4
2007 BUDGET – CAPITAL ASSET REPLACEMENT RESERVES

The Finance and Administration Committee recommends the adoption of the recommendations contained in the following report, June 8, 2006, from the Commissioner of Finance:

1. RECOMMENDATIONS

It is recommended that:

1. This report establishing a policy of funding reserves for the rehabilitation and replacement of capital assets be approved.

2. Commencing with the 2007 budget:
   a) an amount equal to the last complete year's actual supplementary tax receipts (net of write-offs) be included as revenue in the operating budget;
   b) a corresponding contribution of the same amount be included as an expenditure in the operating budget, with 50% funding the capital asset replacement reserves and 50% funding the Capital Reserve;
   c) Any supplementary taxes received in excess of this amount continue to be allocated in accordance with the Region's Surplus Management Policy.

3. As part of the 2007 budget, a long-term funding plan for asset replacement be developed for consideration.

2. PURPOSE

The purpose of this report is to establish a policy for funding rehabilitation and/or replacement of the Region's capital assets.

3. BACKGROUND

3.1 Capital Asset Management

Capital reserves form an important component of a Capital Financing Plan as they provide flexibility and liquidity as well as enhance the Region's capacity to address current and future capital infrastructure needs.

York Region's total capital asset inventory has a preliminary estimated replacement value of approximately $6.3 billion. The estimated useful life of these capital assets range from three years to 100 years. These assets must be supported by contributions to reserves to address and ensure their eventual rehabilitation and/or replacement.

A Capital Asset Management Plan is being developed to prepare the Region for compliance with the implementation of the requirement from the CICA, Public Sector Accounting Board (PSAB) obligating local governments to report capital asset accounting by 2009. A critical component of the Capital Asset Management Plan is to determine the appropriate level of reserve funds required to support the planned rehabilitation and/or replacement program for capital assets. The development of a Capital Asset Management Plan should address the optimum required reserve allocations and contributions to ensure that the investment in capital assets is appropriately protected and managed on a long term basis. The current level of commitment to capital asset replacement reserves is clearly inadequate given the magnitude and value of the Region's asset inventory.

In addition, rating agencies focus on municipal liquidity levels, i.e. the amount of reserves (capital reserves in particular) a municipality maintains. Although the Region's capital reserve currently exceeds the average of other 'AAA' municipalities, this advantage is forecast to erode and could be well below its peer group by 2007.

The Region's financial philosophy has been developed through a combination of historical prudence and the adoption of best practices among municipal governments. This philosophy was embodied in the Financial Mission Statement, adopted by Council in 1999, which formally commits the organization to fiscal responsibility and sound financial management to ensure adequate funding of services and capital infrastructure. In conjunction with the Financial Mission Statement, Council adopted the following Financial Principle, which specifically addresses the use of reserves:

"Adequate reserves will be maintained to:

1. Replace and rehabilitate major capital infrastructure assets as required
2. Provide a buffer for significant unanticipated expenditures beyond the control of the Region
3. Supply funds for new major capital assets identified in the long-term corporate strategy."

In addition, adequate reserves promote fiscal prudence reflecting a primary goal of Vision 2026.

3.2 Surplus Management Policy

The Region has a Surplus Management Policy, which was revised in 2002 and has been the basis for annual recommendations to Committee and Council for the allocation of the year-end surplus to the Region's reserve funds. The reserve funds receiving year-end surplus allocations are the Capital Reserve and the Tax Stabilization Reserve.

The Capital Reserve, established in 1997, is used for funding any purpose of the Regional Corporation as determined by Regional Council. The Capital Reserve is operated and maintained from:

- the Regional tax supported surplus as of December 31st in each year; and
- appropriations made from time to time by the Regional Corporation.

The Tax Stabilization Reserve, established in 2002, is used to fund temporary tax revenue shortfalls and unforeseeable one-time expenditures. The Tax Stabilization Reserve fund is operated and maintained from:

- appropriations made from time to time by the Regional Corporation; and
- an amount not exceeding 50% of any unallocated year-end surplus.

Both reserves benefit from the contribution of annual operating surpluses, the bulk of which are created by supplementary taxes.

3.3 Supplementary Taxes

Supplementary taxes arise from new properties (omitted assessment) and property enhancements (supplementary assessment) that have been brought into the assessment base for the Region during the year. This assessment has not been included on the Returned Assessment Roll for the year and thus the property tax payable on these properties represents new, and currently, unbudgeted revenue for the Region. The current Surplus Management Policy takes into consideration the unpredictable nature of supplementary tax revenues, and the need to strengthen the Region’s reserves.

Supplementary taxes are not a reliable source of funding. This revenue source is highly dependant on the amount of annual growth and new construction within the Region and is therefore subject to the economic cycles associated with the development sector. The amount of supplementary tax revenues in any given year is also affected by the timely recording of building permits and the assessment process of the Municipal Property Assessment Corporation (MPAC).

4. ANALYSIS AND OPTIONS

4.1 Supplementary Taxes as a Funding Source for the Capital Replacement Reserve

Over the last several years the York Region has experienced assessment growth of approximately 4.0% per annum. This level of assessment growth is projected to decline to approximately 2.0-3.0% in future years.

Table 1 illustrates the historical supplementary tax receipts for the Region from 1999 to 2005. On average, over the last seven years, the Region received $12.6 million annually of supplementary taxes (a high of $20.0 million and a low of $7.1 million). Table 1 reflects that supplementary taxes can vary significantly year over year.

Table 1
Supplementary Tax Receipts in York Region

Year	Supplementary Tax Receipts (Net of Write-Offs)
1999	$12.1 M
2000	$9.0 M
2001	$11.3 M
2002	$7.1 M
2003	$8.2 M
2004	$20.0 M
2005	$20.2 M

The Property Tax Write-Off Reserve was established in 2000 to absorb the significant and variable annual costs related to property tax write-offs and provide funds for rebates on eligible vacant commercial and industrial properties. Write-offs are dependant upon the amount of reconsiderations and appeals associated with reassessment. This reserve is maintained at $3 million and is funded by the general surplus at year-end. Any surplus funds in excess of the amount needed to maintain the $3 million balance in this reserve are directed to the Tax Stabilization Reserve and the Capital Reserve Fund.

Currently, the Region's Capital Asset inventory is estimated at $6.3 billion (replacement cost) and over the next decade will require rehabilitation and/or replacement and funding. Also, future demand in areas such as Water and Wastewater, Social Housing, Transit and Roads, and Building Rehabilitation, will continue to present funding challenges and will necessitate even greater reliance on appropriately funded reserves.

Table 2 illustrates the range of useful life and the replacement costs of the Region's existing capital assets as at December 2005.

Table 2
Inventory of Existing Regional Capital Assets
As at December 2005

Asset Class	**Range of Useful Life** (years)	**50 Year Replacement Costs** ($billions - 2005)
Linear Roads	15 & 40	1.8
Other Road Assets	7 - 75	0.6
Linear Water & Wastewater	100 & 75	0.2
Other Water & Wastewater Assets	50 & 30	1.5
Other Program Specific Facilities	25 - 50	0.6
General Buildings	25 - 50	0.2
Rolling Stock	3 - 18	0.8
Other Assets	3 - 25	0.6
Total		**$6.3**

The Region's capital assets must be supported by contributions to reserves to address their eventual rehabilitation and/or replacement. The need to strengthen the Region's capital reserves for infrastructure has been identified previously and was further discussed with Committee and Council during the 2006 budget deliberation. A key element of this strategy will be to build reserve levels to be sufficient to cover the rehabilitation and replacement of Regional assets.

Currently the Capital Reserve benefits from the contribution of annual operating surpluses, the bulk of which is created by supplementary taxes. There is a lack of sustained funding to contribute to the reserves, so use of supplementary taxes would be a source of funding the reserves. For 2007, it is proposed that an amount equal to the last complete year's actual supplementary tax receipts (net of write-offs) be included as revenue item in the Region's operating budget, with a corresponding budget contribution split equally between capital asset replacement reserves and the Capital Reserve. Any supplementary taxes received in excess of this amount will continue to be allocated in accordance with the Region's Surplus Management Policy. In addition, tax levy and user rate contributions will be included to further build capital asset replacement reserves.

5. FINANCIAL IMPLICATIONS

It is proposed that capital asset replacement reserves and the Capital Reserve would be funded on an annual basis by the last complete year's actual supplementary taxes, net of write-offs. This sum of revenue would not be available for allocation to the Tax

Stabilization Reserve. However this contribution would help to address the need for increased replacement reserve balances. Tax levy and user rate contributions will also be proposed as a source of funding to further build capital asset replacement reserves.

6. CONCLUSION

Capital reserves form an important component of the Capital Financing Plan as they provide flexibility and liquidity as well as enhance the Region's capacity to handle current and future capital infrastructure needs. In addition, they reduce reliance on future debt and tax levy. The Region's capital assets must be supported by contributions to reserves to address their eventual rehabilitation and/or replacement. The need to strengthen the Region's capital reserves for infrastructure has been identified and represents a further strengthening of the Region's commitment to prudent fiscal management.

It is recommended that an amount equal to the last complete year's actual supplementary tax receipts, net of write-offs, be included as revenue commencing with the 2007 budget. A corresponding contribution of the same amount would be included as an expenditure in the operating budget, with 50% funding capital asset replacement reserves and 50% funding the Capital Reserve. This policy addresses the described need, strengthens reserves and establishes a base for future budgets. Any supplementary tax received, net of write-offs, in excess of this amount would continue to be allocated in accordance with the Region's Surplus Management Policy.

The Senior Management Group has reviewed this report.