are completed over several years or funds set aside for significant capital projects to be completed in the future, or deductibles for insurance claims, sick leave payouts and so on.

The funds remain in committed reserve funds as approved by Council in the annual budgets (or supplemental Council reports throughout the year) until the expenses have been paid, which may occur over several years. Any capital projects that have reserve funds identified as a funding source that are cancelled at a later time, would be uncommitted in order to use for future capital projects/expenses or used to fund over-expenditures in other capital projects in accordance with the Capital Budget Policy.

By-law

By-law 2015-9, being the by-law to establish and continue reserves, reserve funds and trust funds, is reviewed on a periodic basis and recommendations to establish, discontinue or consolidate reserves are brought to Council for approval, and for authority to amend the By-law.

Trust Funds

Trust funds are not included in this report. Trust funds are monies of others, being held in trust by the City, for specific purposes. The money is spent on the intended purpose or returned to the original source. Examples of trusts are the cemetery trust where money has been received and is held in trust to ensure perpetual care and maintenance of the cemeteries, or the funds belonging to residents of Pioneer Manor being held in trust for them.

Deferred Revenue - Obligatory Reserve Funds

Obligatory Reserve Funds are not included in this report as they represent deferred revenues also known as unearned revenue. Deferred revenues represent funds received from others for specific projects for which the actual costs or spending of these funds for the specific projects have not occurred as of a point in time.

The balance as at December 31, 2016 was \$43.5 million, up from \$36.6 million in 2015. Deferred Revenue - Obligatory Reserve Funds, that by nature of the revenues received, involve restrictions on their use and are not available for the discretionary use of Council. The Obligatory Reserve Funds includes Federal and Provincial Gas Tax Revenues, various deposits (ie. parks, asphalt, etc) relating to subdivisions and site plan agreements, Building Permit Revenues and Development Charges collected but not

earned. The increase mainly relates to spending on capital projects funded with Federal Gas Tax Revenues due to timing of capital expenditures (ie. Lorne Street). In addition, there are development charges collected but not earned due to the timing of the capital projects such as the Fire/EMS Station Development and the Police Headquarters Expansion. Lastly, there is an addition of \$1.6 million for the Social Housing Apartment Retrofit Program (SHARP).

As mentioned above, development charges (DC) collected are included in an obligatory reserve fund by each service area as outlined in the 2014 DC background study. The general purpose of development charges is to fund the growth related portion of capital projects. However, the development charges collected does not cover the full cost of growth through several exemptions as per the DC Act as well as the City's DC By-Law. Therefore, if reserve funds are insufficient, it will require other funding sources for the difference such as reprioritization/delay of capital projects, obtain external debt, or impact on the annual tax levy (to generate additional funds for specific projects and/or for annual debt repayments).

Reserve Fund Guiding Principles

The following are the guiding principles that the City has considered since amalgamation in order to ensure proper financial planning related to important service related capital assets and liabilities.

1. Plan for the replacement of infrastructure through the use of life cycle costing and the development of replacement reserves.
2. Undertake regular reviews of remaining life and condition of assets and determine required annual reserve contributions sufficient to ensure that 90% of approved infrastructure rehabilitation / replacement schedules can be met at the required time.
3. Facility, equipment and infrastructure replacement reserves should be established and funded to ensure that 90% of approved infrastructure rehabilitation / replacement schedules are met (long-term).
4. Establish a Stabilization Reserve for programs that are susceptible to significant annual expenditure fluctuations (ie. Winter Maintenance). Program budgets should be based on a moving five year historical average of program spending. In years when surplus funds occur in these programs, surpluses should be reserved, provided an overall City surplus exists. Where the City's overall surplus is less than the program surplus, funds should only be reserved up to the level of the overall City surplus.
5. Establish reserves to provide funding for future liabilities (ie. sick leave, post-employment benefits, WSIB). Contributions to these reserves should be set, at a minimum, at an amount sufficient to ensure the liability does not increase.

The City needs to address these guiding principles through the establishment of and continuation of increased funding for reserves, especially in terms of recent studies completed such as the Asset Management Plan and Long Term Financial Plan.

Long Term Financial Plan

The Long Term Financial Plan prepared by KPMG and presented to Council in April 2017 further stressed the importance of establishing appropriate reserve and reserve fund balances to achieve the following financial principles: long-term sustainability; and appropriate funding for services. Long-term sustainability is to ensure that the City considers long-term implications in relation to financial decision making and to ensure that there are sufficient sources of funding to achieve the City's role and responsibility over the long-term. Appropriate funding for services is meant to ensure the City's approach to financing services for long term investments and liabilities reflect a fair allocation of costs to residents based on (i) usage; and (ii) ability to pay and that the City's funding will be consistent with the timeframe of the expenditure.

Specifically, the long-term financial plan recommends the following change relating to reserve and reserve funds:

"While the City has established minimum and maximum amounts for some reserve and reserve funds, consideration could be given to undertaking a detailed reserve and reserve fund review that will establish minimum amounts for all reserve funds so as to ensure the sufficiency of these funds. This review would include a reevaluation of reserves and reserve funds where minimum and maximum amounts have already been established."

This plan also reviewed the financial indicator of "total reserves and reserve funds per household". This financial indicator "provides an assessment of the City's ability to absorb incremental expenses or revenue losses through the use of reserves and reserve funds as opposed to taxes, user fees or debt. Low reserve levels are indicative of limited capacity to deal with cost increases or revenue losses, requiring the City to revert to taxation or user fee increases or the issuance of debt". The City has been shown to be at the low end of the recommended range; however there are potential limitations with this indicator as the City has a significant amount of reserves and reserve funds committed to specific projects or purposes and may not necessarily be available to fund incremental costs or revenue losses. As reserves are not funded, the City may not actually have access to financial assets to finance additional expenses or revenue losses.

Asset Management Plan

The Asset Management Plan identified a total of \$3.1 billion of tangible capital assets that are at, or will reach, the end of their useful lives within the 10 year planning horizon of the long-term financial plan. The long-term financial plan included a capital levy as a potential financial strategy as the financial model forecasted \$1.4 billion in capital expenditures over the next 10 years, resulting in a shortfall of \$1.7 billion.

The capital levy financial strategy was explained in the long-term financial plan as follows:

"Practically, the City will be unable to generate the necessary level of incremental funding for capital expenditures due to constraints from an affordability and debt capacity perspective. However, in order to ensure sufficient financing for future capital expenditures, the City may wish to consider expanding the level of available capital funding through the implementation of a multi-year capital levy. Similar to the 10 year series of water and wastewater rate increases implemented by the City in 2001, this strategy would involve a recurring increase in the City's budget specifically allocated to capital purposes, including capital expenditures, debt servicing costs or reserve fund contributions."

A capital levy should be considered in future budgets to balance with existing pressures on the tax levy. During 2017, the City will be hiring an Asset Management Coordinator, as approved by Council as part of the 2017 Budget. This position will lead the process of obtaining asset condition information to assist with the prioritization of capital projects and the allocation of capital envelopes.

Overall, the asset management plan illustrates the shortfall in tax levy funding needs for renewal / replacement requirements of our capital assets. The ability for the City to maintain and grow its reserve funds for future renewal / replacements are important to minimize the annual impact on taxpayers.

CONCLUSION:

Although this is a routine, annual report on reserve and reserve fund balances, staff are making renewed efforts at enterprise wide, long term asset management and impacts on both the capital budget and reserve and reserve fund policy. It is anticipated that this work will lead to an enterprise wide approach to capital budgeting and to fewer department and program specific reserve funds as staff address the most critical needs among intense capital financing pressures the City will be facing over the next five to ten years. Therefore, it is recommended that the City continue to implement and foster prudent reserve and reserve fund policies.

In addition, it is important that reserves and reserve funds are maintained in the event that unanticipated expenditures are incurred or if revenues are not received in order to minimize impact on future property tax levy rates.