TORONTO STAFF REPORT

July 8, 2004

To: Ad Hoc Committee to Develop a Long Term Fiscal Plan

From: Chief Financial Officer & Treasurer

Subject: Policy on Management of Operating Budget Surpluses

Purpose:

This report presents the rationale and strategy for allocating annual year-end operating budget surplus funds so that contributions can be authorized by the Chief Financial Officer and Treasurer to reduce borrowing for capital purposes and/or to make provisions for any underfunded liabilities and/or tax supported reserve or reserve fund.

Financial Implications and Impact Statement:

The 2004 Operating Budget has a budgeted surplus carried forward from 2003 of $15 million. This report is recommending that by 2007 the surplus carried forward be reduced to zero which will result in an Operating Budget pressure of an additional $5 million over each of the next three years – 2005, 2006, and 2007.

Recommendations:

It is recommended that:

(1) the surplus carried forward be zero by the 2007 fiscal year and that this be accomplished by reducing the surplus carried forward in 2005 to a target level of $10 million, in 2006 to $5 million and 2007 to zero;

(2) for the fiscal 2004 surplus, if any, the Chief Financial Officer and Treasurer be authorized, consistent with Recommendation No. 1 above, to apply any additional surplus entirely to the Capital Financing Reserve Fund;

(3) starting with fiscal 2005, for any surplus, the Chief Financial Officer and Treasurer be authorized, consistent with Recommendation No. 1 above, to apply any additional surplus, in priority order to:

(a) Capital Financing Reserve Fund (at least 75 percent of the additional surplus); and

(b) the remainder to fund any underfunded liabilities, and/or reserves/reserve funds, as determined by the Chief Financial Officer and Treasurer;

(4) the Chief Financial Officer and Treasurer report such contributions as per Recommendation No. 2 and 3 to the Budget Advisory Committee, Policy and Finance Committee and Council following the closing of the accounts for the prior year; and

(5) the appropriate City Officials be authorized and directed to take the necessary action to give effect thereto.

<u>Background</u>:

At its regular meeting held on October 3, 4 and 5, 2000, and its Special Meetings held on October 6, 2000, October 10 and 11, 2000 and October 12, 2000, City Council had before it Policy and Finance Committee Report No. 12, Clause #8 entitled ‘Policy on Surplus Management’. This report (August 31, 2000) from the Chief Financial Officer & Treasurer recommended a policy that would:

(i) reduce the then current level of surplus included in the Operating Budget from some $40 million annually to zero over three years;
(ii) establish a Tax Stabilization Reserve Fund with a target of 1% of property tax revenues;
(iii) establish an allocation mechanism to apply any additional surplus, in priority order to:

(a) fund the Tax Rate Stabilization Reserve Fund (if below its target);

(b) Capital Financing Reserve Fund (at least 10 percent of the additional surplus); and

(c) the remainder to fund any unfunded liabilities, or otherwise proven inadequacy in a reserve or reserve fund, on the basis of highest risk of immediate property tax impact as determined by the Chief Financial Officer & Treasurer;

(iv) require the Chief Financial Officer & Treasurer to report any such contributions as per above to the Budget Advisory Committee no later than four weeks following the closing of the accounts for the prior year.

Council adopted the above noted policy but amended the Policy and Finance Committee Report to provide that ‘a target level for the funding of reserves not be established until the 2001 Operating Budget process’ and implementation of the policy be referred to the 2001 Operating Budget process. As a result of consideration of the 2001 Operating Budget, this policy was not implemented.

Council at its meeting of May 18, 19, 20, 2004 in adopting Report No. 4 Clause #8 of the Policy and Finance Committee entitled ‘Consolidation of Reserve Funds’ deleted the Tax Stabilization

Reserve Fund since it was never funded and since the rationale for this type of fund is no longer valid.

Comments:

Notwithstanding the fact that the existing policy has never been applied, there is a need for a surplus management policy.

Surplus Management Policy Rationale:

A surplus arises in the Operating Budget (operating fund) when there is an excess of revenues over expenditures. Year-end surpluses generally arise from two circumstances – higher than budgeted revenues including one-time only revenues, and/or lower than budgeted expenditures.

The Municipal Act requires municipalities to bring the prior year’s surplus forward into the next year as a revenue source for the Operating Budget. On the one hand, this treatment may be deemed to be a positive action because the surplus partially mitigates/reduces any increase in the tax rate in the subsequent year. However, on the other hand, the downside of this requirement is that once a surplus has been carried forward in this way, it must be maintained because the reduction or elimination of the revenue creates a pressure in the following year’s Operating Budget. Where municipalities have had surpluses, there is a need to maintain consistency from one budget year to the next to avoid significant budget pressures, or unsustainable revenue increases.

(A) Municipal Practice:

A survey of municipalities (mostly in Ontario and including the former Toronto municipalities) concerning surplus management policies indicates that for the most part municipalities did not have formal policies in this regard. Municipalities recognized the need to maintain consistency from one year to the next in the amount of surplus carried forward. The majority of municipalities allocate any additional surplus (above that required to maintain consistency) to one or a combination of the following: by placing funds in a tax rate stabilization reserve or by applying funds to the following year’s capital program and/or by applying funds to other unfunded liabilities and reserve/reserve funds.

Generally, a surplus position is not identified until finalization of year-end accounts and so allocations cannot be budgeted for in advance. Hence, it would be useful to staff if there was a surplus management policy from Council to guide in these allocations.

(B) City's Historical Practise:

Table No. 1 indicates the pattern of surpluses carried forward since 1998.

Table No.1
History of Surpluses Carried Forward from Prior Year
($ millions)

1998	1999	2000	2001	2002	2003	2004
52.8	43.6	40.0	10.5	24.0	39.0	15.2

This table clearly indicates the pressure that has been placed on the Operating Budget since 1998 as a consequence of the reduction in surpluses. Over these years the major contributors to the surplus have been over achievement of revenue budgets and less-than-budgeted expenditures.

Recommended Targeted Reduction in Operating Budget Surplus:

It is being proposed in this report that Council adopt the policy that there be no surplus carried forward in future and that the Chief Financial Officer & Treasurer be authorized to allocate funds as indicated below to reduce the surplus carried forward to zero. Given the size of the 2003 surplus carried forward to 2004 – namely $15.2 million, it is not practical to absorb the consequences of this in one year. Therefore, it is being recommended that the surplus carried forward be reduced in equal instalments so that by the budget year 2007, the surplus carried forward is zero and remains such from then onwards. Thus, the projected surplus carried forward for 2005 would be a maximum of $10 million, for 2006 $5 million, and for 2007 would be $0. It must be noted that this direction would result in a budget pressure of $5 million in each of the next three years.

Capital Financing Reserve Fund:

As noted above, other municipalities have applied their surpluses to capital financing and/or unfunded liabilities/reserve and reserve funds. Applying the funds to capital financing would reduce the City's debt service requirements and thus have a positive impact on the operating budget.

The current debt policy is that debt service costs financing should not be more than 10 percent of property taxes. The current capital projections and related debt are that Council will exceed the debt service costs guideline. Therefore, it is being recommended that, should there be surplus funds, that a contribution of at least 75 percent of the surplus be to the Capital Financing Reserve Fund, except for fiscal 2004 surplus carried forward to 2005, where it is being recommended that 100% of the surplus be applied to capital financing.

Liabilities/Reserves/Reserve Funds:

As indicated in the report (February 7, 2000) from the Chief Financial Officer & Treasurer entitled 'Longer Term Reserve and Reserve Fund Adequacy and Funding Strategies', and further report updates in 2002/3, significant inadequacies in reserve/reserve fund balances have already been identified and as other accounts are reviewed further inadequacies will be identified and quantified. A long term strategy must be put in place to deal with these inadequacies. The prudent approach would be to fund the shortfalls directly from the Operating Budget based upon an appropriate schedule which would reflect future expenditure requirements. The City's present operating budget pressures have precluded this normal funding approach.

Table No. 2 indicates a sampling only of the estimated inadequacies identified to date from the report noted above and works in progress.

Table No. 2
Adequacy of Selected Reserves and Reserve Funds

Reserve/Reserve Fund	Uncommitted balance as at December 31, 2003	Total Inadequacy
Vehicle and Equipment Replacement	$0 m.	$201 m.
Staff Benefits	$264.4 m.	$1,792 m.
Social Assistance Stabilization	$94.4 m.	$326 m.
Solid Waste	$40.0 m.	$93 m.

Based on the significant unfunded liabilities, it is being recommended that, at most, 25% of the surplus funds be utilized as a contribution to any underfunded liabilities, and/or reserves/reserve funds, on the basis of highest risk of immediate property tax impact, as determined by the Chief Financial Officer & Treasurer. Such contributions will subsequently be reported to the Budget Advisory Committee, Policy and Finance Committee and Council.

Existing Stabilization Reserve Funds:

There are a number of precedents for 'automatic' allocation of specific operating surpluses to reserves/ reserve funds. In the case of surpluses generated from a number of Agencies, Boards and Commissions (ABC's), since they are to be self-sufficient, and would have no capacity to deal with a deficit, then it has been prudent to place the surplus funds in a stabilization reserve fund to offset any subsequent deficits. Council has already subscribed to this approach in that it has created four stabilization reserve funds for ABC's – Toronto Zoo, Hummingbird Centre for the Performing Arts, Toronto Centre for the Arts, and the Toronto Transit Commission. As well, Council has created two additional stabilization reserves for the Water/Wastewater program. The Chief Financial Officer & Treasurer presently has the authority through Council direction to make the necessary year-end adjustments to transfer any funds into or out of their respective reserve funds depending on whether the programs as noted would otherwise have a surplus or deficit in its operations.

With respect to the social assistance program, as part of Council's plan to mitigate the impact of the next recession on the welfare roles and that impact on the property tax rates, Council approved the establishment of the Social Assistance Stabilization Reserve Fund. Any surplus that results from underspending directly attributable to social assistance caseloads is transferred to the reserve fund.

Recommended Policy for the Allocation of Operating Budget Surplus:

It is being recommended that the surplus management policy provide that the Chief Financial Officer & Treasurer be authorized to apply any surplus, in priority order to:

(a) Capital Financing Reserve Fund (at least 75 percent of the surplus); and

(b) the remainder to fund any underfunded liabilities, and/or reserves/reserve funds, as determined by the Chief Financial Officer and Treasurer.

Table No. 3 outlines a hypothetical application of this policy once it has been implemented based on the premise that the potential surplus carried forward is $25 million.

Table No. 3
Application of Surplus Management Policy

	Budget Year			
	2004	2005*	2006*	2007*
Prior Year Surplus before Provisions	39	25	25	25
Provisions to:				
Capital Financing Reserve Fund	10	15	15	18.75
Underfunded Reserve Funds	0	0	5	6.25
Other Operating Items	14	0	0	0
Prior Year Surplus Applied to Budget	15	10	5	0

* note: 2005-2007 prior year surplus is hypothetical

Conclusions:

The objective of the recommended surplus management policy is maintaining revenue consistency while reducing debt servicing costs and ensuring a planned approach to funding underfunded liabilities.

It is being recommended that the City work towards a corporate operating surplus target with the objective of eliminating surplus funds carried forward by the 2007 Operating Budget. If there are excess funds from the current year-end results over and above the annual surplus target, then the Chief Financial Officer & Treasurer be authorized to apply them to (a) at least 75 percent of the additional funds to the Capital Financing Reserve Fund; and (b) the remainder to any underfunded liabilities, and/or reserves/reserve funds, as determined by the Chief Financial Officer and Treasurer based on mitigating the highest risk of immediate impact on property taxes. Such year-end activity would be reported to the Budget Advisory Committee, Policy and Finance Committee and Council following the closing of the accounts for the prior year.

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