

Type of Decision								
Meeting Date	October 24, 2017				Report Date	October 12, 2017		
Decision Requested	X	Yes		No	Priority	X	High	Low
	Direction Only				Type of Meeting	X	Open	Closed

**Performance Audit of the
Capital Budgeting Process**

Resolution	Relationship to the Strategic Plan/Health Impact Assessment
<p>THAT the City of Greater Sudbury endorses the recommendations as outlined in the report entitled "Performance Audit of the Capital Budgeting Process" from the Auditor General, presented at the Audit Committee meeting on October 24, 2017.</p>	<p>This report supports the strategic objectives of providing responsive, fiscally prudent, open governance and sustainable infrastructure.</p>
Resolution Continued	Background Attached


Report Summary

While Finance staff has taken a number of positive steps in recent years to review and update the City's financial plans, including the development of an asset management plan and a long term financial plan, this audit determined that key links from these plans to the capital budgeting process are missing. To ensure financial sustainability, the capital budgeting process also needs to be more closely tied to the City's core services and integrated with the enterprise risk management program.

Financial Implications

This report has no financial implications.

Recommended by the Auditor General



Ron Foster
Auditor General

Performance Audit of the Capital Budgeting Process

October 12, 2017
FINAL REPORT



Objectives

The objectives of this audit were to:

- Review the capital budgeting process to understand its relationship to other financial planning processes within the City;
- Assess the effectiveness of the capital budgeting process to manage the City's tangible capital assets and associated risks; and
- Recommend improvements to the capital budgeting process.

Background

This audit was requested by Finance staff which sought an independent assessment of the existing capital budgeting process following the approval of the recent asset management plan which identified a number of significant concerns with the age and remaining useful service lives of the City's tangible capital assets.

A number of changes to the current capital budgeting policy, envelope system and project prioritization process are being examined by Finance staff for implementation in 2019. These changes are part of a broader review of major financial planning processes that was initiated by Finance staff in 2016 to update the City's long-term financial plan. Further revisions are anticipated as Finance staff move forward with implementation of asset management and enterprise risk management programs and the development of policies to support the long-term financial plan which was approved by Council in April 2017.

Introduction

Capital budgeting in the City of Greater Sudbury is coordinated by Finance but is a decentralized process. The capital budget policy provides authority for capital envelopes which are funding packages assigned to each department from the annual operating budget or tax levy. These envelopes are increased annually by the greater of 2% or the Non-Residential Building Construction Price Index. Separate capital envelopes are established for water and wastewater projects and are funded by user fees.

The capital budget is a one-year plan for the acquisition, rehabilitation or replacement of tangible capital assets and significant annual repairs or special projects and includes a four-year outlook on future capital projects. This budget identifies the cost of each capital project and the source of funding including the capital envelopes, reserve funds, government funding, external debt financing, internal future financing and third-party recoveries.

Capital Envelopes in thousands (\$000)

Year	Total Amount of Capital Envelopes*	Total Amount of Capital Budget*
2014	66,882	94,381
2015	58,495**	109,048
2016	60,292	106,294
2017	64,824	222,001

*Excluding HCI Funds

**Decrease in the capital envelopes in 2015 was due to the external debt for the Bio-Solids Facility and Transit/Fleet Garage which resulted in a reallocation of capital envelopes to the operating budget to fund external debt repayments.

Between 2014 and 2016, the total capital budget averaged approximately \$104 million. In 2017, the total increased to approximately \$222 million as the City received \$89 million of funding from the upper tiers of government for a number of roads, water and wastewater and transit capital projects.

The first stage of the capital budgeting process is the preparation of the annual capital budget by operational staff and respective Executive Leadership Team member. The next stage is the review of the capital budget by the Executive Leadership Team to ensure it addresses significant needs. The final stage includes a review of the capital budget by the Finance and Administration Committee, potential adjustments, and then the approval of the annual capital budget by this Committee and Council.

Scope

The scope of this audit included the capital budgeting process for the 2014 to 2017 fiscal year as well as the recent Asset Management Plan and Long-Term Financial Plan developed by KPMG.

The scope also included a review of best practice literature from the Association of Municipalities of Ontario, Federation of Canadian Municipalities and Government Finance Officers Association as well as benchmarking with the Cities of Guelph, Kingston, Barrie, Windsor, Halifax, Mississauga, Edmonton and Fort Lauderdale for their approaches to the capital budgeting process.

Report Highlights

Finance staff has taken a number of positive steps in recent years to develop an asset management plan and update the long-term financial plan. In April 2017, Council directed staff to review the findings in the long-term financial plan and recommend policy changes to Council. In anticipation of changes, staff requested an independent audit of the capital budgeting process.

This audit determined that the City's current capital budgeting process is not effective. It is not integrated with the City's asset management plan and long-term financial plan. The capital envelope system does not provide sufficient funding to maintain or replace the City's aging tangible capital assets. Capital projects are also not prioritized using a common approach within different departments, so projects that facilitate the delivery of core services and respond to risks are deferred every year.

As a result of the above weaknesses and other factors, an infrastructure funding gap of \$1.9 billion had arisen by the end of 2016. This gap will grow to \$3.1 billion by the end of 2026 unless staff moves forward with plans to align the annual capital budgeting process with the long-term financial plan, asset management plan, enterprise risk management program and debt management policy.

Audit Standards

We conducted our audit in accordance with Generally Accepted Government Auditing Standards (GAGAS). Those standards require that we adequately plan for the audit; properly supervise audit staff; obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions; and prepare audit documentation related to the planning, conducting, and reporting for each audit. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit.

For further information regarding this report, please contact Ron Foster at the City of Greater Sudbury at 705-674-4455 extension 4402 or via email at ron.foster@greatersudbury.ca

OBSERVATIONS AND ACTION PLANS

1. Capital Budgeting Process

During the annual capital budgeting process, insufficient funding is allocated to the capital envelopes to maintain the City's tangible capital assets which have an estimated replacement cost of \$7.2 billion. Funding levels for the reserves also do not cover the replacement costs of these assets. As a result, the City will be required to issue debt or employ alternative financing techniques to replace its aging tangible capital assets which have deteriorated significantly over the years. Unless steps are taken to extend their lives, over 40% of these assets will be approaching the end of their useful service lives over the next 10 years.

According to KPMG, an estimated infrastructure funding gap of \$3.1 billion will exist by 2026. Approximately \$1.9 billion is required to replace the tangible capital assets that are presently operating beyond their useful lives and an additional \$1.2 billion of investment will be needed by 2026. To address these gaps, KPMG recommended that the City implement a 2% special levy, rationalize its service levels and tangible capital assets and use debt to finance major capital projects.

Our audit indicated that the funding gap has been growing for some time because of insufficient funding of annual capital budgets relative to current levels of service. Despite periodic as well as small annual increases to capital budgets, the City's tangible capital assets have continued to age and deteriorate to the point that higher taxes and debt are likely required to maintain the City's current level of services.

Our analysis indicated that raising taxes via a special annual levy is unlikely to raise sufficient funds to meet the \$3.1 billion of infrastructure funds that KPMG projected would be required by 2026. As shown below, less than one tenth of the required funds would be raised by a 2% annual special levy. Given the size of this funding gap, raising taxes and issuing debt or employing alternative financing techniques such as public private partnerships to replace the City's aging assets will not resolve this growing problem on their own.

Special Levy	10 Years	20 Years	30 Years	40 Years
2%	0.30 billion	1.28 billion	3.17 billion	6.28 billion

Unless the City experiences significant growth in the future or receives significant funding assistance from the upper tiers of government, it will be unable to replace all of its tangible capital assets at the end their useful service lives. To ensure financial sustainability, steps must be taken to develop formal asset management programs, rationalize capital assets and service levels, and shift funding from operating to capital budgets. These steps will align the annual capital budgeting process with the long-term financial plan and asset management plan.

Recommendations:

1. Continue to seek additional funding from upper tiers of government to address the City's infrastructure funding requirements;
2. Continue to move forward with plans to develop a financially sustainable asset management program to rationalize the City's tangible capital assets and manage their lifecycle costs more effectively;

3. Identify options to increase the capital budget to help address the \$3.1 billion of infrastructure funding requirements that were identified by KPMG in the City's asset management plan;
4. Initiate a core service and service level review program to rationalize service levels to allow funding to be directed from operating budgets to capital budgets;
5. Examine the potential merits of using alternative financing strategies such as public private partnerships when planning for the replacement of the City's aging tangible capital assets; and
6. Require business cases to be prepared for all new infrastructure projects to demonstrate their need as well as their affordability within the long-term financial plan.

Management Comment and Action Plan

City management and staff understand the pressures facing the City of Greater Sudbury and its capital infrastructure funding requirements since the first long term financial plan completed in 2002. It is important to note that all municipalities are experiencing the same pressure with its capital infrastructure. For example, the President of the Association of Municipalities of Ontario has been quoted relating to understanding Canada's municipal infrastructure deficit by saying:

"The infrastructure underinvestment problem has emerged over the last two decades. In the early 1990s, the federal government transferred a significant portion of its operating deficit to provinces and territories by drastically cutting funding transfers. In Ontario, in turn, the provincial government downloaded part of its operating deficit to municipalities by downloading costs for programs such as welfare, social housing, ambulance services and 5,000 kilometres of provincial highways and related bridges. The results are clear. Federal and Provincial historical budget deficits have been transformed into a municipal infrastructure deficit. As a result of the massive shift in financial responsibilities, municipalities have had to increase taxes year after year, reduce services in the community, and defer infrastructure rehabilitation to later in its lifecycle."

Staff has presented options for past and current Councils for a special capital levy during the annual budget process. As stated by the Auditor General, past City Councils have approved a special levy to improve the capital budget during the years of 2005, 2006, 2007, 2008 and 2012 which have been partially offset by permanent reductions in years 2010 and 2015.

In addition, staff agrees with the recommendations from KPMG within the Asset Management Plan that was presented to City Council in December 2016. The recommendations include the following:

- a) *Establishing service levels that consider employment of assets beyond the end of their useful lives*
- b) *A multi-year program of affordable tax increases (e.g. 2%) that would be restricted to capital (special capital levy)*
- c) *The increased use of debt for the financing of major capital projects*
- d) *The realignment of the City's capital envelopes to ensure appropriate balancing*
- e) *A focus on asset rationalization*
- f) *Service rationalizations*

These recommendations will be reviewed by staff and presented to Council(s) for consideration of any changes to service levels, use of debt financing (such as for the large projects) as well as special capital levy to improve the infrastructure requirements. Also, staff is preparing a revised Capital Budget Policy which will have one capital envelope that will be used to fund capital projects based on ranking of certain criteria/ranking system. This will ensure that the capital funds are allocated to the capital projects with highest priority for the overall City as opposed to by department/division. This new Capital Budget Policy will also include recommendations

from the Asset Management Coordinator, which was a new position that City Council approved during the 2017 Budget.

2. Capital Project Prioritization Methodology

The current capital budgeting process employs capital envelopes to allocate funding to program areas and requires individual departments to prioritize their capital projects each year. While some departments, such as roads, employ sophisticated methodologies to prioritize capital projects, important projects are deferred every year as the envelopes are not sufficiently funded and an enterprise-wide approach is not used to prioritize these projects.

Finance staff has identified the need to change the capital budget policy and is working towards the development of a new capital budget approach that would evaluate projects using common criteria that align with the City's corporate strategic plan and enterprise risk management program. Our review of best practice literature from the Association of Municipalities of Ontario and the Federation of Canadian Municipalities indicates that this change would be prudent as it would support a move to more financially sustainable infrastructure.

Recommendation:

1. Discontinue the capital envelope system in 2019 and adopt a funding model that is similar to the one shown at Attachment 1 which would allow funding to be directed to capital projects which align with strategic and operational plans, facilitate the delivery of core services, and address significant risks.

Management Comment and Action Plan

Currently, each department has a different priority setting approach/criteria due to the unique nature of capital assets in their respective area. The existing Capital Budget Policy authorizes an amount to each department and then each department Management decides on the prioritization of required capital projects based on available capital funding.

Staff has identified that a change should be implemented with respect to the capital budget and envelope system. Staff is proceeding with updating the capital budget policy along with establishment of an appropriate criteria and ranking system to prioritize all capital projects with funding from the overall capital envelopes.

Meetings have been held during 2017 with each department (Growth and Infrastructure, Community Development, and Community Safety) that included Executive Leadership Team members, Directors and Managers to discuss and obtain their feedback for these principles along with possible criteria that should be considered to properly evaluate each capital project. As departments have unique nature of capital assets, additional criteria may relate to one section than another (ie. specific legislation).

As a result of staff's progress on changing the policy and capital envelope system, staff requested the Auditor General to provide his opinion of possible ranking criteria for us to consider. Staff prepared a preliminary listing of criteria along with possible system of ranking and this was provided to the Auditor General as part of his review. However, the criteria are a work in progress which has not been approved by the Executive Leadership Team until all concerns are considered for respective capital projects (ie. health and safety, legislation, asset condition/beyond useful life, resident enjoyment, economic development, etc) from meetings with departments. Staff will work with the Auditor General on our process moving forward.

The overall goal is to have a new capital budget policy along with approved criteria with an appropriate ranking system for use in the 2019 Budget. Staff will continue to work and refine criteria to ensure each asset class evaluated properly relative to other asset classes to determine which is in the greatest need of rehabilitation. This will ensure that the City will properly assess and invest in the capital projects with the highest priority and importance for the overall City and its residents.

Attachment 1 – Suggested Enterprise Funding Model

		Prioritization Criteria	1 to 5
Operational Program Considerations	1	Legal or Regulatory Requirements Whether there are legal or regulatory requirements for the project	
	2	Asset Condition and Age Whether the existing asset is at or near the end of its useful service life or has deteriorated so significantly that its usefulness is impaired	
	3	Core Service Whether the project supports the delivery of core services	
	4	Risk Management Whether completion of the project would improve the management of important risks such as public health and safety, business disruptions and disasters	
	5	Project Consistency with Operational Plans & Priorities Whether the project is consistent with operational plans and priorities	
Strategic Goals	6	Growth & Economic Development Whether the project would grow the economy and attract investment	
	7	Quality of Life and Place Whether the project would strengthen the high quality of life we already know and love	
	8	Responsive, Fiscally Prudent, Open Governance Whether the project would allow the City to lead in public service excellence	
	9	Sustainable Infrastructure Whether the project would allow the City to prioritize build and rebuild our community's foundation	
	10	Other Strategic Priorities Whether the project addresses other strategic goals of Council	
		Total Score	