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REPORT TO THE FINANCE COMMITTEE
MEETING OF WEDNESDAY, JULY 07, 2021

SUBJECT **Capital Reserve Funding Guidelines**

ISSUE SUMMARY

Report on optimal capital reserve balances and funding for sustainable service delivery.

BACKGROUND

Through various staff reports to Committee and Board, including statements of financial information and the asset management strategy, staff were directed to report on reserve fund health and optimal levels to ensure sustainable service delivery and sound financial decision making.

Prudent and sustainable management of service delivery objectives are continually integrated and prioritized through the annual planning process. Previous decision models and guidelines that inform service and financial planning include:

- Corporate Asset Management Program & Asset Management Strategy; intervening through the life-cycle of an asset to ensure long-term service delivery
- Financial Debt Term Guidelines; setting optimal long term debt amortization periods based on value for money
- CAWTP Financing Strategy; integration of life-cycle costing, cost expectations, debt tolerance, and cash flow planning
- CRHD Funding Model; where minor capital is funded from cash on hand and major capital projects are debt financed in alignment with asset life
- CRHD Summit Financing Strategy; alignment of long term debt to operating lease agreement, risk mitigation of fluctuating interest rates
- Regional Housing First Program Business Model; leveraging grant funds to create 5x investment through the use of debt
- Renewable Natural Gas Business Case Model and Analysis; optimizing agreement terms and financing strategy

The developed models and guidelines to date form a common approach to defining an overarching corporate financing strategy to support the organization's goal of sustainable service delivery. To measure performance, financial health indicators were introduced and have been tracked since 2017. Using the DBRS[1] rating methodology for municipal governments, the CRD has maintained a AA or better rating since 2017. Other key health indicators monitor liquidity, interest coverage, leverage, and capital reserve health.

This report focuses on capital reserve health, the relationship with leverage and debt affordability, and the integral impact both have on service delivery. The analysis includes a measure of existing reserves against the guideline to illustrate funded status. During 2021, staff developed capital reserve guidelines which were reviewed and approved by the Executive Leadership Team (ELT).

[1] The Dominion Bond Rating Service (DBRS) is the largest rating agency in Canada and fourth largest in the world.

ALTERNATIVES

Alternative 1
The Finance Committee recommends to the Capital Regional District Board:
That the Capital Reserve Funding Guidelines report be received for information.

Alternative 2
That this report be referred back to staff for additional information.

IMPLICATIONS

Adequate and appropriate funding sources are key to the organization's ability to execute capital investment and sustain service delivery. A scan of the organization's current environment included:

- capital reserve bylaws
- reserve balances in relation to asset value
- a review of current CRD and best practices

The review focused on the following key indicators:

- assessment of overall funding differential by service (Acc Am – Reserve Balance)
- application of optimal % savings (Optimal D/E based on asset useful life)

The objective was to identify early opportunities and leading indicators to address shortfalls in funding health through the annual planning processes. Through exception reporting of leading indicators, staff will drive further analysis by service and integrate recommendations through asset management and financial planning.

Legislative Implications

Capital reserves are established either legislatively for statutory reserves or by bylaw for all other capital reserves. Once established, reserve funds can only be used for the identified purpose except when funds are no longer required or when used for inter-service borrowing. Both legislation and bylaws state where reserves will be funded from and what the funds can be used for. Currently, neither legislation nor existing bylaws define how to set target reserve levels.

Financial Implications

The CRD has 70 capital reserves established. Some services have more than one reserve but the majority have a single reserve. When applying the indicators on funded status, the results show:

- 45 reserves are funded within or above reasonable target range
- 25 reserves are flagged as requiring attention and below target range

While the overall results highlight that the majority of reserves are considered well-funded, benchmarking within or above target, it should be noted that 25 reserves are identified as requiring attention and benchmarking below target. Additionally, a majority of the 25 are within the Electoral Areas. Lower reserves may be acceptable, given the longer life of some Electoral Area utility assets; however, if savings rates are not within guideline ranges, future borrowing levels and costs will be higher and could be fiscally challenging.

For services where reserve balances are above the target range, there is an opportunity to reduce transfers from operating budgets, in addition to incorporating optimal leverage in a financing strategy for future investment.

Through the financial health indicators introduced in 2017, reserve funding levels have been measured using the Capital Reserve Health Ratio (CRHR). In 2020, reserves were 9% of asset value, where best practices benchmark in the 15-20% range. In partnership with the CRHR, Revenue Supported Debt Servicing has been measured against the benchmark maximum of 25% of recurring revenue. The target is in alignment with both DBRS ratings for local governments as well as the Ministry of Municipal Affairs legislative limit for municipalities in British Columbia. In 2020, the CRD had 7.6% of revenue supporting debt servicing.

Additionally, an analysis of the 2020 DBRS indicators resulted in a AA overall rating, indicating a high capacity for financial sustainability and a low vulnerability to negative future events.

Other Local Governments
Local, and International, Government Finance Officers associations publish case studies on a regular basis. A review of current publications showed recommendations on alignment of reserve balances to asset life and replacement, recognizing there are challenges in estimating future costs, in particular for long-life assets. Additionally, there was minimal documentation on optimizing reserves (savings) with debt (borrowing) and external revenue such as grants.

A call to local governments across the province demonstrated wide ranging practices with limited documentation on optimal reserve targets. Metro Vancouver was the most progressive. While silent on target reserve levels, Metro opted for setting a maximum % of revenue for debt servicing; currently 40%. Regional districts long-term borrowing is not restricted by legislation.

Analysis
Optimal financing strategies are essential in supporting and enabling the service delivery requirements of the CRD. At a fundamental level, saving and borrowing or reserves and debt are the internal drivers; thus, optimizing the blend or ratio is critical to a financing strategy.

Where reserves impact current rate payers, debt can both distribute costs over time and multiply investment capacity. Both reserve balances and debt need to be actively managed against external conditions including interest rates, inflation, and changes in the treasury marketplace.

In evaluating and balancing internal drivers, staff utilized cost sensitivity analysis to develop target debt to equity ratios, with the goal of evaluating optimal financing strategies on new purchases, replacement of capital infrastructure, and land acquisition.

The foundation of the guideline is the relationship between asset life and an optimal blend of debt and equity. Shorter-life assets should utilize a lower ratio of debt to equity vs assets with longer useful lives being better suited to higher leverage.

Appendix C includes graphics to articulate the concepts above.

The guideline is a standard approach to be applied in each service, and involves:

- evaluation of asset life cycles and asset types
- assessment of target debt and equity based on the life of the asset
- analysis to develop financing strategy, incorporating CRD Debt Term Guidelines

In March 2021, the ELT reviewed results of the analysis and proposal, and directed a guideline be established to set target reserve levels within each service while maintaining the key financial health indicators.

In April 2021, the ELT approved the Reserve Guidelines included in Appendix B and directed the guidelines and accompanying analysis be incorporated into the 2022 financial planning process. Staff recommendations will be included in budget deliberations by ELT through the summer, and ultimately through Commissions, Committees, and the Board this fall.

Other Considerations

The guideline is intended to address sound financial management practices, but recognizes that a philosophical approach may override recommendations. Philosophically, a decision to borrow provides immediate benefit and spreads liability over time, whereas a decision to save impacts current ratepayers with a future benefit.

By matching higher levels of borrowing for assets with longer lives, the guideline incorporates matching costs of a service over its life, across generations, particularly in the case of assets with lives greater than 40-50 years.

An illustrative example is the land acquisition levy for the Regional Parks Service. The money is saved by todays' taxpayers to buy land that will benefit many future generations, as land would be expected to serve community needs in perpetuity. In addition to concepts of inter-generational equity, economically, consideration should be given to the rate of land appreciation versus the rate of borrowing. Where one outpaces the other, the funding approach could be impacted.

CONCLUSION

Optimal financing strategies are essential in supporting and enabling the service delivery requirements of the CRD. The guidelines optimize use of debt and capital reserves; they are not policy, rather an optimized reference point balancing multiple objectives. Staff will incorporate and apply the guidelines through the 2022 financial planning process.

RECOMMENDATION

The Finance Committee recommends to the Capital Regional District Board:
That the Capital Reserve Funding Guideline report be received for information.

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ATTACHMENT(S)

Appendix A: Capital Reserve Analysis
Appendix B: CRD Capital Reserve Guideline
Appendix C: Corporate Finance Concepts