COMMITTEE REPORT
CORPORATE SERVICES DEPARTMENT
Monday, December 16, 2019

Subject: Policies for Reserves and Reserve Funds, Capital Financing and Debt

Recommendation:

> **THAT Committee receive Report #2019-0151-Corporate Services and recommend:**
>
> **THAT Council approve the Reserve and Reserve Fund Policy and the Capital Financing and Debt Management Policy; and**
>
> **THAT Council approve the wind-up of the Future Subdivision Projects Reserve, and transfer of its balance to the Roads Reserve, effective December 31, 2019.**

Background:

As part of the Town of Pelham Strategic Plan 2019-2022, the Town committed to the following as part of the strategic priority to "Ensure Financial Sustainability":

Update Reserves Policy (2019)
Develop Debt Policy (2019)
Develop Cash Management Policy (2019)

Analysis:

Appendix 1 to this report includes the draft Reserve and Reserve Fund Policy, while Appendix 4 to this report includes the draft Capital Financing and Debt Policy. The Cash Management Policy has been incorporated into the Reserve and Reserve Fund Policy under subsection 4.2c) through 4.2e). In 2020, the Investment Policy will be updated to include a section on Cash Management as well.

Financial Considerations:

Reserve and Reserve Fund Policy

The Town of Pelham administers several reserves and reserve funds. Most of the reserves and reserve funds were established to meet statutory requirements, to fund capital expenditures, or to finance specific initiatives.

The audited balances of reserves and reserve funds are included in the Town's Consolidated Financial Statements and also in the reserve and reserve fund report that is presented to Council annually. In addition, forecasted balances for the reserves and reserve funds are included as part of the annual capital budget.

This reserve and reserve fund policy seeks to establish targets toward which the Town will strive in order to ensure financial sustainability in addressing the Town's operating and capital needs. These targets will be updated when the capital asset management plan is completed, but until such time, targets have been set based on amortization (multiplied by an inflation factor) and some other adjustments as outlined in the Appendix B to the policy.

The total tax levy supported reserve/discretionary reserve fund balances at December 31, 2018 is negative ($269,421). The projected balance at December 31, 2019 is negative ($1,611,519). The target minimum that these reserve/discretionary reserve fund balances should be is $5,456,350. The targeted balance for these reserves is $11,410,700 in order to reduce the need for debt, respond to unanticipated events, and to meet the needs of the capital asset management plan. The increase required to meet the minimum target is $7,574,985 which would be equivalent to 50% tax levy increase which is not financially sustainable to the taxpayer.

The existing capital plan was created demonstrating the need to increase tax levy supported transfers by approximately $600,000 to $1,00,000 per year from 2021 to 2023. This plan would maintain the tax-supported reserve and reserve fund levels as they exist today.

However, the policy lays out a plan to reach the minimum reserve balances by 2039, by creating phased-in minimum targets every 5 years.

To reach the 2020-2024 phased-in target would require a further increase of $288,627 (2% tax levy increase) each year above the $600,000 to $1,000,000 increase already planned.

The total non-tax supported reserves/discretionary reserve fund balances (building, water and wastewater) at December 31, 2018 is $3,207,875. The projected balance at December 31, 2019 is $2,312,656. The minimum target that these reserve/discretionary reserve fund balances should be is $2,144,976. The targeted balance for these reserves should be $2,744,976 in order to be able to meet the needs of the capital asset management plan. The Town is following the recommendation from BMA and it will be re-evaluated as part of the Capital Asset Management Plan in 2020.

The graph in Appendix 2 shows the bar graph with the minimum and maximum reserve target balance. The red line shows the target balance for the reserve. The purple line shows the 2019 projected reserve and reserve fund balance (including commitments). The biggest gap is in the Roads Reserve which is currently in a deficit (negative balance) and the minimum reserve target balance is $2.9 million.

The graph in Appendix 3 shows the 2019 Projected reserve and reserve fund balance in purple, the phase-in target reserve balance to 2024 in orange; and the green line shows the reserve target balance. At current rates of increase planned in the 2020 capital forecasts, plus the phased-in increases, it will take 20 years to 2039 in order to reach the minimum target reserve balance.

It is recommended that the Future Subdivision Projects Reserve of $362,613 be wound-up and the balance be transferred to the Roads Reserve, as at December 31, 2019. These funds have been set aside for sidewalks and road work for new subdivisions and the balance has been unchanged since 2011. This will decrease the negative balance in the Roads Reserve.

Capital Financing and Debt Management Policy

The Capital Financing and Debt Management Policy introduces a debt management strategy to ensure that the Town is able to meet any future financing needs, and it can adapt and respond to unanticipated capital or operating requirements should they arise.

It is recommended that the internal debt limit be lower than the Annual Repayment Limit (ARL) in order to ensure long-term financial sustainability and flexibility. This is important to protect and preserve capital while maintaining solvency and liquidity to meet ongoing financial requirements.

The internal limit will be phased in as follows:

(a) From 2020 to 2024: Annual Debt Financing Charges shall not exceed 20% of Own-Source Revenues.

(b) From 2025-2029: Annual Debt Financing Charges shall not exceed 15% of Own-Source Revenues.

(c) From 2030 onward: Annual Debt Financing Charges shall not exceed 10% of Own-Source Revenues.

(d) The Town will strive toward the target that a maximum of 50% of the anticipated obligatory Reserve Fund collections will be spent on Debt in order to maintain a minimum cash balance in the Reserve Fund.

(e) Annual Debt Financing Charges for non-tax supported Debentures, such as water and wastewater rate supported Debt, shall not exceed 15% of own-source rate-supported revenues.

Appendix A to the Policy shows the maximum financing term of an asset. Appendix B to the Policy lists the Debt-related financial indicators which are important to assess risk.

Appendix 5 to this report shows the Town's Debt related Financial Indicators at December 31, 2018. It also includes the calculations for other Niagara municipalities based on their 2018 FIR (or 2017 where 2018 is not yet available).

1. Debt Servicing Cost as a % of Own-Source Revenues: The Town is rated as a high risk since the debt servicing is consuming a higher portion of the operating budget and may constrain the funding that is available for other service delivery.

2. Debt Service Coverage Ratio: The Town is rated as a moderate risk since the Town's operating income is constrained in covering debt serving costs. The Town's operating cash flows are just sufficient to cover debt servicing, with a ratio of 1.01. If it moved below 1, it would be a high risk. This ratio is measuring the Town's ability to service debt with recurrent operating cash flows.

3. Debt to Reserve Ratio: The Town has a ratio of 10.23 to 1 which means that the debt outstanding exceeds reserves available tenfold. This ratio measures the amount of debt taken out that will need to be funded in the future, versus the amount that has been put away into reserves to provide for future expenditures.

4. Debt per Capita: The Town has the highest debt per capita in the Niagara Region. This ratio measures how much debt is outstanding per citizen of the Town. This can give an indication of the amount of future tax revenues that need to be recovered to pay for existing infrastructure.

5. Net Financial Assets (Net Debt) as a % of Own-Source Revenues: This ratio measures the amount that Own-Source Revenue is servicing debt. An increasing negative number may indicate challenges for long-

term sustainability because an increasing amount of future revenues will be required to pay for the existing debt. The Town is rated at a high risk.

6. Total Reserves and Reserve Funds as a % of Operating Expenditures: This ratio measures the amount of funds that have been set aside for future needs and contingencies. The Town has a lower percentage with a moderate risk and close is to a high risk. This means that the Town is relying more heavily on in-year tax levy and rates to pay for expenditures.

7. Asset Consumption Ratio: A measure of the amount of the Town's capital assets' life expectancy which has been consumed. A lower ratio may indicate that there is not a significant aging of the Town's capital assets. The Town has a low risk in this category which is a result of having the new Meridian Community Centre asset added to the capital assets with a high dollar amount of $36 million. The Capital Asset Management Plan will verify the condition of the Town's Assets. The calculation without the Meridian Community Centre would put the ratio at moderate risk.

Alternatives Reviewed:

N/A

Strategic Plan Relationship: Financial Sustainability

It is critical for the Town to work towards building up the reserves and reserve funds to at least a minimum target balance in order to support the future long-term capital asset requirements. The Town needs to work towards decreasing the current internal debt limit in the recommended phased-in period. This will help to improve the financial risk indicators.

Consultation:

The draft policies for Reserves and Reserve Funds and Capital Financing and Debt have been reviewed by the Audit Committee and recommended to Council for approval.

Other Pertinent Reports/Attachments:

Appendix 1- Reserve and Reserve Fund Policy

Appendix 2-Reserve Funds-Graph of Reserve Balances vs. Reserve Policy

Appendix 3-Reserve Funds-Graph of Reserve Balances vs. Reserve Policy

Appendix 4-Debt Policy

Appendix 5-Debt Related Financial Indicators

Prepared and Recommended by:

Teresa Quinlin, MBA, CPA, CA
Director of Corporate Services/Treasurer

Prepared and Submitted by:

David Cribbs, BA, MA, JD, MPA
Chief Administrative Officer