



STAFF REPORT ACTION REQUIRED

2007 Operating Budget – Required Reserve Contribution To Balance The Budget

Date:	April 13, 2007
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer
Wards:	All
Reference Number:	P:\2007\Internal Services\CF\ec07013Cf – et (AFS #4546)

SUMMARY

This report identifies \$202.3 million of reserve funds required to balance the 2007 Operating Budget. The funds are composed of \$131.3 million already recommended by the Budget Committee and the replacement for the \$71 million which was to be provided by the Province to fund its cost-sharing shortfall. This report recommends that \$131.3 million be provided from the Capital Financing Reserve Fund, \$41.0 million be provided from other reserve funds and the remaining \$30.0 million be provided from the City's share of interest earnings in the Move Ontario Trust.

Use of funds in this manner is an extraordinary decision needed to avoid significant service reductions and/or significant increases in property taxes as previously noted to Committee and Council. Also, it must be emphasized that the City has utilized more than \$1.3 billion in capital and other reserves for operating revenues since 2001. Discretionary Reserves are no longer available in 2008 and beyond, resulting in the City facing service and/or tax impacts without sustainable revenues.

Resolving the City's structural fiscal operating position will require significant restructuring of financial responsibilities (uploading cost shared programs/social services) and appropriate sharing of revenues which grow with the economy (e.g. GST).

RECOMMENDATIONS

The Deputy City Manager and Chief Financial Officer recommends that:

1. Council authorize the Deputy City Manager and Chief Financial Officer to:
 - (i) transfer funds in the amount of \$71.0 million to the 2007 Non-Program Revenue Budget – Other Corporate Revenue Account from the following accounts:
 - a) Land Acquisition Reserve Fund (\$32.5 million)
 - b) City Parking Reserve Fund (\$5.0 million)
 - c) Social Assistance Stabilization Reserve Fund (\$3.5 million), and
 - d) Move Ontario Trust (\$30.0 million)
 - (ii) amend the 2007 Operating Budget accordingly;
2. transfer \$131.3 million from the Capital Financing Reserve Fund to the Non-Program Revenue Budget – Other Corporate Revenue Account;
3. Council authorize the Deputy City Manager and Chief Financial Officer to close any accounts with nil balances that result from Recommendation No. 1 and the City Solicitor to be authorized to introduce a bill at Council, at a later date, to amend Municipal Code 227 – Reserve and Reserve Funds – to delete any such accounts from the Code; and
4. the appropriate City officials be authorized and directed to take the necessary action to give effect thereto.

Financial Impact

The 2007 Budget Committee Recommended Base Operating Budget includes \$76.0 million of draws from reserve funds to support social service cost shared programs such as the Social Assistance Stabilization Reserve Fund, Ontario Works Reserve Fund and Social Housing Stabilization Reserve Fund, exclusive of funding for new/enhanced services. The utilization of these accounts will result in a significant operating budget pressure in 2008 and beyond for the cost shared social services programs.

This report identifies the withdrawal of an additional \$131.3 million from the Capital Financing Reserve Fund (following the transfer from the 2006 operating surplus), \$41.0 million from other reserves and \$30.0 million from the Move Ontario Trust for a total of approximately \$278.3 million to be utilized as a one-time funding source for the 2007 Operating Budget. The majority of the recommended withdrawals are from accounts which normally would finance capital expenditures and so, in the long run, the City's debt financing will most likely increase as a consequence of this withdrawal unless capital expenditure plans are reduced in the future or alternate funding is found. The

impact of the recommended action will be reviewed as part of the 2008 budget process and could adversely affect both the capital and operating expenditure plans.

Table 1 below, a reconciliation of the City's reserves and reserve funds, is designed to show the significant impact that the one-time only draws from reserve funds will have on the City's future flexibility in responding to risk and adverse circumstances. Specific accounts are excluded because of the non-discretionary purpose of the reserve account:

- Obligatory funds that are governed by legislation or agreement as explained in the Comments section of this report
- The Capital - State of Good Repair accounts, Vehicle accounts, Land Acquisition accounts and Water reserves that are required to fund significant capital backlogs and future capital contracts approved by Council.
- Working Capital and Capital Financing that are required to provide flexibility and stability for the over-all City operations should funds be required for any major unforeseen circumstance.
- Accounts with significant accounting and/or legislative requirements and other long-term risks, such as:
 - Benefit accounts and the Insurance Reserve Fund which are already significantly underfunded.
 - Community services accounts required to meet social, community, cultural and recreational plans.
 - Stabilization accounts required to stabilize the revenue flows from Agencies, Boards and Commissions and major social/community service programs.
 - Arbitration and Legal Awards required on a continual basis to meet the results of litigation (other Corporate Commitments).

Table 1 Reserve/Reserve Fund Balances (\$000s)			Fund Balance
Total Year-End Balance Dec. 31/06			\$1,700,941.6
Add:	2006 Operating Surplus – Transfer to Reserves per Policy	\$81,429.0	
	2006 Extraordinary Item – Transfer to Capital Reserves per Policy	49,000.0	
			1,831,370.6
Less:	<u>Obligatory/Non-discretionary</u>		
	Obligatory Accounts	638,024.7	
	Employee Benefit Accounts	237,918.9	
	Stabilization (incl. TTC)	165,678.3	
	Vehicle Replacement Accounts	146,762.8	
	Land Acquisition Commitments	85,910.0	
	Working Capital	79,395.4	
	Capital - State of Good Repair Commitments	77,658.1	
	Community Service Commitments	61,481.2	
	Capital Financing	26,809.9	
	Water Reserves	15,786.4	
	Insurance	17,536.0	
	Other Corporate Commitments	<u>5,795.9</u>	
		1,558,757.6	272,613.0
Less:	2007 Operating Draws		
	Social Services	76,001.0	
	Capital Financing	131,266.0	
	Land Acquisition	32,500.0	
	City Parking	5,000.0	
	Social Assistance Stabilization	3,500.0	24,346.0

The recommended withdrawals as a consequence of this report as well as the approved 2007 Capital Budget and the 2007 Recommended Operating Budget will have a significant impact on the state of the City's reserve accounts, especially in terms of capital financing as well as to protect the City should unforeseen events occur such as a down turn in the economy. As shown in the above table of reserves/reserve funds, based on balances as at the end of December 31, 2006, the result of this report would be to reduce the 'discretionary' funds held in reserves and reserve funds for a wide variety of other risks from \$272.6 million to \$24.3 million. It should be noted that the majority of this \$24.3 million is comprised of a Land Acquisition uncommitted balance (\$16.5 million), and Elections (\$7.0 million) funds.

DECISION HISTORY

At its meeting of April 12, 2007, the Budget Committee adopted the following motion:

“That the \$71 million Provincial funding shortfall be:

- a. partially funded from \$30 million from the City’s share for the Spadina Subway Extension project; and
- b. the \$41 million remaining Provincial funding shortfall be offset by a further one-time use of City reserve funds and that the Deputy City Manager and Chief Financial Officer report directly to the Executive Committee at its meeting of April 16, 2007, on which City reserve funds will be utilized.”

As well at the same meeting, the Budget Committee had before it the 2007 Recommended Operating Budget and, among other things, the Committee adopted Recommendation #5 without providing a specific source of funds:

“the use of reserves and reserve funds totalling \$131.266 million as a source of funds to balance the 2007 Budget Committee Recommended Operating Budget.”

ISSUE BACKGROUND

This report identifies reserve funds to be utilized once again as a one-time funding source for the 2007 Operating Budget. Since 2001 it has been necessary to similarly support the operating budget with draws from reserve accounts. The total amount of funds withdrawn to date for operating budget revenue short falls (inclusive of 2007) equals approximately \$1.3 billion. As noted below (based on 2005 figures), had these reserves not been required to support the operating budgets over the years, then the City’s per capita reserve holdings would be just above the Provincial average, but substantially below the 905 average.

Until the City solves its long term fiscal problem by:

- a) uploading services back to other orders of government, especially social services and transit support, and
- b) receiving 1¢ of the GST or some equivalent sustainable funding source which grows with the economy,

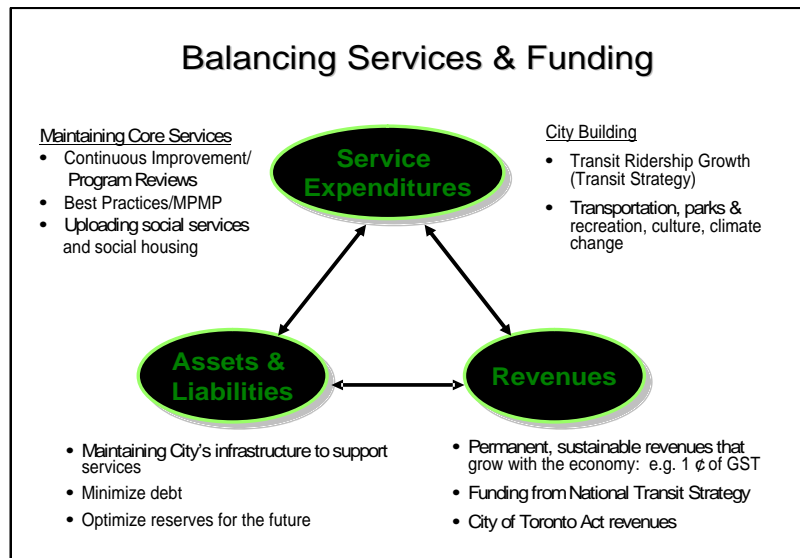
the remaining reserves and reserve funds will continue to be depleted.

When the capital reserve accounts are depleted, the City will be forced to increase debt financing even more substantially than it has already, unless the City is prepared to have an even greater backlog of capital projects.

COMMENTS

Long Term Fiscal Plan:

The success of a long term fiscal plan depends on a balancing of three components of fiscal sustainability – expenditures; revenues; and assets and liabilities. For example, excessive cost reductions on the expenditure side will result in degradation of physical infrastructure through deferral of asset replacement or increasing maintenance backlog. Also, higher property taxes on businesses will lower the City's tax competitiveness. The following diagram provides a schematic representation of the balancing of the three components:



Reserve Accounts:

Reserves and reserve funds form an integral part of sound financial management and planning, as a component of the asset and liability leg of the above noted triangle, whereby revenues from one period can be set aside to accumulate and finance planned expenditures in a future period. They are used to:

- (a) anticipate potential liabilities and to provide resources, when and if, these liabilities have to be funded (such as the employee benefit reserve fund);
- (b) even the flow of disbursements over a time period so that there are not significant impacts on the tax rate due to the fluctuations of expenditures (such as a social services reserve);

- (c) accumulate funds in anticipation of a large purchase (such as major building/construction capital fund) in order to minimize debenture debt and related credit rating impacts; and
- (d) provide a pool of funds to self-finance an on-going activity (such as an insurance reserve fund).

Reserves and reserve funds have designated purposes and are created through the specific authorizations of Council. The major difference between the two, in the City's practice, is that all earnings from the investment of 'reserve funds' must form part of the reserve fund, whereas the earnings from 'reserves' flow to the operating budget. As such, the assets of reserve funds are segregated and restricted to the purpose of the reserve funds and generally they may be combined for investment purposes.

Reserves:

The authority for the creation of a reserve is governed by the clause 228 (4) (e) of the *City of Toronto Act, 2006*, which provides that the City, in preparing its budget for the year, may provide for such reserves as the municipality considers necessary."

A reserve is funded by contributions from the operating budget at the discretion of Council, after provision for projected expenditures. It has no reference to any specific asset and does not require the physical segregation of money or assets as in the case of reserve funds. The creation or increase of a reserve should only be reported as appropriations to reserves on the Consolidated Statement of Operations of the City and not as an expenditure. Likewise, the decrease of a reserve should only be reported as appropriations from reserves on the Consolidated Statement of Operations of the City. The actual expenditure for the reserve should be reported as an expenditure for current or capital operations.

Reserve Funds:

Reserve Funds have designated purposes.

The City of Toronto may use its natural person powers under Section 7, and its power to pass by-laws in respect of the financial management of the City under Section 8 of the *City of Toronto Act, 2006* to create reserve funds.

Furthermore, Section 242 of the *City of Toronto Act, 2006* states: "The Minister of Municipal Affairs and Housing may make regulations,

- (a) requiring the City to establish a reserve fund designated for prescribed liabilities of the municipality which are incurred but not payable until later years;
- (b) defining "liabilities" of the City which are incurred for the purpose of clause (a);
- (c) requiring the City to make payments into the reserve fund to fund all or part of a prescribed liability at the prescribed times and in the prescribed manner;

- (d) prohibiting the City from changing the purpose for which the reserve fund is designated;
- (e) prescribing the conditions under which and the purposes for which the City may,
 - (i) change the designation of all or any part of the reserve fund; and
 - (ii) borrow from the reserve fund. 2006,c. 11, Sched. A, s 242.”

There are two types of reserve funds: obligatory and discretionary (Council directed). The *City of Toronto Act* does not provide clear references, so reference to the *Municipal Act* can help in explaining these financial instruments.

Obligatory Reserve Funds:

Obligatory reserve funds are governed by legislation or agreement, and require revenue received for the special purpose(s) to be segregated from the general revenues of the municipality. They must be created whenever a statute or an agreement requires revenues received for a special purpose to be used solely for the purpose described for them in the statute or agreement, so as to segregate such funds until they are spent. Some examples would be surplus parking revenues, funds received in lieu of land for parks purposes as set out under Subsection 42(14) and (15) of the *Planning Act* or funds received as development charges under the *Development Charges Act, 1997*. Similarly, where the City is contractually bound to spend money derived from a contract for a particular purpose or other obligation results in the receipt of funds, an obligatory reserve fund must be created to segregate the funds until such time as they are expended as an operating budget object or a capital project. Some examples would be agreements under section 37 of the *Planning Act* or funds received from other levels of government for non-profit housing.

For financial reporting purposes, obligatory reserve funds are reported as deferred revenues on the consolidated statement of financial position as prescribed by the Canadian Institute of Chartered Accountants.

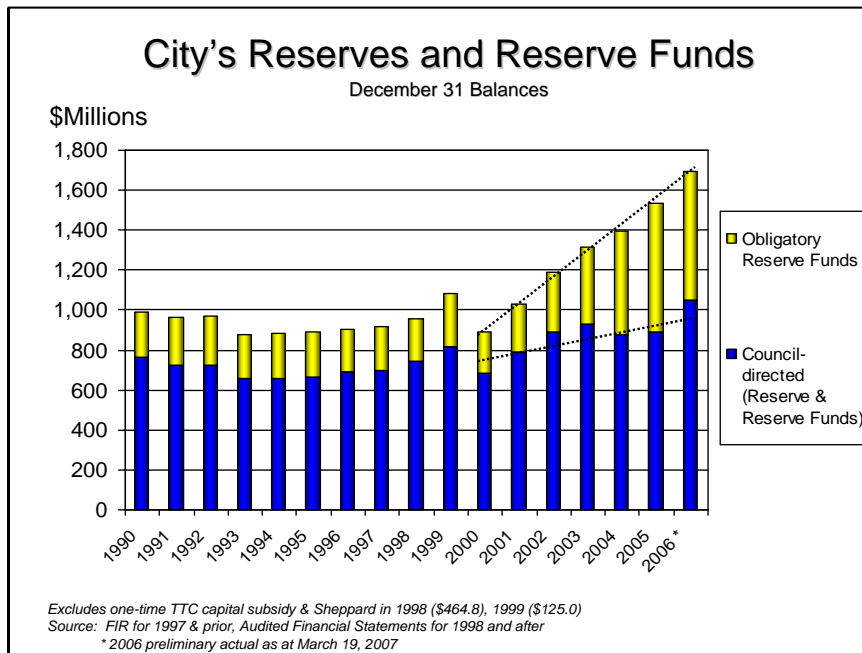
Discretionary Reserve Funds:

Discretionary reserve funds may be established whenever a municipal council wishes to earmark revenues to finance a future expenditure for which it has the authority to spend money, and physically set aside a certain portion of any year's revenue so that the funds are available as required in subsequent years. The Provincial guidelines suggest that “municipalities create new reserve funds or additional allocations to a reserve fund through the estimates process, defining the purpose for which the reserve fund is being created”. Reserve funds allow for a number of different purposes such as future expenditures on land acquisition, buildings, capital projects, vehicle replacement, insurance, and employee benefits. The main difference between these funds and reserves is that interest is applied in the case of reserve funds, and forms part of the reserve fund.

When the funds in a discretionary reserve fund are no longer required because the purpose for which the funds were set aside is no longer part of the municipality's plans, the funds can be withdrawn from the account and returned to general revenues.

History of Reserve Accounts in the City:

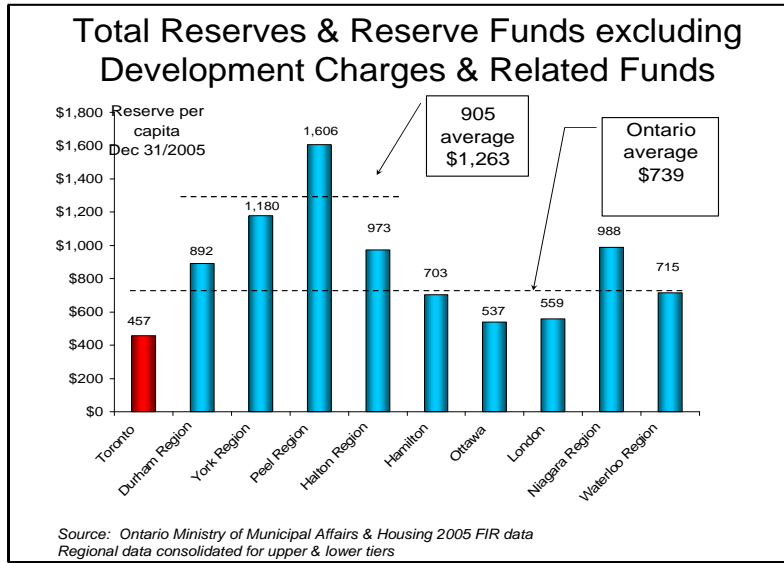
The table below of the year-end reserve account balances since the 1990s indicates that since amalgamation the total of the reserves and discretionary reserve funds has been relatively stable and that the recent growth has mainly been in obligatory reserve funds with a growth from \$212.3 million in 2000 to \$640.7 million in 2006.



Note that the 2006 year-end Council-directed funds contained an amount of \$100 million set aside for TTC's 2007 Operating Budget. If this amount was excluded, the total fund balance would be similar to that in 2005.

Consequences:

The City's reserve accounts are under-funded for its outstanding liabilities, risks and capital requirements in the long run as identified in previous reports to Council. As well, the City's per capita reserves are low in comparison to the municipalities as noted in the chart below. Had reserve draws in the amount of \$655 million (total up to 2005) not been required to support the operating budgets over the years, then the City's per capita reserve holdings would be just above the Provincial average at approximately \$719; substantially below the 905 average.



Since amalgamation, the major reserve/reserve funds have been reviewed on the basis of their adequacy vis-à-vis the liability, risk or capital object that they were intended to support. In virtually all areas of risk reviewed to date, the amount of funds held by the City has been deemed to be inadequate as noted in Table 2 below:

Table 2

Selected Reserve /Reserve Fund	Reserve Inadequacy
Capital e.g. transit, roads, vehicle & equipment replacement, buildings & facilities	\$1.0 Billion +
Operating e.g. employee benefits, environment, insurance	\$1.5 Billion +
Total reserve inadequacy	\$2.5 Billion +

As noted in Table 1 (on page 4), once the obligatory accounts, accounts with significant long term risks and capital state of good repair accounts are removed from the total amount of funds on hand, this report along with the recommended draws included in the 2007 Operating Base Budget will result in a \$278.3 million draw of available funds. Should the recommendations of this report be adopted, virtually no reliable source of reserve funds for 2008 and beyond will be available for the Operating Budget or any emerging requirements.

Reserve Review:

Any review of reserve accounts to determine whether a particular account is still serving its original purpose requires a judgement about the 'risk' that the original account was established to protect the City against in the first place. If the purpose is no longer

applicable for the financial planning of the City, then the remaining funds could be transferred to general revenues or some other revenue account and the account can be closed.

The 2007 Operating Budget has presented, once again, the City with extraordinary financial pressures. As a result, staff have had to review the balances in the reserve accounts to determine where funds can be withdrawn without jeopardizing the City's financial position. This resultant review was based on the following principles:

- (1) funds remaining in accounts which are deemed to be no longer necessary should be spent;
- (2) funds available in accounts over and above those identified as necessary in the 2007 Operating Budget and as necessary for capital purposes for the years 2007-9 provided in the 2007 Capital Budget; and
- (3) funds that could be utilized from accounts where the withdrawal is deemed to be of minimal impact to the City's ability to counter a potential liability/risk in the next three years.

Recommended Accounts to be Reduced:

Move Ontario Trust

As part of the Ontario Budget on March 23, 2006, the Province announced the creation of the Move Ontario Trust to manage the \$670 million of provincial funds that it had committed toward the extension of the Spadina subway line into York Region. The Trust has been established for the purpose of funding a new heavy rail inter-regional public transit infrastructure project to be selected by the Trustees in the City of Toronto and the Regional Municipality of York. The City of Toronto and York Region have been designated as the beneficiaries of the Trust. Based on an agreement between The Region and the City the interest from the Trust is provided to the City of Toronto and the Regional Municipality on a 60/40 basis annually. This split is consistent with the split in capital contributions.

Therefore, it is being recommended that funding in the amount of \$30.0 million be drawn from the City's share of the interest derived from the Move Ontario Trust which represents the 2006 actual earnings and the 2007 projected earnings.

Other City Reserves

As noted in Table 1, once the obligatory accounts, accounts with significant long term risks and state of good repair accounts are removed from the total amount of funds on hand, this report along with the recommended draws for the 2007 Operating Budget represent a substantial draw down of available funds.

In order to balance the 2007 Operating Budget, it is recommended that the Deputy City Manager and Chief Financial Officer be authorized to transfer funds from reserve funds

in the amounts as shown from the following accounts to 2007 Non-Program Revenue Budget – Other Corporate Revenue Account:

- a) Land Acquisition Reserve Fund (\$32.5 million)
- b) City Parking Reserve Fund (\$5.0 million)
- c) Social Assistance Stabilization Reserve Fund (\$3.5 million).

Should the consequences of this exercise result in an account having a nil balance, then it is recommended that Deputy City Manager and Chief Financial Officer be authorized to close the account and the City Solicitor be authorized to have leave to introduce a bill at Council, at a later date, to amend Municipal Code 227 – Administration of Reserve and Reserve Funds – to delete said accounts from the Code.

The recommended use of the funding from reserves and reserve funds in the 2007 Operating Budget is an extraordinary event which can only be justified on the basis that a new long term funding arrangement with the other orders of government will be realized in 2007 to correct the fiscal imbalance for 2008 and beyond.

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