Capital Reserve GUIDELINES
CRD FINANCIAL SERVICES

Purpose
To present a capital reserve guideline and framework to establish a standard practice for setting CRD service area reserve target balance levels.

Background
Adequate capital reserve balances are critical to sustainable service delivery. Achieving an optimal capital reserve balance target achieves three goals:

1. Ensures an adequate level of capital assets is maintained required to meet existing service levels,

2. Expansion of service levels required for new service provision and/or to absorb future growth, and

3. Contingency funds on-hand required to address unexpected situations requiring immediate investment in tangible capital assets.

These guidelines are based on the principle that the each CRD service area should maintain or build enough reserves to fund the future replacement of those assets, after accounting for permissible debt levels applicable to each service area. Some level of debt is beneficial in order to amplify the impact of operations, but only to the point where an optimal level is achieved.

Capital reserve balance targets are set during long term sustainable service delivery planning activities and annually in the financial planning process. Capital reserve balance targets are determined within each service by operational management in partnership with Financial Services. These targets are reviewed annually for changes in assumptions and service delivery commitments. This guideline provides formulas which permit the service area management and finance to determine the permissible level of debt and establish the target capital reserve balances as guideline. Individual service area circumstances will justify higher or lower levels of permissible debt and target capital reserve balances.

For planning purposes, the primary sources of funding for capital investment are assumed to be debt and reserve funds (i.e. equity). While grants and funding from other levels of governments are considered, their contingent nature prevent them from being a reliable source for planning purposes. If these alternative funding sources materialize, they are expected to offset or reduce the target debt for that service area rather than reduce target capital reserve levels.

The key inputs to the analysis of a service area target reserve balances are:

- Master plans
- Service level strategic and service plans
- Sustainable service delivery plans
- Capital plans
- Grant opportunities, donations and other partnerships

Continued development of sustainable service delivery plans and long-term financial plans will provide more reliable and available asset and operational data to better inform future funding levels. Reserve funding levels should always be revisited with the completion or revision of these plans.

Each year as part of the annual financial planning process, reserve transfers and reserve levels will be reviewed by Staff to ensure alignment with these guidelines. This review is subject to existing bylaw restrictions and, with respect to statutory reserves, legislative restrictions. Reserve funding and use of reserves should be determined in conjunction with policy and best practice with regard to debt, grants, donations and other partnerships.

Financial Services, in cooperation with the operations manager, would determine the target capital reserve balance for each service area. Target levels would be reviewed corporately (i.e. Senior Manager/ CFO) on an annual basis. Finance staff responsible for the service area should be contacted if there are questions regarding interpretation or application of these guidelines.

Audited information from the financial statements can be relied on in determining the minimum maintenance target capital reserve levels. This audited information is the best source of data available and is immediately available without imposing additional administrative burden. In the future, once asset management matures, a more granular assessment can be conducted via a long-term financial planning process which incorporates asset management best practices.

Reserve Guideline Overview

Capital Reserve Balance Approvals

Each service or project in question should use these guidelines as a starting point for further analysis. Traditional oversight approval responsibilities are still required through both the long term planning process and the annual financial planning process.

Target capital reserve balances would be reviewed corporately (i.e. Senior Manager/ CFO). The ideal target ratios would balance minimizing overall borrowing and asset management costs while using judgement.

Reserve Target Levels - Categorization

In general, CRD service areas can be divided into two broad categories:

1. Capital Intensive – These are very capital intensive service areas (e.g. IWS, facilities, landfill operations, regional parks land acquisitions, etc) with engineering heavy operations. They are typically characterized by high capital asset requirement benefiting the region and with higher life cycle costs and longer-asset replacement cycles (e.g. 30 years or more). Capital Intensive service areas will take on more debt than corporate weighted average cost of capital ("WACC") suggests;

2. Service Focused – These are service areas (e.g. Leg & Gen) with a 'service-only' focus. They generally require a building, computers and perhaps fleet vehicle access to maintain service levels. They are typically characterized by low capital asset requirement with lower life cycle costs and shorter-asset replacement cycles (e.g. 5 or 10 years or less, excluding buildings). Service Focused service areas should take on no debt or less debt than corporate WACC might otherwise suggest; due to variations in service area level weighted average cost of capital as well as the desire to balance inter-generational equity concerns, a service area is not necessarily required to save 100% of its future capital replacement.

In determining a level of savings, after understanding replacement projections, a level of debt can be factored in based on the following guidelines which relate life of the asset to a tolerance for debt (generally):

Asset Category	Average Life	Debt %
Engineering Infrastructure *	50+	60 - 80%
Buildings and Heavy Equipment	25-45	40 - 60%
Equipment and Vehicles	10-20	21 - 40%
Office Equipment and Leaseholds	5-10	0 - 20%

Excludes services based primarily on the user fee/utility rate method of recovery as debt % strategy is subject to alternative targets within a utility rate model.

These useful life estimates above form the basis of the calculation guidelines below. By determining permissible debt based on estimated useful life, permissible debt can be deducted from the accumulated amortization balance in order to arrive at a target capital reserve balance for the service area.

RESERVE GUIDELINES

Financial Indicators

Reserve Target Levels – Calculation Guidelines

Assumptions

Capital expenditures (CAPEX) 're-charges' or 'regenerates' the TCA base and this CAPEX is funded from capital reserves. If annual CAPEX is:

- equal to the annual depreciation rate, the net book value (NBV) of the service area will be held constant.
- Less than the annual depreciation rate, the NBV will fall. If service levels are constant this outcome is a 'red flag'. CAPEX must be increased in order to maintain future service levels.
- More than the annual depreciation rate, the NBV will rise. If service levels are constant this outcome is also sub-optimal. It indicates potential 'over-savings' assuming the service level is constant.

Annual Reserve Funding Goal - Minimum:

The goal is to hold the historic tangible capital asset (TCA) level constant assuming this level provides an adequate service level. The formula for the minimum annual reserve funding goal is as follows:

Annual Amortization X (1 – debt %) = *Target contribution to capital reserve, less annual CAPEX*

If there is:

- no annual CAPEX, then reserves must be funded to match the annual deprecation ($) adjusting for WACC Debt to equity factor for the service area categorization.

- Some annual CAPEX but less than annual depreciation, then reserves must be added to in order to match the annual deprecation ($) less the annual CAPEX ($); i.e,. the gap must be plugged.

- Greater annual CAPEX than annual depreciation, then reserves must be reviewed to ensure there is not an 'over-saving' situation. This review must be reported to the Senior Manager, Financial Services.

Overall Reserve Funding Target Goal - Minimum:

The goal is to hold the historic tangible capital asset (TCA) level constant assuming this level provides an adequate service level. The formula for the minimum overall reserve funding goal is as follows:

Accumulated Amortization X (1 – debt %) = Target level of total capital reserve

Cases considered:

- If current reserve level is below the current accumulated depreciation balance, adjusting for permissible debt based on the WACC debt to equity factor for the service area categorization, future financial plans must be updated to incorporate 'closing this gap'.

- If current reserve level is +/-5% of the current accumulated depreciation balance, adjusting permissible debt based on the WACC debt to equity factor for the service area categorization, no action is required.

- If current reserve level is above the current accumulated depreciation balance, adjusting for permissible debt based on the WACC debt to equity factor for the service area categorization, future financial plans must be reviewed to ensure there is not an 'over-savings' situation. This review must be reported to the Senior Manager, Financial Services.

The above minimum goals would be modified to incorporate inflation and replacement cost factors into the consideration, whenever possible.

Reserve Target Levels – WACC component

Using the above service area categorization, target reserve levels may be established. Establishing the target reserve levels requires balancing the service area's exposure to inter-generational equity. Those service areas with capital intensive operations and long-asset-service lives will typically utilize higher debt levels, whereas those service areas with low capital requirements and shorter-asset service lives will typically utilize lower debt levels.

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CRD FINANCIAL SERVICES

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