



**CITY OF HAMILTON**  
**CORPORATE SERVICES DEPARTMENT**  
**Financial Planning and Policy Division**

<b>TO:</b>	Chair and Members Audit, Finance and Administration Committee
<b>COMMITTEE DATE:</b>	June 20, 2016
<b>SUBJECT/REPORT NO:</b>	Rate Reserves Policy (FCS16056) (City Wide)
<b>WARD(S) AFFECTED:</b>	City Wide
<b>PREPARED BY:</b>	John Savoia (905) 546-2424 Ext. 7298
<b>SUBMITTED BY:</b>	Mike Zegarac General Manager Finance and Corporate Services Department
<b>SIGNATURE:</b>	

**RECOMMENDATION**

That the Rate Reserves Policy, attached as Appendix “A” to Report FCS16056, be approved.

**EXECUTIVE SUMMARY**

The City of Hamilton does not currently have updated formalized policies regarding rate supported reserves for its water, wastewater and storm funds. Rate (utility) reserve policies are intended to create a measure of safety and security for the uncertain events that impact a utility’s financial health. Reserves can address variability in the timing of expenditures and receipts of revenues, as well as occasional disruptions in activities, costs, or revenues that are not part of the annual budget process.

The general objectives of reserve policies are to facilitate stable / predictable rates and funding sources, along with, an equitable recovery of costs from customers. Overall, a utility’s reserve policies are a collection of rules and guidelines.

The City currently maintains three general rate reserves for each rate supported system with the following balances as of December 31, 2015:

- Waterworks Reserve (108015): \$23.9 million
- Wastewater Reserve (108005): \$80.2 million
- Storm Reserve (108010): \$13.8 million

Financial policies, such as the proposed Rate Reserves Policy (“Policy”) are fundamental to good financial management and provide a standard for assessing fiscal performance. The purpose of this Policy is to establish consistent principles, standards and guidelines for the maintenance, management and accounting of Rate Reserve Funds.

The proposed Policy incorporates a target range of 0.5% - 2% of asset value replacement. This fund balance target with upper and lower targets will assist in ensuring future liabilities can be met, that Capital infrastructure assets are properly maintained and that the City maintains sufficient financial flexibility to respond to economic cycles or unanticipated financial requirements.

Based on current Rate Supported Asset Replacement Values, the Target Rate Reserves Balances are as follows:

<b>Rate Supported Reserve</b>	<b>Asset Replacement Value</b>	<b>Lower Limit Target Fund Balance (0.5%)</b>	<b>Upper Limit Target Fund Balance (2.0 %)</b>
Waterworks (108015)	\$2.65 Billion	\$13 Million	\$53 Million
Wastewater (108005)	\$4.35 Billion	\$21 Million	\$87 Million
Storm (108010)	\$1.95 Billion	\$10 Million	\$39 Million

As per the Rate Reserve Policy (Appendix “A” to Report FCS16056), Rate Reserve Funds may be used:

- To offset extraordinary and unforeseen operating expenditures
- To offset rate revenue shortfalls
- To fund operating program phase-ins, pilot programs and one-time grants
- To fund large capital projects
- To borrow to fund rate supported operating programs or special requests

***Alternatives for Consideration – Not Applicable***

**FINANCIAL – STAFFING – LEGAL IMPLICATIONS**

**Financial:** It is recommended that the Policy incorporate a target range for the Rate Reserves Fund balances of 0.5% - 2% of asset value replacement of the Rate supported Capital infrastructure assets. This reserve fund balance target with upper and lower targets will ensure future liabilities can be met, that Capital infrastructure assets are properly maintained and that the City maintains sufficient financial flexibility to respond to economic cycles or unanticipated financial requirements.

As of December 31, 2015, the three rate reserve fund balances (Waterworks-108015, Wastewater-108005, Storm-108010) are forecast to remain above the lower target fund limits as reflected in the charts provided in the Analysis and Rationale for Recommendation section of this report.

**Staffing:** N/A

**Legal:** N/A

## **HISTORICAL BACKGROUND**

A reserve is a fund established by setting aside current revenues from user rates or other charges. Reserves serve two general purposes:

- they are used for rate stabilization to prevent against annual revenue fluctuations; and,
- they are used for Capital finance (for example, the repayment of a debenture due in the future or the financing of a future capital investment.)

Reserve funds have become an increasingly important part of water utilities' efforts to ensure financial stability and resiliency. Hamilton Water, similar to other Ontario municipal utilities, operates under an "enterprise" business model, and generally does not intend to generate "profits" above its current needs with surplus reserves to assist with responsible financial planning. As such, the water utility operates without outside assistance from the City, for example, in the form of property tax subsidy. Operating revenues from fixed and variable charges directly support the utility and comprise the bulk of utility revenues. Due to fluctuations in the economy, weather, and other unexpected events, utilities need to have adequate financial management, which typically involves reserves of money set aside to be used for protecting against risk.

The *Municipal Act, 2001*, section 290 provides that a municipality's budget shall set out amounts to be paid into and out of reserves. A municipality may establish reserve funds for any purpose for which it has authority to spend money.

In March 1975, three general rate reserves were established by the predecessor municipal government of the City; the Regional Municipality of Hamilton-Wentworth as:

- Waterworks Reserve (108015)
- Wastewater Reserve (108005)
- Storm Reserve (108010)

## **POLICY IMPLICATIONS AND LEGISLATED REQUIREMENTS**

This Report presents a new Rate Reserves Policy for the consideration of Council. The General Reserve Policy No. GEN-01 will be updated to reflect the recommended rate

reserves fund balance targets be established at a minimum of 0.5% of asset replacement value and a maximum of 2% of asset replacement value.

## **RELEVANT CONSULTATION**

Corporate Services Department, Finance and Administration (Hamilton Water) staff has been consulted and supports the objectives and recommendation of this Report.

## **ANALYSIS AND RATIONALE FOR RECOMMENDATION**

One of the key attributes of a financially stable organization is appropriate reserves. Adequate reserves position an organization to more effectively address significant economic downturns and unexpected emergencies, such as natural disasters, catastrophic events caused by human activity, or excessive liabilities or legal judgments against the organization. In concert with the City's other financial policies, the proposed Rate Reserve Policy ("Policy") will serve as an important tool to guide the use of City resources in meeting the City's financial commitments and provides a framework for addressing unexpected future events in a fiscally prudent manner.

"Appropriate" sizing of reserve funds is critical, yet reserve fund targets vary widely among utilities. A literature review has been conducted to explore how a number of utilities are using reserve funds and identify targets in-place for these reserves. This review considered the functional role of reserve funds.

There are four major purposes for reserve funds:

- **Contingency Planning** – Most water utilities rely on volume-based pricing structures. Revenues are somewhat variable and may not closely match utility expenditures within a given year. In Hamilton's case, approximately 25% of the 2016 budgeted water revenues are derived by the fixed charge portion of water rates, however, approximately 90% of expenditures are fixed in nature. This volatility in revenue, coupled with unexpected weather-related events, can drastically increase costs and create wide gaps between utility expenses and revenue. This uncertainty within water, wastewater and storm utility finance creates a significant need for reserve funds.
- **Achieve or maintain good standing with credit rating agencies, and subsequently benefit from lower borrowing costs** – Credit rating agencies often use reserve funds as an indicator of financial health because financial reserves increase a utility's ability to pay off debt. However, these agencies also take into account the ways in which reserves are used. Depletion of a reserve fund, for example, may be viewed unfavorably by a rating agency even if the reserve fund was depleted for a utility-designated reason, particularly if there is not a plan to replenish the fund.

- **Provide additional revenue through Investment** – Investing a reserve fund can provide utilities with additional revenue. There are limits to the level of risk of investments that the City may invest funds.
- **Provide cash availability to cover lost revenues or to correctly time entrance into the Capital market** - Reserve funds provide a utility access to additional money when revenues are low or there is seasonal variability in revenue generation. Also related to cash flow, reserve funds can allow utilities to better time their entrance into the Capital market for long term borrowings. These funds can subsequently be replenished once the debenture is issued.

Water and sewer utilities have two general types of reserve funds (restricted and unrestricted), though the use of these reserve funds varies widely from utility to utility. Restricted or dedicated reserve funds refer to those funds that must be used for a specific purpose, for example, senior government grant funding may be required to be deposited to a restricted reserve as the funds are to be dedicated to a specific Capital project for which the funding was granted. Unrestricted reserve funds, however, are available for appropriation with limited restrictions on how these reserves are used. Some utilities prefer to have fewer reserve funds, each with multiple uses and more flexibility of funds, and others prefer to have several different funds each with very specific uses.

In Hamilton's case, there are three long established rate reserves: Water (108015), Wastewater (108005) and Storm (108010). These reserves would be considered unrestricted in nature to accommodate a number of uses for each of the respective systems that include:

- To provide rate stabilization in the face of variable and uncontrollable factors (changes in consumption, interest rates, changes in subsidies);
- To provide financing for one-time or short term requirements without permanently impacting the rates;
- To make provisions for replacements/renewals/acquisitions of assets/infrastructure that are currently being consumed;
- To avoid spikes in funding requirements for large capital projects by reducing their reliance on long-term debt borrowings;
- To smooth the impact of major projects on the Operating Budget;
- To provide a source of internal financing;
- To ensure adequate and sustainable cash flows;

- To provide flexibility to manage debt levels within Council approved guidelines and protect the City's financial position; and,
- To provide financial sustainability.

### **Target Reserve Fund Balances**

The Government Finance Officers Association (GFOA) recommends that governments adopt a formal fund balance policy that defines the appropriate level of fund balance target levels. Reserve policies typically consider the purposes for which the reserve fund balances are intended. The additional transparency afforded by a formal policy helps decision makers understand the reason for maintaining the targets described in the Policy.

Restrictions on reserve funds may vary greatly from utility to utility. Capital-intensive infrastructure projects, customer demand trends, geography, governance and political priorities can affect reserve fund sizes and regulation. GFOA recommends establishing minimum reserve fund levels, and many utilities have specific reserve policies based on expected revenues for the following year.

When setting policies for maintaining minimum reserve fund balances, several factors need to be taken into account, including the volatility of revenues and expenditures, the perceived exposure to financial risk (from natural disasters, drought, unexpected infrastructure repair, etc.), the amount of money and potential drain on other reserve funds, liquidity, and financial commitments to dedicated reserve funds.

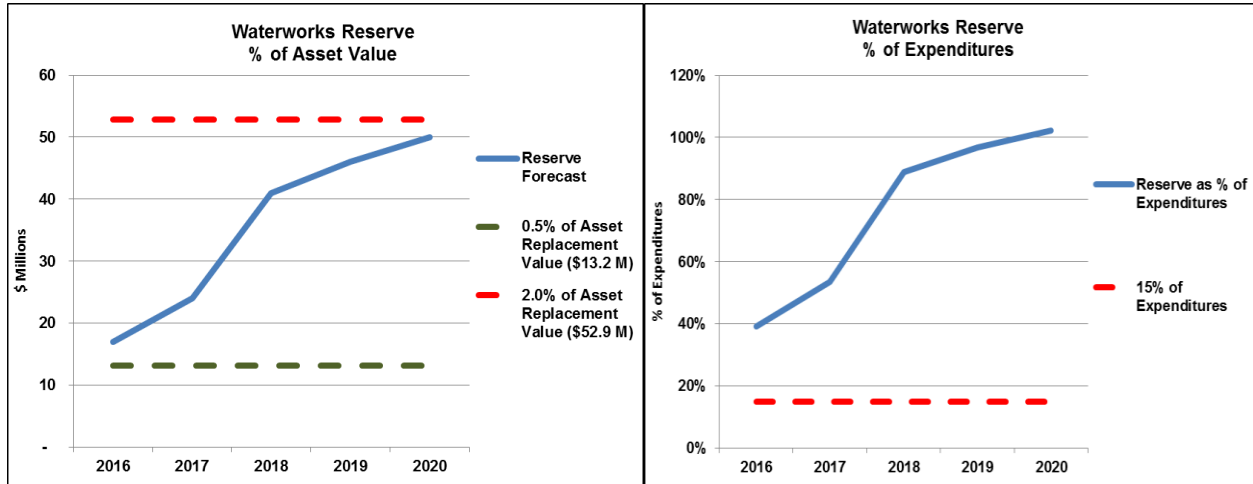
Another consideration when setting an unrestricted reserve fund target balance is the size of a utility's budget. Typically a utility's unrestricted reserve fund level on a relative basis is inversely proportional to the size of its total budget. For example, a smaller utility may be more susceptible to financial risk and economic changes and thus, may require larger relative reserve funds. Additionally, a reserve fund's purpose may also influence its size.

The literature review found two common utility reserve fund balance targets:

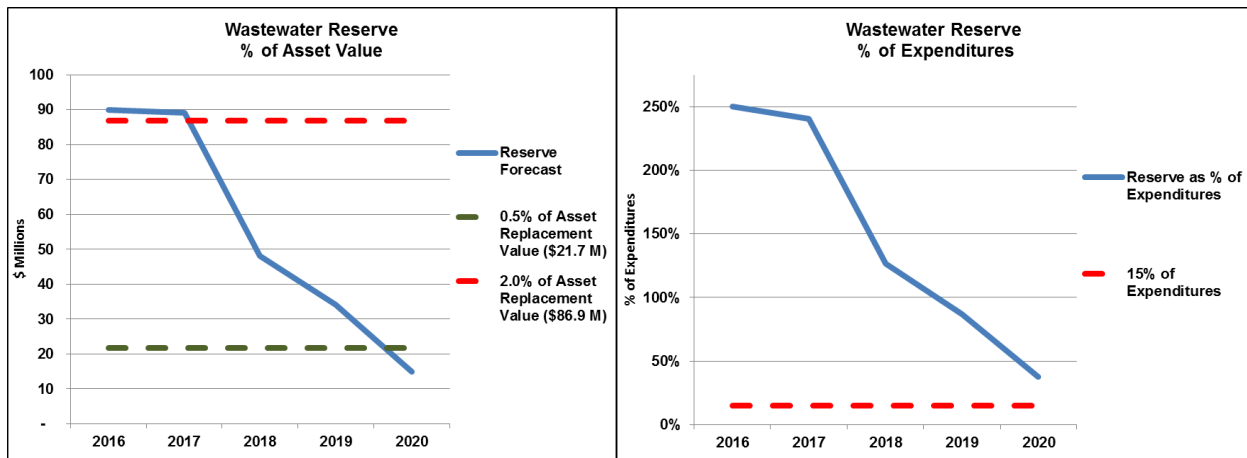
- Target range of 5% - 15% of annual operating expenditure requirements – consistent with American Water Works Association (AWWA) recommended reserve fund targets to provide a reasonable balance should unforeseen events occur. Where rate reserves are used for both Operating Budget shortfalls (stabilization) and Capital replacement they should not fall below 15% of expenditures.
- Target range of 0.5% - 2% of asset value replacement – reflects that utility reserve funds assist in smoothing out rates for water users by creating a funding source for future larger, intermittent projects and fluctuating revenue streams. Capital Budgets can vary significantly year over year and large non-recurring projects can create funding needs that are best funded over time.

Based on the current forecast of Hamilton’s rate reserves accounts, the following charts provide an indication of the rate reserve fund levels with respect to the aforementioned fund balance targets.

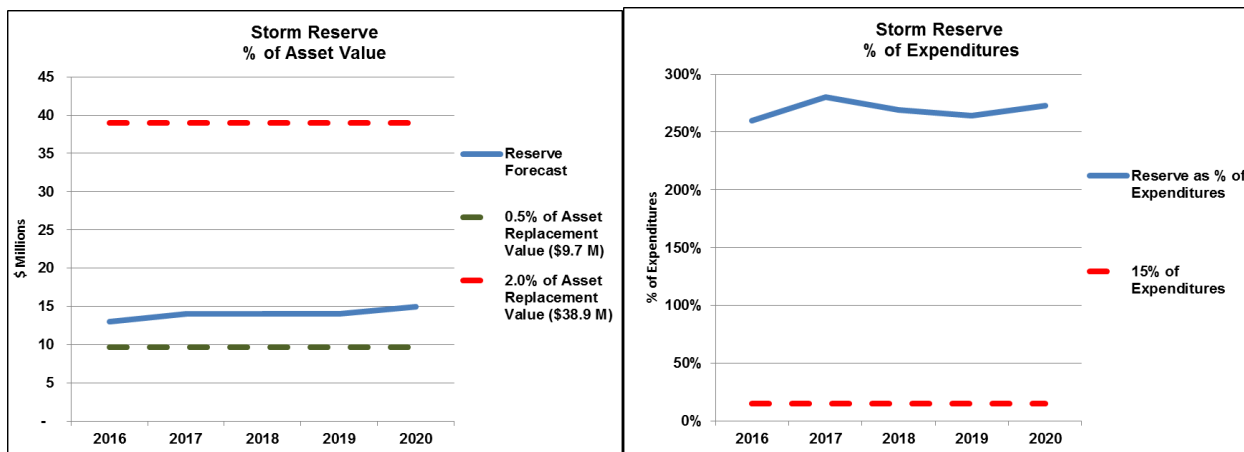
**Waterworks Reserve (108015)**



**Wastewater Reserve (108005)**



**Storm Reserve (108010)**



Based on current Rate Supported Asset Replacement Values, the Target Rate Reserves Balances are as follows:

<b>Rate Supported Reserve</b>	<b>Asset Replacement Value</b>	<b>Lower Limit Target Fund Balance (0.5%)</b>	<b>Upper Limit Target Fund Balance (2.0 %)</b>
Waterworks (108015)	\$2.65 Billion	\$13 Million	\$53 Million
Wastewater (108005)	\$4.35 Billion	\$21 Million	\$87 Million
Storm (108010)	\$1.95 Billion	\$10 Million	\$39 Million

Considering Hamilton maintains a single reserve for each Rate supported system to serve as a potential funding source for a number of purposes, the City must strive to maintain solid reserve positions, yet there needs to be an upper limit to fund balance targets. The upper limit will assist to ensure that excessive funds are not being accumulated in reserve funds, thereby charging customers higher user rates than necessary. As such, it is recommended that the proposed Policy incorporate a target range of 0.5% - 2% of asset value replacement. This fund balance target with upper and lower targets will ensure future liabilities can be met, that Capital assets / infrastructure are properly maintained and that the City maintains sufficient financial flexibility to respond to economic cycles or unanticipated financial requirements.

**ALTERNATIVES FOR CONSIDERATION**

N/A



**ALIGNMENT TO THE 2012 – 2015 STRATEGIC PLAN**

**Strategic Priority #2**

Valued & Sustainable Services

*WE deliver high quality services that meet citizen needs and expectations, in a cost effective and responsible manner.*

**Strategic Objective**

- 2.1 Implement processes to improve services, leverage technology and validate cost effectiveness and efficiencies across the Corporation.

**APPENDICES AND SCHEDULES ATTACHED**

Appendix “A” to Report FCS16056 – Rate Reserves Policy