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City of Ottawa 2016 Budget - Financial Reserves Review Study

Prepared for Councillor Jeff Leiper, City of Ottawa
by
LAC & Associates Consulting

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Lorne Cutler, P.Eng., MBA founded LAC & Associates Consulting following his a 25-year career in international trade finance and development. LAC & Associates specializes in providing consulting services to the private, public and NGO sectors in the areas of finance, international trade development and finance; municipal finance; and public policy. LAC & Associates Consulting is located in Ottawa, Canada.

City of Ottawa – 2016 Budget
Financial Reserves Review Study

BACKGROUND

In November 2015, the City of Ottawa tabled its draft 2016 Operating and Capital Budget. In late-2015, it was reported that there were a significant number of pressures on the 2015 budget which had resulted in a $52 million deficit for 2015. Some of these pressures were also reflected in the 2016 budget. Some key pressures that were identified in late-2015 that have affected the 2015 and 2016 budgets are:

- Winter maintenance costs
- Arbitrated wage settlements
- Increased insurance costs
- Decreased revenue from development charges
- Slowing of assessment tax growth due to declining levels of home ownership formation

As a result of these shortfalls there has been pressure put on the City's reserves.

The purpose of this report is to review the status of the City's reserves. In preparation of this report, proposed budget documents for 2016 were reviewed as well as the City's financial statements for the past several years. A number of questions were posed to City staff through Councillor Leiper. The responses from the City are shown in Appendix 4 while some of their answers are also highlighted (in red) in the body of this report. Other than reviewing the current budget documents and prior financial statements, there has been no opportunity to review more detailed City reports or documentation or to revert back to City Staff on the information provided by them. As well, a very high level review was done of Winnipeg and Edmonton with respect to their reserves as these cities are of somewhat similar size and have similar winter climates. A more cursory review of Toronto's reserves was also conducted.

CITY OF OTTAWA CREDIT RATINGS

Credit ratings are an important indication of the financial health of an entity. By reviewing the credit ratings and determining whether the factors that went into assigning the rating are still applicable, the health of an organization can be somewhat measured.

The City of Ottawa has a Aaa credit rating from Moodys. This rating was reconfirmed in April 2014. This is the highest rating that is possible and is higher than Moody"s rating for the Province of Ontario which is currently only Aa. Standard & Poors has an even lower credit rating for Ontario of A+ while giving Ottawa a rating of AA+. Ottawa's credit ratings are amongst the highest for Canadian cities. In 2012, S&P cited the following factors in determining its credit rating of AA+ for the City of Ottawa (http://ca.reuters.com/article/idCAWNA621720120430):

- Ottawa's strong credit profile benefits from its very positive liquidity. At the end of 2011, the city had cash and investments of C$1.1 billion-C$1.2 billion. In addition, it had a banking facility of C$100 million (which was undrawn) and held sinking funds of close to C$90 million.
- The ratio of free cash and liquid assets plus committed facilities to prospective debt service cost was more than 300%.
- Ottawa also has good access to Canada's well-developed capital markets.
- The local economy is stable, with high wealth and income levels. Ottawa's large share of public-sector employment provides a high level of employment stability.
- Historically, the city's debt burden has been low-to-moderate. At the end of 2011, S&P estimated that the debt burden stood at 57% of projected operating revenues. With expanded capital projects in 2012 and 2013, S&P expected the burden to rise to about 78% by the end of 2013, which they still considered to be moderate.

FINANCIAL REPORTING OF RESERVES

Ottawa does not specifically report its reserves on its Balance Sheet. Included under financial assets on the Balance Sheet are Cash & Cash Equivalents and Investments. The amounts under these headings show the nature of financial assets but do not provide an explanation of what they assets represent. As a major financial corporation, at any time the City of Ottawa will have capital and operating reserves; tax money and other revenue received that has not yet been spent (taxes are raised primarily in February and June but are spent over a 12 month period); money put aside for debt servicing; contributions from higher levels of government and unspent development charges. As such a City can have significant financial assets. In the case of Ottawa, its financial assets were approximately $1.53 billion as of December 31, 2014.

The City reports two types of reserves in the Notes to the Financial Statements. Note 14 deals with the City's Reserve Funds. The funds listed in Note 14 are, however, primarily capital reserves with perhaps the exception of insurance and employment benefits. The second type of

reserves held by the City is reported in Note 10. These are Sinking Fund deposits in respect of Long-Term Debt.

The bulk of the City's debt is in the form of long-term debentures. These debentures pay interest annually but principal is not typically paid until the maturity of the debenture. Sinking fund deposits are deposits that are put away each year to insure that the principal is in the bank and available when the debenture eventually matures. Bonds may or may not have a contractual requirement for sinking funds to be associated with them. The presence of a sinking fund usually results in lower interest rates as the risk of repayment has been lessened. In the absence of sinking fund reserves, a bond at maturity would either have to be repaid from other cash reserves, sales of assets, new tax revenue or by refinancing the debt.

Rather than report the Sinking Funds as an asset on the balance sheet with the full amount of the Long-Term Debt reported in the liability section of the balance sheet, Ottawa only reports the net amount of long-term debt (long-term debt minus sinking fund deposits) on the liability side of the balance sheet. While not as transparent as reporting the two amounts separately, this method of reporting the net debt is consistent with generally accepted accounting practices and is the same method used by such cities as Edmonton, Winnipeg and Toronto. That being said, if debt is reported on a net basis, this should mean that once any funds are put into a debt servicing reserves these funds should truly never be available for other uses.

Given concerns with the City's 2016 budget and the deficit of 2015, it is useful to review the City's current liquidity, reserves and obligations to determine if liquidity could be a problem going forward. Ottawa's current and historic financial position has been determined based on its historic audited Consolidated Financial Statements. Such an analysis, however, is only going to be as current as the latest available financial statements, which are from December 31, 2014.

LAC and Associates has reviewed the City's audited financial statements from 2007 to 2014 to determine any trends. Only those reserves that are reported in the financial statements have been included in this analysis. As such, operating reserves, such as tax stabilization and winter maintenance which are not explicitly reported in the financial statements have not been included in this analysis. Reserves can vary from year to year as major capital projects get planned and completed. The City's current priorities on the LRT and Ottawa River Action Plan have resulted in reserves in the areas of transportation and Environment Services showing the most growth.

Long-Term Reserves

Figure 1 shows reported reserves for the past 5 years. A more complete listing of reserves can be found in Appendix 1. Figure 1 shows that while Total Reserve and Sinking Funds have been steadily growing since 2007, the allocation of reserves have changed significantly. While funds reserved for debt servicing were $197 million in 2007 (representing 32% of all reserves) debt servicing reserves had dropped to $74.6 million or 11.5% of all reserves in 2014. This was over a time when total debt had grown from $948 million to $1.96 billion. During the same eight year period, reserves associated with transportation and environmental services grew from $90 million to $234.1, a factor of 2.6. The most significant growth in the City's reserves, however, was with respect to Employment Benefits which grew from $6.0 million in 2007 to $69.4 million in 2014. This growth in employee benefit reserves was due to the potential liability that the City could face with respect to employee benefits such as sick leave. There do not appear to be any reserves with respect to the City's share of unfunded OMERS pension liability.

Figure 1 – Reported Reserve Levels (Cdn. $ millions)

	Year				
Reserve Category	**2014**	**2013**	**2012**	**2012**	**2011**
Reserves Set Aside by Council	4.7	8.1	9.7	4.0	8.9
Reserve Funds Set Aside for Specific Purposes					
Endowment	164.4	176.6	183.4	185.0	195.1
Transportation & Environmental Services	234.1	157.7	53.9	101.2	82.8
Social Housing	67.3	71.8	57.6	34.4	50.8
Debt Retirement	n.a.	n.a.	n.a.	n.a.	7.7
Insurance	1.7	4.8	2.3	2.2	2.1
Employment Benefits	69.4	66.2	2.7	6.1	6.0
Other	8.8	7.9	7.2	11.3	11.1
Total Reserve Funds	564.0	500.0	322.9	346.3	361.5
Sinking Fund Deposits	74.6	60.2	47.8	86.1	174.4
Total Reserves and Sinking Funds	***643.3***	***568.3***	***380.4***	***436.4***	***544.8***

In an email from the City, the City advised that:

> "The projected closing balances for reserves for the next three years are: $338.5M in 2017, $299.7M in 2018 and $272.3M in 2019 from a $297M projected closing balance in 2016."

Since these capital reserves are tied to specific projects, reserves can go up and down depending on the size of the projects being scheduled for implementation in the various years. The City did not indicate which specific reserves the amounts specified above cover. If they represent total reserves, then this would be a drop from current levels but they probably do not include some specific reserves such as the Employment Benefits Reserve. Staff has also noted, that it is Council which controls which capital projects are schedule to proceed.

The two major projected projects in Ottawa are the expansion of the LRT and the Ottawa River Action Plan. Both of these projects have committed funding from both the Provincial and Federal governments. As well, both of these projects are being partially financed by development charges. As such, while these are major projects, the need to increase reserves to fund these projects may be offset by the funding coming from other levels of government and Development Charges.

Operating Reserves

While not noted in Ottawa's financial statements, the Draft 2016 budget does show a Tax Stabilization Reserve valued at $5.7 million at 2015 year-end projected to reduce to $1.55 million by year-end 2016. In comparison, Winnipeg's has a projected Financial Stabilization Reserve of $73.97 million by year-end 2015 and Edmonton's had a Financial Stabilization Reserve of $94.8 million at year-end 2014. Toronto reported a Stabilization Reserve of $574 million at year-end 2014 and $709 million at year-end 2013. In 2015, Winnipeg approved the target level for its Financial Stabilization Reserves to drop to 6% of tax supported expenditures whereas it had previously been 8% in 2014.

While the nature of the stabilization reserves of these other cities may not be identical, Ottawa's stabilization reserve is clearly not even close in comparison in value to Winnipeg and Edmonton or proportional to that of Toronto.

Ottawa's policy with respect to its Tax Stabilization Reserves is:

> "In the Fiscal Framework policy, Council did establish a target for the "Tax Stabilization Reserve" at a level of 1% of tax supported spending (excluding Police) which would equate to ~$25m. That level has not been achieved since that reserve was established in 2004."

Even if the City should achieve a level of 1% of tax supported spending for its Tax Stabilization Fund, it would be well under other major Canadian cities, including Winnipeg which recently lowered its target to 6%.

The City furthermore advised that its policy with respect to operating reserves is:

> "There are a few "operating" reserves that are built up over time by annual operating surpluses or reduced by deficits. Examples of these include the Tax Stabilization Fund and Winter Reserves. These operating reserves help to buffer year over year fluctuations in spending. We do not budget specifically for increases to these reserves. Our efforts to reduce the projected budget shortfalls are what will replenish these reserves over time, if we stay within our budgets and save over time, and if we have surpluses in a particular year then these reserves will increase in those years."

This means that the only way that these operating reserves will increase is if spending stays under budget. It is not clear as to what incentive staff have to stay under budget if there is no real requirement to increase operating reserves. Clearly given the drop in these operating reserves over time and the fact that the City has never met its 1% target demonstrate that the City has not been successful in meeting its targets based on spending surpluses.

LIQUIDITY AND DEBT COVERAGE

While reserves have continued to grow, it is useful to compare them against actual expenditures and future expenditures to see if they are likely to be adequate. The scope of this report does not allow for such a thorough study. This study, however, does look at to see how much cash and current investments are available to cover annual expenditures. This ratio does not, however, give a picture of future liquidity requirements as it is based on past expenditures and not future expenditures. Nevertheless it is useful to see how the City's liquidity coverage has performed over the past 7 years to see if there are any trends. Figure 2 shows reserves as a function of annual expenditures.

Figure 2 – Cash & Reserves and Liquidity (Cdn. $ millions)

Year	Total Expenditures	Total Cash & Investment Assets	Total Reserves & Sinking Funds	Cash & Investments as % of Expenditures	Total Reserves & Sinking Fund as % of Expenditures
2014	3,185.6	1,532.7	643.2	48%	20%
2013	2,970.0	1,621.5	568.3	55%	19%
2012	2,894.0	1,545.5	380.4	53%	13%
2011	2,804.5	1,155.4	436.2	41%	16%
2010	2,719.1	945.8	544.8	35%	20%
2009	2.559.2	1,016.5	433.2	40%	17%
2008	2,613.0	1,268.2	580.9	49%	22%
2007	2,433.9	1,115.5	615.0	46%	25%
Average				**46%**	**19%**

For 2014, the ratio of Cash & Investments to total expenditures was 48%. This compares favourably with the average for the past eight years which was 46%. Similarly, the ratio of Total Reserves & Sinking Funds as a percentage of annual expenditures was 20% in 2014 compared to an average amount of 19% over the past eight years. Given that the City has been able to easily handle all of its expenditures over the past 8 years and the coverage ratios have not deteriorated, there is no indication that the City is likely to experience any liquidity problems. The City has also been able to maintain its strong investment grade credit ratings of Aaa from Moodys and AA+ from S&P. Both of these agencies would take this type of liquidity analysis into consideration.

Figure 3 examines the City's debt coverage by its sinking fund and other reported debt-related reserves. For purposes of this analysis, LAC & Associates looked at all types of debt, not only long-term debt. Much of the reporting of the City's debt just focuses on the City's long term debt. LAC & Associates have also included mortgage payable and capital lease as these forms of debt have equal standing. Contingent liabilities such as underfunded employee benefits or the City's portion of the underfunded OMERS pension have not been included in this analysis. Further details can be found in Appendix 3.

Figure 3 – Debt & Debt Coverage (Cdn. $ millions)

Year	Total Debt	Sinking Fund Deposits	Total Debt Related Reserves	% Debt Related Reserves to Total Debt
2014	1,962.4	74.6	74.6	3.8%
2013	2,048.8	60.2	60.2	2.94%
2012	1,834.3	47.8	47.8	2.62%
2011	1,510.8	86.0	86.0	5.69%
2010	1,343.3	174.4	182.0	13.55%
2009	1,086.0	160.5	172.4	15.87%
2008	1,046.6	193.8	209.8	20.05%
2007	948.0	177.1	197.0	20.78%
Average				***15.84%***

While the City has maintained strong liquidity ratios for its annual expenditures and its overall reserves as a percentage of annual expenditures has been well maintained, there has been a significant deterioration in the amount of reserves put aside to service the City's debts. It is not known as to whether this is because less debt had a contractual obligation for sinking funds or whether Ottawa has been lowering these reserves in order to fund its other activities. Ottawa's financial statements show that the principal and sinking fund payments over each of the next five years start at approximately $90 million and go up by approximately $2 million per year.

The City's sinking funds decreased significantly between 2010 and 2011. It is not clear whether this happened because a significant debt was paid off in 2010 that required sinking fund coverage or whether the City became less conservative in putting away reserves to cover its debt. As sinking fund bonds generally have lower interest rates, by moving away from its sinking fund, Ottawa may be increasing its cost of capital.

Figure 4 shows a comparison of different cities with respect their sinking fund reserves. Figure 4 also includes the amount of debentures due between 2015 and 2019 for these four cities (information obtained from the respective city's audited financial statements). It should be noted, however, that while Toronto, Edmonton and Winnipeg's financial statements clearly show how much debt is due over each of the next five years, Ottawa's financial statements lump actual debentures due with required sinking fund payments. As such, it is not clear as to how much debt is actually being paid off and how much is going into reserves for future debt repayment.

A comparison of Ottawa with Toronto, Edmonton and Winnipeg shows that there is quite a variance with respect to sinking fund reserve policies. Toronto and Winnipeg are far more conservative than Ottawa and Edmonton in both the absolute amount of reserves maintained and the percentage those reserves represent of total debentures and total debenture repayments required over the next five years. It is not clear whether any of the sinking funds in place by any of the four cities are required under the terms of the debenture contracts or whether the funds are voluntary or how much might be of each.

As noted previously, Ottawa's level of sinking fund reserves have decreased significantly since 2008. At that time, Ottawa had a 20% level of reserves. With $214.4 million in debentures due between 2009 and 2013, Ottawa had a 90% coverage ratio of debt due within five years. This has now dropped to 15.6%. While Ottawa has greater coverage than Edmonton, it is far less than both Winnipeg and Toronto which both have over 100% coverage.

Figure 4 – Comparative Sinking Fund Coverage of Long-Term Debentures

Item	Ottawa	Winnipeg	Edmonton	Toronto
2014 Total Debentures	1,568.5	745.6	3,000.1	6,182.6
2014 Sinking Fund	74.6	125.6	72.6	2,004.1
2014 % Sinking Fund of Debentures	4.76%	16.8%	2.42%	32.42%
2013 Total Debentures	1,637.7	658.0	2,608.4	5,821.9
2013 Sinking Fund	72.7	195.2	66.2	1,965.7
2013 % Sinking Fund of Debentures	4.44%	30.0%	2.54%	33.76%
Total Debentures due 2015-2019	476.8	118.0	762.1	1,737.6
% 2014 Sinking Fund of 2015-2019 Debentures Due	15.65%	106.4%	9.5%	115.3%

DEBT AND DEBT SERVICING PROJECTIONS

While the 2014 financial statements show $386.5 million of principal payments, including contributions to sinking funds over the period 2016 to 2019, the draft 2016 budget actually shows $435.8 million due in this same period; an increase of 13%. Over this same four year period, the City is planning to pay $445.7 million in principal and sinking fund contributions.

This means that the sinking fund is only expected to increase by about $10 million year over this four year period. An additional $327.1 million in interest is also due over this period.

When asked about this increase in debt and its servicing requirements, the City responded:

> "The increase represents the total debt servicing cost increase. This amount needs to be split between tax and rate supported. On the tax supported side, debt servicing costs that are funded from property tax revenues are projected to increase from $99.5mn in 2016 to $107.0m in 2019 – an increase of $7.5m. That increase in tax supported debt servicing costs over that period will be funded from future increases in taxation revenues.
>
> On the Rate side, the increase in debt servicing costs which is funded from water bill revenues only is projected to increase from $32.2m in 2016 to $54.4m in 2017. That projected increase will need to be funded from future increases in water revenues. As part of the rate review process undertaken by staff, a report … include an analysis of the funding requirements of the capital program."

While principal payments are projected to increase by 23.5% over the four year period, interest payments are expected to increase by 47% over this same period. As well, over this same period, Issued Net Debt is projected to increase from $1.697 billion to $2.026.7 billion, an increase of 19%. Over this same period only $10 million appears to be allocated to sinking funds. While Ottawa is still within both provincial and municipal debt and debt servicing limits, Ottawa's debt is increasing quickly and may become problematic if not watched closely. This is compounded by the apparent decrease in debt servicing reserves.

SNOW REMOVAL RESERVES

In response to an email of November 18, City staff responded that the bulk of the City's reserves are capital reserves rather than operating. City Staff responded more specifically with respect to non-capital reserves, including snow removal reserves:

> "There are a few "operating" reserves that are built up over time by annual operating surpluses or reduced by deficits. Examples of these include the Tax Stabilization Fund and Winter Reserves. These operating reserves help to buffer year over year fluctuations in spending. We do not budget specifically for increases to these reserves. Our efforts to reduce the projected budget shortfalls are what will replenish these

> reserves over time, if we stay within our budgets and save over time, and if we have surpluses in a particular year then these reserves will increase in those years."

Notwithstanding this response, Ottawa's financial statements show no entry for Tax Stabilization Fund or Winter Reserves. The Capital Reserve Continuity Report, which forms part of the 2016 draft budget documents, shows only $5.75 million in the Tax Stabilization Fund and $4.1 million in the Winter Reserve with both amounts dropping to $1.55 million and 0 respectively by year-end 2016.

In response to a specific question on snow removal reserves, Edmonton advised:

> "Specifically around the snow reserve questions, the City does not have a specific snow reserve. The surpluses or deficits related to snow removal are dealt with through the Financial Stabilization reserve. The operating budget currently funds snow removal to a level of 95% and then the reserve is there to manage the annual swings either positive or negative."

This position is not very different from that of Ottawa. The difference, however, is that Edmonton has a tax stabilization reserve of almost $95 million, while Ottawa's is only approximately $5.7 million and dropping and a winter reserve currently with $4.2 million but expected to end 2016 with zero funds remaining.

Winnipeg's position is similar in that Winter reserves are based on savings from the approved budget rather than specific amounts budgeted to be transferred to reserves. Any shortage of winter maintenance funds would be found from general revenue or the Tax Stabilization reserve. Similar to Edmonton, but unlike Ottawa, Winnipeg has a sizeable Tax Stabilization reserve.

An examination of Ottawa's financial statements for any year shows that there is a very strong correlation between budgeted and actual spending. In 2014, overall actual spending was approximately 0.6% over budgeted spending ($3.186 billion actual vs. $3.167 budgeted). While most operating expenses are typically very predictable or can be adjusted to stay within budget, winter maintenance can vary significantly from year to year based on weather conditions and is a critical service that must be provided even if budgets are exceeded.

Without a clear and transparent policy for establishing snow removal reserves, however, these reserves are not going to be true reserves that build up in mild winters and drop in more severe

winters. As well, by not disclosing such reserves on the City's financial statements there is also no incentive to insure that they are truly sustainable.

Currently it appears that the City will budget a certain amount for snow removal. If the amount is not required, any remaining amounts are allocated to reserves. Money is taken out of reserves when winters are harsher than usual.

It is recommended that with respect to snow removal services, that if the City wants to have a truly sustainable reserve for snow removal then the City should adopt a clear policy on reserve contributions and that the reserves need to be built back up now. Given the current deficit in the existing reserve, the City should budget a realistic amount for snow removal. In order to determine the appropriate level of reserves that are required, there are two key factors:

1. Average cost of winter maintenance for a mild, average and worse than average winter. These costs can be determined by looking at historic costs vs. weather patterns. The costs should be adjusted for inflation
2. Winter patterns to determine the maximum number of severe winters that can be expected in a row as well as mild winters. This analysis will help to determine how many years of reserves are required at any given time.

For illustrative purposes only, a structure for building a winter maintenance budget might be handled as follows:

If the historic (adjusted for inflation and growth in surface area to be cleared) variance between the cost of dealing with a mild winter versus an average winter is $5.0 millon less and the variance between average winter and a severe winter has been $10 million more and historic data shows that the City could experience up to three severe winters in a row, then the reserves should be structured so that they build up to $30 million. Depending on statistically how many mild winters can be expected in a row will determine how much should be put away each year in reserves during mild and average years. This will impact on the actual amount budgeted each year. Once the reserves exceed $30 million, the amount budgeted for snow removal can drop to the actual amount without any need for further reserves to accumulate. Similarly if the reserves drop to less than $5 million at the end of a year, the reserves should be built up during the next winter regardless of whether the next winter is mild, average or harsh. A floor and ceiling would be placed on the reserves to that they are always available regardless of winter conditions. This means that until the reserves are stabilized, the City should be contributing to them regardless of winter conditions. Under this structure, reserves will be drawn down in the more severe years and will be built up in mild years. The floor and ceiling amount on the

reserves will insure that they are always available and the City isn't caught short. Weather patterns and historic removal costs will guide the amount required in the reserves.

The recently tabled Auditor General's report should be used as a guide in helping Public Works determine the appropriate costs for winter services. A number of valuable recommendations with respect to operating snow removal services and monitoring the effectiveness of the services were made by the Auditor General and accepted by the Public Works management. LAC and Associates, however, makes no comments on what should be the appropriate budget for snow removal, only the methodology for establishing sustainable reserves.

As an alternative to specific winter maintenance reserves, the City would be in a much stronger position to weather fiscal shocks if its tax stabilization reserves were to be built up to a level comparable to other major Canadian cities.

SELF-INSURANCE RESERVES

This study did not include an extensive review of the nature of Ottawa's self-insurance program but a cursory overview was conducted. As such, LAC & Associates is not familiar with what Ottawa self-insures or the nature or amount of the risk to which the City could potentially be exposed.

Under its various capital reserves, the City shows a reserve for Insurance. While over time, the value of this reserve has ranged from $2.1 to $4.8 million, in 2014, this reserve dropped to $1.7 million and is projected to drop to $22,000 by the end of 2016. It is not uncommon for cities to self-insurance a portion of their risk. At year-end 2014, Winnipeg showed insurance reserves of $5.2 million. Edmonton has self insurance reserves (specifically indicated as for vehicles) as $2.5 million. Edmonton only self-insures vehicle claims of under $250,000. The City of Toronto holds approximately $70 million in trust as collateral for the provision of automobile and primarily liability insurance.

While self-insurance is quite common for cities, it is important that there be sufficient reserves out aside for such self-insurance. If the reserves are not there and the city is required to pay, this will have to come out of the Tax Stabilization Reserve which is expected to be virtually depleted by year-end 2016.

CONCLUSIONS AND SUMMARY

The following observations are based on the current budget and historic financial statements.

1) **Cash and Investments** – The city has maintained a conservative policy with respect to its cash and investment policy. Cash and investment continue to represent approximately 48% of all current spending which is consistent with the historic average for the City.
2) **Capital Reserves** – Overall, reserves have stayed on track of approximately 20% of the City's annual expenditures. Given that this historic value seems to have served the City well, it appears that capital reserves appear to be sufficient.
3) **Operating Reserves** – The City does not appear to clearly report its operating reserves on its financial statements. It is assumed that the reserves reported in Note 14 of the statements were primarily capital in nature with perhaps the exception of the Employment benefit and the insurance reserves. Winter maintenance reserves are not transparent. The City should adopt a policy of reporting its operating reserves in its financial statements similar to other cities. This would likely require the reporting of a Tax Stabilization Reserve and possibly a Winter Maintenance Reserve.
4) **Tax Stabilization Reserve** – As noted by the City, Ottawa has a tax stabilization reserve policy that has never been followed since implemented in 2004. Even if implemented, this policy would result in reserves far below other major Canadian cities. In 2016, this reserve is expected to dwindle to only $1.5 million. If the City is not prepared to provide sufficient funding to a "tax stabilization" reserve, then it may have to accept that taxes rates cannot be stabilized at only 2% annual growth.
5) **Winter Maintenance Reserves** – While the city may have a reserve for winter maintenance, it is not publicly reported in its financial statements. As such, it is hard to monitor these reserves and it is easy to dip into these reserves. More importantly, however, the current methodology for running this reserve does not seem to be working. After only two harsher winters than normal, the City seems to have depleted these reserves entirely and is running a deficit on its winter maintenance. For this fund to become sustainable a more robust method should be put into place for funding this reserve and there should be greater reporting transparency for this reserve. Assuming Ottawa's winter maintenance reserve is included in its tax stabilization reserve (which is only reported on the City's draft budget, not its financial statements) given that this reserve only has approximately $5.7 million, it is not surprising that Ottawa does not have sufficient resources to cover two particularly harsh winters in a row. A city such as Winnipeg or Edmonton with almost $82 million and $95 million in their tax stabilization reserves is in a much better position to weather a financial shock such as unexpected winter maintenance costs.

6) **Self-Insurance Reserves** – While a detailed review of the self-insurance reserves was not conducted, it appears that projected $22,000 balance in this reserve by year-end 2016 would not be considered a prudent amount put away for self insurance. Cities such as Edmonton and Winnipeg, while only having $2-5 million in their self-insurance reserves seem to have a policy to keep the reserves replenished. If Ottawa has such a policy, it does not seem to be following it for 2016.
7) **Sinking Fund Reserves** – The City has seen a marked drop in sinking fund reserves since 2010. This may have been primarily due to a debenture with a sinking fund requirement coming due and less ongoing reliance on sinking fund debentures by Ottawa. While there is no contractual requirement to establish debt reserves if a bond issue does not have a contractual requirement for a sinking fund, it is far more prudent to build up debt servicing and/or sinking fund reserves. This is likely to lower the cost of debt if such reserves exist. On the other hand, it may be more difficult to assume debt if you know that you have to put funds away on an ongoing basis. If, however, funds are not put away, at maturity, the debt will have to either be repaid from existing liquidity or refinanced. While Ottawa still has an excellent credit rating and strong confidence by investors, both growing debt levels and the decline of debt servicing reserves may become a problem in the future.

Appendix 1
City of Ottawa 2016 Budget – Financial Reserves Review Study
Expense Coverage

		Cash & Investments ($ millions)			Reserve Funds ($ millions)						
Year	**Total Expenditures**	**Cash**	**Investments**	**Total Cash & Invest.**	**Reserve Funds**	**Reserves**	**Sinking Fund**	**Total Reserves**	**Cash & Inv. As % of Expenses**	**Reserve Funds as % of Expenses**	**Total Reserves & Sinking Fund as % of Expenses**
2014	3,185.60	435.50	1,097.20	1,532.70	4.70	563.90	74.60	643.20	48%	18%	20%
2013	2,970.00	575.80	1,045.70	1,621.50	8.10	500.00	60.20	568.30	55%	17%	19%
2012	2,894.00	300.00	1,245.50	1,545.50	9.70	322.90	47.80	380.40	53%	11%	13%
2011	2,804.50	212.00	943.40	1,155.40	4.00	346.20	86.00	436.20	41%	12%	16%
2010	2,719.10	207.90	737.90	945.80	8.90	361.55	174.40	544.85	35%	14%	20%
2009	2,559.20	124.10	892.40	1,016.50	2.40	270.30	160.50	433.20	40%	11%	17%
2008	2,613.00	495.50	772.70	1,268.20	14.70	372.40	193.80	580.90	49%	15%	22%
2007	2,433.90	420.50	695.00	1,115.50	25.90	411.96	177.10	614.96	46%	18%	25%
Average									***46%***	***15%***	***19%***

Appendix 2
City of Ottawa 2016 Budget – Financial Reserves Review Study
Total City of Ottawa Reserves

Cdn. $ million

Category	2014	2013	2012	2011	2010	2009	2008	2007	2006
Reserves set aside by Council	4.7	8.1	9.7	4.0	8.9	2.4	14.7	25.9	35.2
Reserve Funds Set Aside for Specific Purposes by Council									
Endowment	164.4	176.6	183.4	185.0	195.1	202.4	211.3	203.8	200.0
Transportation & Environmental Services	234.1	157.7	53.9	101.2	82.8	10.7	56.7	89.8	64.1
Social Housing	67.3	71.8	57.6	34.4	50.8	24.6	58.1	63.7	56.0
Debt Retirement	n.a.	n.a.	n.a.	n.a.	7.7	11.9	16.0	19.9	23.5
Equipment Replacement	18.3	15.0	15.8	6.1	5.9	1.7	14.4	18.9	21.1
Insurance	1.7	4.8	2.3	2.2	2.1	4.2	3.6	4.0	3.8
Employment Benefits	69.4	66.2	2.7	6.1	6.0	5.9	5.8	6.0	5.7
Other	8.8	7.9	7.2	11.3	11.1	8.9	6.5	5.9	5.3
Total Reserve Funds	**564.0**	**500.0**	**322.9**	**346.3**	**361.5**	**270.3**	**372.4**	**412.0**	**379.5**
Sinking Fund Deposits	74.6	60.2	47.8	86.1	174.4	160.5	193.8	177.1	157.8
Total Reserves & Sinking Funds	***643.3***	***568.3***	***380.4***	***436.4***	***544.8***	***433.2***	***580.9***	***615.0***	***572.5***

Appendix 3
City of Ottawa 2016 Budget – Financial Reserves Review Study
Debt Retirement Reserves and Debt

Canadian $ million

Year	Long-Term Debt	Mortgage Payable	Capital Leases	Total Debt	Debt Retirement Reserves	Sinking Fund Deposits	Total Debt Related Reserves	% Debt Related Reserves To Total Debt
2014	1,633.7	215.2	113.5	1,962.4	-	74.6	74.6	3.80%
2013	1,710.6	221.9	116.3	2,048.8	-	60.2	60.2	2.94%
2012	1,483.7	220.7	118.9	1,823.3	-	47.8	47.8	2.62%
2011	1,177.3	212.2	121.3	1,510.8	-	86.0	86.0	5.69%
2010	998.7	221.1	123.5	1,343.3	7.6	174.4	182.0	13.55%
2009	748.2	212.3	125.5	1,086.0	11.9	160.5	172.4	15.87%
2008	735.3	221.5	89.8	1,046.6	16.0	193.8	209.8	20.05%
2007	634.0	230.3	83.7	948.0	19.9	177.1	197.0	20.78%
2006	666.6			666.6	23.5	157.8	181.3	27.20%
2005	618.8			618.8	31.0	154.2	185.2	29.93%
2004	544.3			544.3	38.2	135.0	173.2	31.82%
Average								***15.84%***

Appendix 4
City of Ottawa 2016 Budget – Financial Reserves Review Study
Response to Questions from LAC & Associates

From: Leiper, Jeff
Sent: Wednesday, November 18, 2015 3:52 PM
To: Jasmin, Isabelle
Cc: Kirkpatrick, Kent
Subject: Information re: reserves

Good afternoon, Isabelle. I'm getting some help understanding how this budget will impact our reserves, and am wondering if I can get the following information, please, as soon as feasible? The page numbers below refer to the report filed with the budget documents at our Council meeting on November 12.

1. The table on Page 29 – Capital Reserve Continuity Report for the past 2-5 years.
   Continuities for 2010-2016 are attached.
2. Any future projections that the city has for the Capital Reserve Continuity Report. Is there a plan to be able to rebuild reserves
   The projected closing balances for reserves for the next three years is: $338.5M in 2017, $299.7M in 2018 and $272.3M in 2019 from a $297M projected closing balance in 2016.

   Each year the City contributes to the various capital reserve funds from monies collected from property taxes and water rates. For 2016, ~$442 million will be contributed to City reserves – the vast majority to capital reserves such as City Wide, Transit, Gas Tax, Water, Sewer, Police, Fleet, Parking etc. These contributions are contained in the 2016 draft operating budget. The amount contributed each year will, in general, increase by CPI per Council direction, plus in the case of the City Wide capital reserve fund, a further increase of $5.4 million included each year in accordance with the LRFP4 report. The funds in the reserves are used to cash finance the capital program submitted in that year. Although we call these reserves, they are not intended to build up overtime. These funds get contributed from tax or rate or other sources in the budget year and are used during the year to fund the capital program. As described earlier we are increasing our contribution to capital reserves each year to attain a level where we are maintaining our assets in a state of good repair.

   There are a few "operating" reserves that are built up over time by annual operating surpluses or reduced by deficits. Examples of these include the Tax Stabilization Fund and Winter Reserves. These operating reserves help to buffer year over year fluctuations in spending. We do not budget specifically for increases to these reserves. Our efforts to reduce the projected budget shortfalls are what will replenish these reserves over time, if we stay within our budgets and save over time, and if we have surpluses in a particular year then these reserves will increase in those years.

3. Draft capital budget on Page 28 – how likely are these numbers to change, particularly increase.
   Depends if you are asking about the numbers in the 2016 budget or the numbers in the 2017 – 19 forecast. If you're asking about 2016, that is dependent on Councillors - the reviews / recommendations of the Standing Committees and final Council approval on Dec 8. If you're asking about 2017 – 19, a recent memo sent to all Councillors showing the change between last year's forecast 2016 capital and this year's 2016 budget can provide an example. Overall, the amount decreased by $70M. The 2017-19 forecasts are for information only at this time. They serve to provide Councillors and the public with an indication as to what future works are being contemplated.

   Does the city have a summary breakdown of where the money for these projects are company from. The sources of finance should be split between Reserves, Debt, Government Transfers, Development Charges, etc.

In each Committee budget book, the funding for each project is provided under the "Capital Budget" section.

With capital projects going up by 126% by 2019, a drop in reserves is troubling unless the financing for these projects has already been identified as coming from other sources.
Most of the expenditure increase noted is related to LRT Phase 2 and related works such as the Baseline Transit Corridor project which are presented assuming 2/3 funding from the Federal and Provincial governments. In the 2016 Forecast Continuity of Reserves and Reserve Funds schedule there is not a drop in reserves. The total "2015 Opening Uncommitted Balance" column shows $234.2m and is projected to end the year with a balance of $297.0m. As mentioned above the funding for these projects is provided in the "Capital Budget" section of each Committee budget book.

4. The Deferred Revenue Charge (page 30) shows an estimated 2015 year-end balance of $439 mln. Based on prior year commitments, new DC's coming in, debt service charges and capital expenditures, there is a negative projected uncommitted balance. Am I reading this correctly? Where will the money come from if it is negative?
Yes that is correct. In May 2006 Council adopted funding principles on development charge accounts. A link to that report is provided.
http://ottawa.ca/calendar/ottawa/citycouncil/csedc/2006/05-16/ACS2006-CRS-FIN-0011.htm

4 key funding principles were adopted:

1. **Funding Principle for Growth Related Sanitary Sewer and Water Projects:**
Development charge accounts will be allowed to go into deficit even if they are in a current cash deficit.

2. **Funding Principle for Growth Related Transit and Roads Projects:**
Development charge accounts will be allowed to go into a deficit on a commitment basis but not a cash basis.

3. **Funding Principle for Growth Related "Soft Service" Projects:**
Projects will not be allowed to go into a deficit on either a cash or commitment basis.

4. **Funding Principle for Growth Related Project Costs in Excess of Amount in Background Study:**
If eligible, additional project costs above that identified in the background study will be debt financed

In accordance with the first principle, the DC accounts for Water, Sewer, and Storm water management are in a deficit as these works are required to be in place before development occurs.

The Roads & Related Services are also in a deficit on commitment basis. However you will note that on a cash basis (column - "Estimated Year End 2015 Cash Balance") the account has a surplus position. There still remains a sizeable DC funding commitment on road related works that have been approved by previous Council's. As stated in the 2016 Budget Transmittal report, due to the slowdown in the economy and resulting decline in DC revenues, departmental road growth submissions have been restricted which has resulted in the deferral of a number of growth related road works identified in Phase 1 of the Transportation Master Plan.

As these projects take several years to complete, the DC revenues will flow into the City over the construction period.

5. Debt servicing charges are expected to go up from $167 mln. in 2016 to $222 mln. in 2019. This is a growth of 33%. City revenue increases by only about 4-5% per year. How is this gap going to be filled.

The increase represents the total debt servicing cost increase. This amount needs to be split between tax and rate supported.
On the tax supported side, debt servicing costs that are funded from property tax revenues are projected to increase from $99.5mn in 2016 to $107.0m in 2019 – an increase of $7.5m. That increase in tax supported debt servicing costs over that period will be funded from future increases in taxation revenues.

On the Rate side, the increase in debt servicing costs which is funded from water bill revenues only, is projected to increase from $32.2m in 2016 to $54.4m in 2017. That projected increase will need to be funded from future increases in water revenues. As part of the rate review process undertaken by staff, a report will be presented in early 2016 which will propose a revised water, wastewater and storm water rate structure. Later in 2016, staff will be developing an updated long range financial plan based on Council's decision on this new rate structure and will include an analysis of the funding requirements of the capital program.

6. In 2016 (page 31 it shows that the City has to pay $167 mln. in debt servicing charges. Page 30 shows that $55 mln. is being transferred from Development Charges to "Debt Servicing Charges and Other Transfers". This seems to imply that 1/3rd of all debt is being serviced by Development Charges which seems quite high. While DC's may be allowed to pay for debt servicing for development charges related capital projects, 1/3rd seems to imply that money is being borrowed from the Development Charges Reserves. Is my interpretation correct and is this allowed. If it is allowed, what plans are being made to insure that the money is returned to the DC reserves so that it is there when the actual projects for which it is raised are being built?
The heading "Debt Servicing Charges and Other Transfers" includes a sizeable amount of "Other Transfers" that being to the Confederation Light Rail project of $31.2m in accordance with cash flow financing plan for this project. Also, "other transfers" includes estimated refunds stemming from the recent proposed OMB settlement.

   Removing these amounts leaves ~$17m as being DC debt servicing costs. The conclusion that "money is being borrowed from the DC reserves" is incorrect. DC debt is allowed under the legislation as per Funding Principle #4 above. The DC debt is not issued until the subsequent update of the DC by-law. The projected debt servicing costs associated with this debt is incorporated into the calculation of the new DC rates. As the debt servicing costs are already incorporated into the current DC rates, the DC revenues are effectively having "the money returned" to fund these debt servicing costs.

7. Does the City have any historic financial strategy documents with respect to the proposed handling of reserves.
The majority of reserve funds are established and approved by Council through a by-law. The by-law stipulates how the fund is to be managed – i.e. where the contributions are coming from and for what purpose the funds are to be used for. In general, specific desired balances are not identified in the by-law. In the Fiscal Framework policy, Council did establish a target for the "Tax Stabilization Reserve" at a level of 1% of tax supported spending (excluding Police) which would equate to ~$25m. That level has not been achieved since that reserve was established in 2004.

   Through the Rate LRFP4 report in 2012, Council also established a target for the rate supported reserves at the equivalent of 1 years worth of debt servicing costs. Based on the 2016 draft budget, that would equate to $37.5m. The projected 2016 balance in the rate reserves is $24m.

8. In 2014, the City's financial statements indicated that the City earned $47 mln. in investment income (budgeted amount was $44.7 mln.) , up from $36 mln. the year before. However, on Page 19 of the above document, it states the City earned $35.65 mln. in investment income in 2014. For 2015, the City budgeted $42.8 mln. in investment income but is now forecasting only $32 mln. Why the big drop? Since the City is not in equities, why the drop? Interest bearing investments should not have seen earnings decreased even if bond prices dropped as long as the bonds are held to maturity. In 2016, the City is

projecting $44.8 mln in investment income. Why did it drop so much in 2015 and how realistic is this number for 2016? As well, how is this amount likely to be impacted if reserves and hence cash balances and investments are down (see next question).

The amount shown as actuals in 2014 on page 19 is understated. It should have included investment income from the Endowment Fund of $34M. This $34M is actually included in the Own Funds row. This will be corrected in the final budget books. The investment income was high in 2014 because we had excellent returns on the Endowment Fund. The City does have more flexibility investing for the Endowment Fund and does invest in Equity. So the returns that we would have distributed in 2015 were actually distributed earlier in 2014 to take advantage of the high returns in 2014. Which is why 2015 shows a forecast that is lower than budget in 2015. We budget $13M each year for investment income from the Endowment Fund. We project that we can again meet that target in 2016.

9. On the City's 2014 financing statements, it shows $435 mln. in cash compared to $575 mln. in 2013. Investments are up from $1045 mln. in 2013 to $1097 mln. in 2014. Is there any breakdown that shows what these amounts are made from? The drop in cash and investments is not necessarily problematic as long as there is enough for operations and required reserves. Ideally something like:

Item	2014		2013	
	Cash & Cash Equivalents	Investments	Cash & Cash Equivalents	Investments
Capital Reserves				
Operating Reserves				
DC Reserves				
Unspent Tax Dollars				
Total	$435	$575	$1097	$1045

Maturity of investment holdings are matched with the City's anticipated cash outflows. In 2014, some funds were moved to longer term investment to take advantage of higher returns while also matching to capital project payments.