

# 2006 BUDGET BRIEFING NOTE

## – Economic Factors

### Issue/Background:

This briefing note discusses the economic factors utilized in producing the 2006 Operating Budget. The starting assumption for the 2006 operating budget process was that services and service levels approved in 2005 would be maintained wherever possible. To derive the 2006 Operating Budget, the 2005 Council Approved Operating Budget was first adjusted to annualize in-year Council initiatives and decisions, then for inflation. The result of the above exercise was the cost of continuing to provide the 2005 approved services and service levels in 2006 dollars.

The City has identified 13 price volatile commodities for which specific economic factors are warranted (see Table 1). Excluding hydro, water, natural gas, salt, TTC diesel, and other contract

<b>Expenditures Description</b>	<b>Forecast as at June 5, 2005</b>	<b>Revised Forecast - Jan 2006</b>
Printing & Paper Products	0.0	0.0
Food	2.4	2.1
Hydro	3.0	1.0
Gas	(2.1)	2.0
Steam Heating	15.0	20.0
Diesel	(2.1)	6.0
Natural Gas	4.0	10.0
Water	7.0	9.0
Postage	2.0	2.0
Telephone	0.0	0.0
Salt	City Contract -- 4.0% Increase	
Medical Supplies	3.0	3.0
General	2.0	2.0

driven prices, the economic factors for 2006 were determined based on predictions of credible private sector organizations. For expenditure items not specifically listed in Table 1, the CPI rate of 2.0% was applied.

As indicated in Table 1, the economic factors utilized to develop the 2006 Operating Budget were first established in June 2005. Consistent with the City's budget policies and good

business practices, the economic factors were reviewed in December 2005. While some revisions were evident (see Table 1), it is not recommended that any change in the 2006 Proposed Budget be considered at this time. Instead, these rates will continue to be reviewed by the Financial Planning Division and any changes warranted, along with the budget impact, will be reported to the Budget Advisory Committee at its Final Wrap-up meeting on February 13, 2006.

## **Key Points:**

### Gasoline and Diesel

#### (i) 2006 Price Forecast

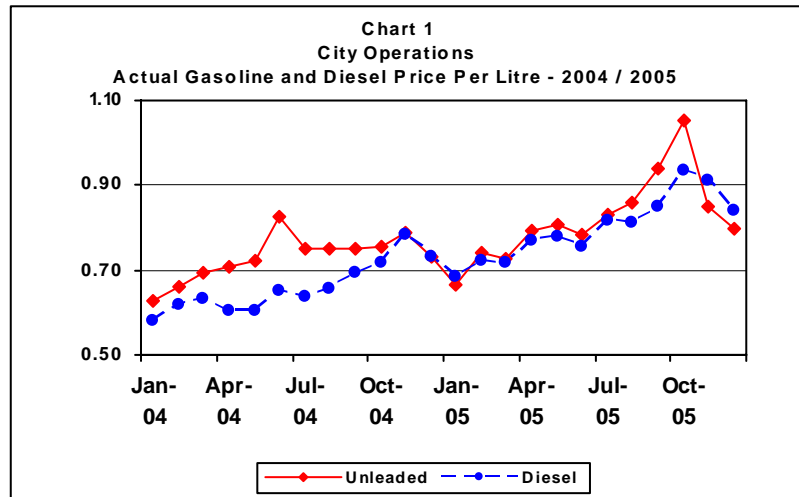
- In June of 2005 an economic factor of minus 2.1% was set for gasoline and Diesel. Since then, 2006 gasoline and diesel prices have been quite difficult to forecast especially as a result of Hurricane Katrina. Since September last year, the price of gas and oils has fluctuated dramatically. Similarly, price forecasts have shown significant inconsistencies and variation for these commodities: many analysts both in Canada and the United States expect the price of gasoline to fall albeit marginally in 2006; others predict increases as high as 23%. Note the following:
  - In a Country Report – Canada (prepared by Peter Dungan et al, University of Toronto), it is forecasted that \$70 (per barrel) oil was a spike, and that “prices are headed back from the current \$60-\$65 range ... into the \$40-\$50 range as 2006 and 2007 unfold.” This represents a decrease of between 23% and 33%.
  - The Royal Bank Financial Group in its October 2005 ‘New Forecasts 2005-2006’ stated that oil “prices are expected to decrease in 2006 ... to average US \$58 a barrel in 2005 and US \$57 a barrel in 2006.” This proposes a price reduction of 1.7%.
  - A TD Economics Special Report (September 22, 2005) acknowledged that crude oil prices over the short run is anybody’s guess, and forecasted that corrections would begin in 2006. The researchers expect “to see a pull back in Canadian gasoline pump prices during the 2006-07 period to the \$0.70-\$0.80 per litre range.” This represents a forecast decrease in the price of gasoline ranging from 11% to 22%.
  - Subsequently, in its November 21, 2005, Commodity Price Report, TD Economics noted that oil prices had pulled back to pre-storm levels given that concerns about inadequate supplies had eased. The November report echoes the earlier prediction that prices will decline as evident in the following excerpt: Our forecast for lower prices in 2006 is based on an expected reduction in crude oil demand growth, as the pace of world economic expansion downshifts in the second half of 2006 and conservation efforts increase.
  - CIBC in its ‘World Markets Forecast’, December 16, 2005 predicts that crude prices will increase in 2006. The analysts hold that “Limited new supply prospects and signs of firm demand ... should support a further rise in West Texas crude.”
- Unanticipated shocks along the lines of Katrina could sideswipe the oil market and derail the corrections expected by private sector forecasters and resultantly, pump prices. Given the price volatility evidenced by the wide spread in price forecasts for oil and gas at this time, it continues to be difficult to state conclusively what the economic factor for gasoline and diesel should be for 2006. Financial Planning Division staff will continue to monitor prices and will make recommendations to the Budget Advisory Committee on any rate and/or 2006 budget adjustment warranted.

- The 2006 gasoline and diesel prices proposed by Fleet Services and communicated to City Programs is \$0.85 cents representing 2 cents or 2% increase over the 2005 weighted average price per litre for gasoline, and 5 cents or 6 % increase per litre for diesel.

(ii) Consumption and Price – 2004 to 2005

- In 2004, City Operations acquired 7.358 million litres of diesel at a total cost of \$4.865 million; and 3.109 million litres of gasoline at a cost of \$2.279 million. Diesel consumption in 2005 increased to 8.508 litres costing \$6.813 million in 2005; and gasoline increased to 3.672 million litres costing \$3.014 million.

- Evident in Chart 1 is that monthly price per litre varied significantly. Under existing contracts prices are set on a monthly basis. In 2004, diesel prices ranged from 58 cents per litres in January to 78 cents per litre in November. Prices in 2005 ranged from a low of 69 cents in January to a high of 93 cents in October. The weighted annual average diesel price was 66 cents in 2004 and 78 cents in 2005. The 2005 actual weighted average price increased by 18%, compared to an applied economic factor of 5%.



- Gasoline prices ranged from 63 cents per litre in January to a high of 83 cents per litre in June 2004; and in 2005, from a low of 67 cents in January to a high of \$1.05 in October. The weighted average annual gasoline price was 73 cents in 2004. Despite the spike in gasoline prices in October when prices rose to \$1.05, the 2005 weighted average price per litre was 82 cents. The 2005 weighted average price increased by 12%, compared to an applied economic factor for the same year of 8%.
- Increases in the actual price of gasoline and diesel in 2005 suggest that the economic factors applied in developing the 2005 Operating Budget were low. This is reflected in the fact that the 2005 gasoline and diesel combined budget was \$1.106 million or 14.8% overspent.

Electricity

- In June 2005, it was determined that 2006 electricity prices would increase by an average of 3%. This change was based on the Ontario Energy Board set rates and contracted commodity rates negotiated with Toronto Hydro.

- Subsequent to establishing the 2006 price increase, Toronto Hydro made a submission to the Ontario Energy Board (OEB) to reduce distribution charges by approximately 5%. As yet, the request has not been approved and it is still uncertain how exactly the reduction will impact the City of Toronto accounts.
- Despite the uncertainty noted to above, it is estimated that the effective 2006 hydro rate will approximate a 1% increase over the 2005 rate. However, until the reduction is approved it is not recommended that the 2006 Proposed Budget be decreased. Instead, staff will continue to monitor the decision of the OEB and will report any budget impacts and adjustments will be reported to BAC at its Final Wrap-up meeting on February 13, 2006.

### Natural Gas

- In June of 2005, the economic factor for natural gas was set at 4%.
- Commodity rates are much higher than forecast due to ongoing increases in the price of oil. The City has locked in 90% of its consumption at a fixed price. The remainder is subject to market rates. The revised commodity rate increase is forecast to be about 12%. Enbridge has announced distribution rate increases amounting to about 4% for 2006. Overall, the blended 2006 natural gas price is expected to increase by 10%.
- Given significant uncertainty on where rates will settle in 2006, no adjustment of the 2006 Proposed Operating Budget is recommended at this time. Instead, prices will continue to be monitored in 2006 and any required adjustment will be reported to BAC at its Final Wrap-up meeting on February 13, 2006.

### Water

- In June of 2005, it was forecasted that the water rate would increase by 7%. Since then, at its meeting of December 8, 9 and 10, 2005, Council approved a water rate increase of 9% effective on January 1, 2006, representing an incremental increase of 2%. The net impact on the 2006 Tax Levy Budget of the additional 2% increase will be reported to BAC at its Final Wrap-up meeting on February 13, 2006.

### Steam and Heating Oil

- In June of 2005, it was forecasted that the price of steam heating would increase by 15%. More recent information from Enwave indicated that the 2006 price is expected to increase by an additional 5% to 20%.
- 90% of the steam and heating oil price is based on natural gas prices that are now higher than forecasted. Enwave will pass on the increased natural gas prices through increased steam rates. Any budget adjustment warranted by the additional rate increase will be reported to BAC at its Final Wrap-up meeting on February 13, 2006.

### Telephone

According to CRTC, telephone rates are directly tied to a formula that includes inflation and productivity factors. Based on this formula, and given that inflation is less than the threshold rate increase of 3.5% set by CRTC, it is assumed that telephone rates will remain unchanged in 2006.

### Printing and Paper Products

Scotia Bank and BMO Commodity Price Report predicted a slight decline in prices for pulp and paper products in June 2005, revised to a 1% increase in January 2006. No price adjustment (that is, zero economic factor) was proposed for printing and paper products.

### Food

BMO Nesbitt Burns predicted a 2.4% increase based on their April report. The January 2006 report adjusted the economic factor for food to 2.1%.

### Postage

Historically, postage has increased by approximately 2% annually. In the absence of a specific announcement by Canada Post a 2% economic factor has been assumed.

### General

A general inflation rate of 2% was recommended for goods and services not assigned a specific economic factor or not covered under specified contract prices. Scotiabank Group: Global Economic Research Forecast Update, Jan 4, 2006 proposed a 2006 inflation rate of 2.4%. CIBC World Markets, Forecast, Dec. 16, 2005 predicts that inflation will be 2.3%.

### Conclusion:

The Economic Factors used to develop the 2006 Operating Budget were established in June, 2005 and were based on private sector forecasts. These economic factors were reviewed in November and December 2005. These reviews revealed that several of the June predictions were revised primarily because of Hurricane Katrina. In the case of gasoline and diesel, forecast rates for 2006 vary considerably: many analysts still expect the 2006 prices to decrease, albeit marginally; while others forecast increases as high as 23%. Because of the wide variation in price forecasts for gasoline and diesel, no revision to the June 2005 economic factor is recommended at this time.

Analysis indicated that the actual 2005 gasoline and diesel price change per litre were higher than the economic factors used to develop the 2005 budget.

The Financial Planning Division will continue to monitor the 2006 economic factors and will recommend to the Budget Advisory Committee any required adjustments to the 2006 Proposed Operating Budget at its Final Wrap-up meeting on February 13, 2006.

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