TO:	**CHAIR AND MEMBERS STRATEGIC PRIORITIES AND POLICY COMMITTEE MEETING ON DECEMBER 7, 2015**
FROM:	**MARTIN HAYWARD MANAGING DIRECTOR, CORPORATE SERVICES AND CITY TREASURER, CHIEF FINANCIAL OFFICER**
SUBJECT:	**SURPLUS/DEFICIT POLICY**

RECOMMENDATIONS

That, on the recommendation of the Managing Director, Corporate Services and City Treasurer, Chief Financial Officer:

a. The attached proposed by-law (attached as Appendix A) **BE INTRODUCED** at the Municipal Council meeting on December 8, 2015 to enact a Surplus/Deficit Policy, in order to provide Civic Administration with a set of guidelines to manage yearly surplus or deficit positions; and

b. The Civic Administration **BE DIRECTED** to bring forward the necessary by-laws regarding the establishment of a Municipal Council Community Investment Reserve Fund and a Capital Infrastructure Gap Reserve Fund.

BACKGROUND

The purpose of this report is to seek Municipal Council approval of a Surplus/Deficit Policy by-law. On December 3, 2007, Municipal Council passed by resolution a Surplus/Deficit Policy. Civic Administration is bringing forward a new Surplus/Deficit Policy due to:

1. A comprehensive review of the existing policy has not been conducted since 2007;
2. To ensure the policy is aligned with the current desires of this term of Municipal Council; and
3. To ensure the policy provides the necessary flexibility to meet current operational demands.

Definition Of A Surplus Or Deficit

A surplus arises in the operating budget when there is an excess of revenues over expenditures. Year-end surpluses generally arise from two circumstances – higher than budgeted revenues (including one-time only revenues), and/or lower than budgeted expenditures.

A deficit arises in the operating budget when there is an excess of expenditures over revenues. Year-end deficits generally arise from two circumstances – lower than budgeted revenues, and/or higher than budgeted expenditures (including one-time only expenditures).

The Municipal Act, 2001 Disposition Of Surplus/Deficit

The *Municipal Act, 2001* requires municipalities to bring the prior year's surplus forward into the next year as a revenue for the operating budget; conversely the *Municipal Act, 2001* also requires municipalities to bring the prior year's deficit forward into the next year as an expenditure for the operating budget.

Either method would result in fluctuations in the tax levy requirement from year to year, a reduction in the case of a surplus or an increase in the case of a deficit. With respect to surpluses, this treatment may be seen as a positive action because the surplus partially mitigates/reduces any increase in the tax rate in the subsequent year. However, the downside of this requirement is that once a surplus has been carried forward in this way it must be maintained because the reduction or elimination of the revenue creates a pressure in the following year's operating budget (i.e. if a surplus of $1 million was realized and carried forward, the following year would have to see the same surplus realized otherwise an increase to the tax payer to make up the difference would be required).

Where municipalities have had surpluses or deficits, there is a need to maintain consistency from one budget year to the next to avoid significant budget pressures or unsustainable revenue increases. Thus the Surplus/Deficit Policy provides parameters to support the yearly balancing of the operating budget to mitigate future year impacts of carryover surplus or deficit.

What's The Discussion On Surplus/Deficit And Why Does It Keep Happening?
Each year Municipal Council sets an operating budget that is balanced. This means we anticipate revenues will come in from various services and expenditures will be made in various services to achieve the goals and expectations of Municipal Council and the community.

The operating budget sets the tax levy by detailing the expected net cost to run the Corporation of the City of London (the "City"). The tax rate is then set by dividing that cost among property owners and businesses according to provincial rules and tax policy.

How can we have a surplus or deficit when we have already set a budget? The budget is a plan and, like any plan, circumstances can change. Some of the variables that can change are:

1. Local economy – affects Ontario Works costs and revenues, building permit revenue, recreation revenues and participation levels, and incentive programs;
2. Regulatory changes – affect service levels (costs) in various services ranging from provision of social, health and emergency services to safety standards for other services;
3. Legal and collective bargaining issues – potentially affects the cost of all services, although the final outcome may be more or less than anticipated in the budget estimate; and
4. Weather – affects recreation revenues, parking revenues, bus revenues, snow removal costs, recreation cost and sewage treatment plant costs.

Although every effort is made to ensure that estimates are close to actuals, to plan for every eventuality would mean significantly higher taxes. This is a prospect that would be unacceptable to the community. If no provisions were made to accommodate some variability, Municipal Council would be forced to:

1. Issue higher tax bills mid-way through the year;
2. Cut services mid-way through the year; or
3. Increase taxes the following year by the amount of the deficit that would ensue.

None of these alternatives are acceptable as they may create unpredictability in the property tax rate or inconsistency in the delivery of municipal services each year.

Therefore, Municipal Council approves reasonable program estimates (not the best or worst case scenario) and makes reasonable provisions for contingencies to mitigate some risk of unexpected or emergent issues. This has the effect of smoothing budget impacts across various services and contingency accounts. Actual performance may vary from account to account, but overall the budget should balance.

What Is The Difference Between One-Time And On-Going Impacts?
One-time means that we can only expect to see the expenditure or the revenue in a given year and should not build it into our base operating budget.

- If one-time expenditures are built into the base operating budget we would see automatic "built-in" surpluses as taxes would be raised to cover expenditures that would not materialize.
- The converse is true of revenues. If one-time revenues were built into the base operating budget the effect would be to reduce the amount of tax levy (or other revenue) raised to pay for the same level of expenditure. If the revenue source does not materialize the expenditures have to be reduced or a deficit will result causing a corresponding increase in the tax levy requirement the following year.

On-going impacts are those that can be reasonably expected each year. In order to properly fund on-going costs each year, ongoing revenues must be raised. Slight adjustments may be required over time, but generally the expenditure or revenue will remain stable from year to year (except for changes resulting from significant inflation, volume or regulatory requirements).

What Are Other Municipalities Doing?
As part of the development of this policy, a review of other Ontario municipalities was conducted. The majority of Ontario municipalities that were researched allocate surplus to one or a combination of the following: a stabilization reserve, unfunded capital projects, or other unfunded liabilities and reserve/reserve funds. In regards to the treatment of deficits, we found that the majority of Ontario municipalities that were researched fund deficits through established contingency reserves (such as a tax rate stabilization reserve).

A sample of Ontario Municipalities was conducted to determine how they treat surplus/deficit positions. The table below provides a summary:

Municipality	Treatment of Surplus or Deficit
City of Barrie	**Surplus:** Operating surpluses are treated as non-recurring revenues and therefore are not used for funding the following year's operations. Any operating surplus in any given year is allocated to reserves in accordance with the Reserve/Reserve Fund Management Policy. **Deficit:** The tax rate stabilization reserve is used to cover potential deficits and to fund one-time non-recurring expenditures. Operating deficits, if not funded from other sources within the year or from the tax rate stabilization reserve, become the first item of taxation in the subsequent year.
City of Ottawa	**Surplus:** Surpluses are brought forward to the following year as revenue, then allocated as follows: • Replenish the tax rate stabilization reserve; • Replenish other reserves; • Reduce any asset maintenance deficit; and • Reduce or maintain the property tax rate. **Deficit:** A deficit is funded by prior year surpluses (tax rate stabilization reserve or capital reserves, if required).
The City of Toronto	**Surplus:** Surpluses are to be distributed in the following priority order: • The Capital Finance Reserve Fund (at least 75% of the surplus); and • The remainder to fund any underfunded liabilities and/or reserves/reserve funds, as determined by the Deputy City Manager and Chief Financial Officer. **Deficit:** *Policy contains no direction concerning deficit management.*
Regional Municipality of York	**Surplus:** Surpluses are allocated in priority order as follows: • To cover off any contingent liability reserves when it is determined these reserves are inadequately funded; • The General Capital Reserve if it is determined there is a need for further funds in that reserve; • The Fuel Cost Stabilization Reserve if there is a loss incurred during the year from hedging transactions; and • Any remaining funds will be transferred to the Debt Reduction Reserve. 80% of annual surpluses attributable to housing operational savings compared to budget is placed in the Social Housing Development Reserve; the other 20% is placed in the Working Capital Reserve. **Deficit:** Deficits are to be funded using either the Tax Stabilization reserve or the Fiscal Stabilization reserve.

Overview Of Proposed Surplus/Deficit Policy
The proposed Surplus/Deficit Policy is based on a set of principles for surplus/deficit management. These principles provide Municipal Council and Civic Administration with direction regarding the annual treatment of surplus or deficit positions.

Before considering which principles will guide the allocation or funding of year-end surplus or deficit positions, the nature of a surplus or deficit must be defined. For the purpose of the Surplus/Deficit Policy, all surpluses and deficits are to be considered one-time in nature. One-time means that we can only expect to see the expenditure or the revenue in the current year budget and it will not be realized in future year budgets. As a result, year-end surplus or deficit positions are not to be built into the City's base operating budget, but rather allocated on a one-time basis.

With the overarching principle that all surpluses and deficits be treated as one-time in nature, the one-time allocation and funding principles of the proposed Surplus/Deficit Policy are as follows:

<u>In A Year Of Surplus</u>

a) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to contribute an amount to the Operating Budget Contingency Reserve (OBCR) not to exceed the reserve target balance of 1.5% - 2.0% of the property tax gross expenditure budget.

   Many municipalities establish contingency reserves (sometimes known as a tax rate stabilization reserve). These reserves are used to avoid/fund deficits or one-time/emergency expenditures. The OBCR is the City's contingency reserve used to help manage contingencies that are unforeseen or hard to predict with specificity. In a year of surplus, on a one-time basis, a contribution to the OBCR should receive priority consideration if it is determined the balance of the reserve is not adequate.

b) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to contribute an amount to the Unfunded Liability Reserve not to exceed any operational savings realized from personnel and contingency budgets at year-end.

   The Unfunded Liability Reserve was established in part to provide for future employee benefits payable. These employee benefit costs include vested sick leave, vacation credits, benefits under the Workplace Safety and Insurance Board Act, life insurance and extended health and dental benefits for early retirees, and pension plan contributions (OMERS). Given the direct correlation of this reserve to personnel and contingency costs, in years of surplus, on a one-time basis, a portion of the personnel surplus is to be allocated to the Unfunded Liability Reserve at the discretion of the City Treasurer or designate. The amount to be contributed each year will be assessed based on the City's net Unfunded Liability Reserve balance. This practice is supported by the fact that the reserve is historically underfunded.

c) Remaining surplus to be reported in the 4^{th} Quarter Operating Budget Status Report with the surplus contributed to the OBCR to balance year-end operations. The remaining surplus allocations shall be drawn down from the OBCR and allocated in accordance with the following proportions:

   i. 50% of any operating surplus shall be applied to reduce authorized but unissued debt, it being noted that debt reduction will reduce future year's debt servicing costs.

      On an annual basis, Municipal Council approves a capital budget with corresponding financing such as debt. Often due to the nature of capital works, the issuance of debt is not required until the work is close to complete, 2 – 3 years after budget approval. As a result of this timing difference, Municipal Council can reduce the amount of authorized but unissued debt through the allocation of year-end surplus to debt substitution.

   ii. 25% of any operating surplus shall be contributed to the Municipal Council Community Investment Reserve Fund to be allocated at the discretion of Municipal Council.

Throughout the year, emerging issues and opportunities requiring funding are brought to the attention of Municipal Council by Civic Administration and/or the community. These types of funding requests are often one-time in nature and may assist Municipal Council in advancing its Strategic Plan.

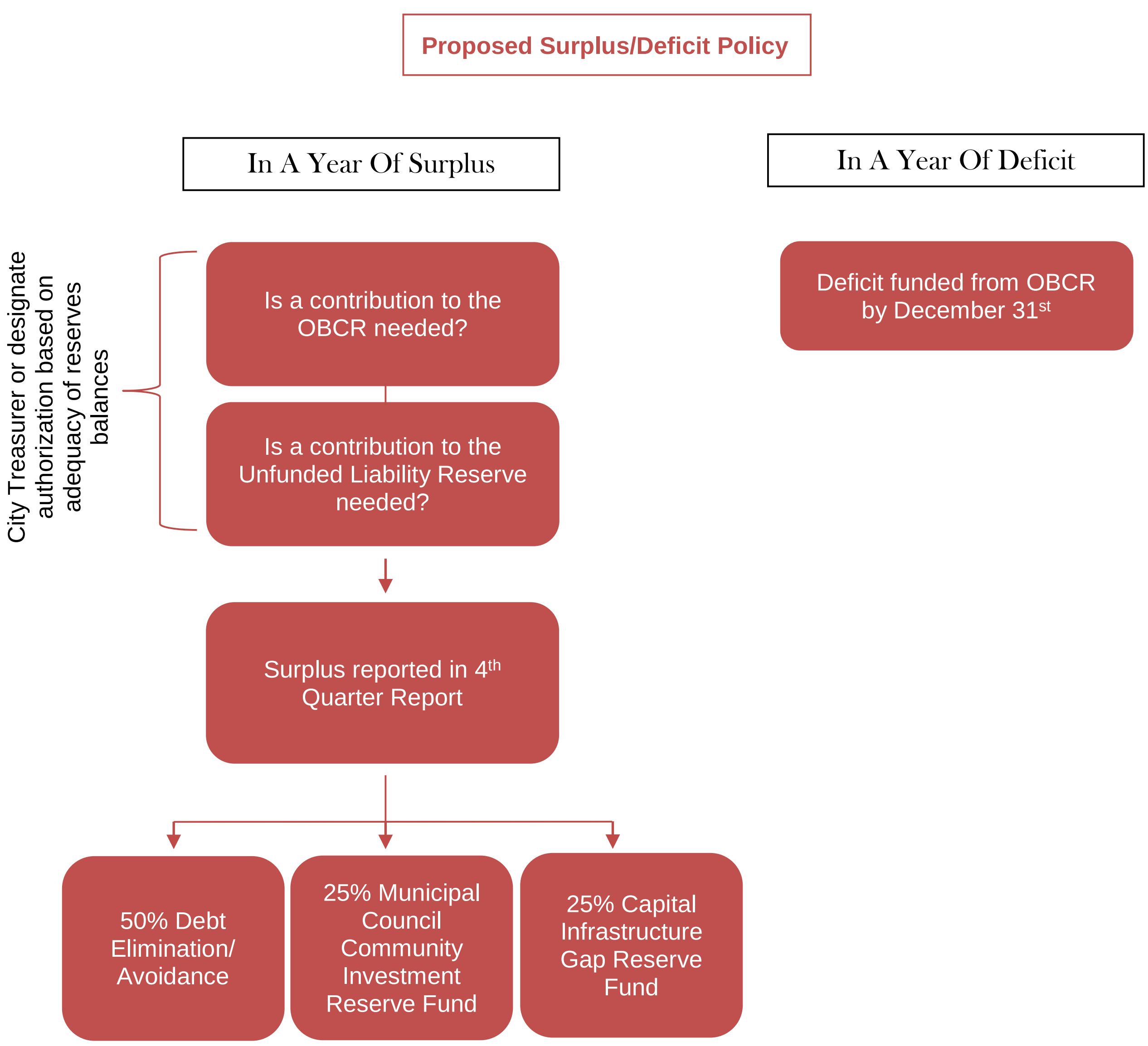
iii. 25% of any operating surplus shall be contributed to the Capital Infrastructure Gap Reserve Fund to mitigate growth in the infrastructure gap.

The 2013 State of Infrastructure Report identified an approximate infrastructure gap of $52.1 million and projected that gap to grow to $405.5 million by 2022. The risks of not investing in the infrastructure gap are the potential to shorten the useful lives of assets, inefficient investments, litigation, damage to the environment, lost opportunities (i.e. government transfer payments), and rising maintenance costs. The one-time contribution to this reserve fund would be used to mitigate growth in deteriorating City owned assets.

In A Year Of Deficit

d) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to drawdown from the OBCR to balance year-end operations

The following diagram provide an overview of the proposed Surplus/Deficit Policy.



Reporting

e) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate shall strive to provide the following reports related to year-end projected surplus or deficit positions within 45 days of the close of the reporting period:

   i. Second Quarter Operating Budget Status Report to be submitted at the discretion of the City Treasurer (January 1st to June 30th)
   ii. Third Quarter Operating Budget Status Report (January 1st to September 30th)
   iii. Fourth Quarter Operating Budget Status Report (January 1st to December 31st)

The purpose of these reports are to monitor the performance of the operating budget. As part of these reports, Civic Administration provides projections to Municipal Council on anticipated surplus/deficit positions.

Transition To New Surplus/Deficit Policy
As part of the existing Surplus/Deficit Policy (passed by Municipal Council on December 3, 2007), an annual draw of $850 thousand from the OBCR was established. This annual draw is recognized as revenue each year, reducing the property tax levy requirement.

To mitigate budget pressures within the implementation of the City's first multi-year budget (2016-2019), the plan is to phase out the $850 thousand draw from the OBCR by the year 2021. This approach provides needed continuity to the City's existing budget framework, while ensuring the elimination of this draw occurs in a reasonable period.

Conclusion
Operating budget variances are to be expected at the end of a fiscal year. Disposition of these budget variances based on agreed upon principles will enable Municipal Council to achieve maximum benefit for the community in terms of the achievement of strategic goals, while maintaining the long-term fiscal health of the City.

PREPARED BY:	**PREPARED BY:**
DAVID BORDIN **MANAGER, ACCOUNTING & REPORTING**	**JASON SENESE** **MANAGER OF FINANCIAL PLANNING & POLICY**
REVIEWED BY:	**RECOMMENDED BY:**
LARRY PALARCHIO **DIRECTOR OF FINANCIAL PLANNING & POLICY**	**MARTIN HAYWARD** **MANAGING DIRECTOR, CORPORATE SERVICES AND CITY TREASURER, CHIEF FINANCIAL OFFICER**

APPENDIX "A"

Bill No.

By-law No. A.-xxxxx

A by-law to establish a Surplus/Deficit Policy.

WHEREAS subsection 5(3) of the *Municipal Act, 2001* provides that a municipal power shall be exercised by by-law;

AND WHEREAS the Municipal Council wishes to implement a policy with respect to surplus/deficit management;

NOW THEREFORE the Municipal Council of The Corporation of the City of London enacts as follows:

1. The attached Municipal Council Policy entitled "Surplus/Deficit Policy", appended hereto as Schedule "A", is hereby approved and adopted.

2. This by-law shall come into force and effect on the day it is passed.

PASSED in Open Council on December 8, 2015.

Matt Brown
Mayor

Catharine Saunders
City Clerk

First Reading – December 8, 2015
Second reading – December 8, 2015
Third reading – December 8, 2015

SCHEDULE "A"

x(xx) Surplus/Deficit Policy

1.0 POLICY STATEMENT AND PURPOSE

The purpose of this policy is to establish a priority framework for the allocation of any operating surpluses and funding for any operating deficits.

2.0 SCOPE

This policy applies to the annual operating property tax supported budget.

3.0 PRINCIPLES

With the overarching principle that all surpluses and deficits be treated as one-time in nature, the one-time allocation and funding principles of the Surplus/Deficit Policy are as follows:

<u>In A Year Of Surplus</u>

a) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to contribute an amount to the Operating Budget Contingency Reserve (OBCR) not to exceed the reserve target balance of 1.5% - 2.0% of the property tax gross expenditure budget.

b) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to contribute an amount to the Unfunded Liability Reserve not to exceed any operational savings realized from personnel and contingency budgets at year-end.

c) Remaining surplus to be reported in the 4th Quarter Operating Budget Status Report with the surplus contributed to the OBCR to balance year-end operations. The remaining surplus allocations shall be drawn down from the OBCR and allocated in accordance with the following proportions:

   i. 50% of any operating surplus shall be applied to reduce authorized but unissued debt, it being noted that debt reduction will reduce future year's debt servicing costs.

   ii. 25% of any operating surplus shall be contributed to the Municipal Council Community Investment Reserve Fund to be allocated at the discretion of Municipal Council.

   iii. 25% of any operating surplus shall be contributed to the Capital Infrastructure Gap Reserve Fund to mitigate growth in the infrastructure gap.

<u>In A Year Of Deficit</u>

d) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate be authorized to drawdown from the OBCR to balance year-end operations.

4.0 REPORTING

e) The Managing Director, Corporate Services & City Treasurer, Chief Financial Officer or designate shall strive to provide the following reports related to year-end projected surplus or deficit positions within 45 days of the close of the reporting period:

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5.0 TRANSITION TO NEW SURPLUS/DEFICIT POLICY

As part of the existing Surplus/Deficit Policy (passed by Municipal Council on December 3, 2007), an annual draw of $850 thousand from the OBCR was established. This annual draw is recognized as revenue each year, reducing the property tax levy requirement.

To mitigate budget pressures within the implementation of the City's first multi-year budget (2016-2019), the plan is to phase out the $850 thousand draw from the OBCR by the year 2021. This approach provides needed continuity to the City's existing budget framework, while ensuring the elimination of this draw occurs in a reasonable period.