

COMMITTEE OF THE WHOLE (WORKING SESSION) FEBRUARY 28, 2006

LONG-RANGE FINANCIAL PLANNING STUDY

Recommendation

The Commissioner of Finance & Corporate Services, the Director of Budgeting & Financial Planning, the Director of Reserves and Investments and endorsed by the City Manager and the Senior Management Team recommends:

1. That the following report and presentation on the Long-Range Financial Planning Study be received;
2. That the results of the Study be referred to the 2007 budget process;
3. That a funding strategy for infrastructure repair and replacement be incorporated into the 2007 budget;
4. That staff continue to pursue opportunities to advocate for additional infrastructure funding from other levels of government;
5. That the repair and replacement of the City's existing infrastructure be reviewed with the objective of reducing future capital funding requirements, while minimizing any impact on service levels; and
6. That the future funding implications of the eventual repair and replacement of new infrastructure construction be taken into consideration by the City when establishing standards, developing infrastructure plans and during the annual capital budget deliberations.

Economic Impact

The City of Vaughan has a significant investment in infrastructure. The Study has identified that there is a significant requirement for additional infrastructure reinvestment above current levels. The recommendations contained in this report have no specific economic impact. The results of this Study are being referred to the 2007 budget process.

Purpose

The purpose of this report is to review with the Committee the objectives of the Long-Range Financial Planning Study, the process undertaken, the results of the study and in particular to assess the need for increased funding for the repair and replacement of City's major assets.

Background - Analysis and Options

The Long-Range Financial Planning Study is a multi-faceted process incorporating the objectives of predicting future financial trends, the impact of decisions, developing and/or reinforcing financial policies, addressing reserve adequacy including cash flow implications, and most importantly, assessing the need for and quantifying the financial impact of the repair and replacement of the City's major capital assets. These objectives have been met.

The challenge of funding the significant cost of the repair and replacement of municipal infrastructure is of paramount concern to municipalities in Canada. As stated in a 2003 Municipal World article, "Canadian municipalities are facing a \$50 billion infrastructure backlog and are falling behind at \$2 billion per year". In the case of high growth municipalities, new facility construction, including roads, community centres, fire halls, etc.; have been primarily funded through development charges paid for by the development community and not from the municipal tax base. Development charges fund only the initial capital construction cost of the infrastructure. Therefore, the funding for the future infrastructure repair and replacement resides within the municipality, predominantly the tax base. It is therefore critical that municipalities have a clear understanding of the future implications of their infrastructure decisions today, the future implications of infrastructure repair and replacement and a strategy.

The concept of a comprehensive 25-year Long-Range Financial Planning Study is unparalleled in Ontario and puts Vaughan in the forefront and in a leadership position in terms of municipal long-range financial planning.

The need for a long-range financial plan with supporting policies was recognized by Finance as early as 1994. Since then Finance has brought forward for Council approval fiscal performance indicators and a number of policies designed to guide the municipality and achieve the targets.

The municipality's finances have improved considerably since 1994. A comparison of the fiscal performance indicators between 1994 and 2005 is outlined in the chart below.

	<u>1994</u>	<u>Target</u>	<u>2005</u> (1)
Discretionary Reserves	\$27.5m		\$88.3M
Discretionary Ratio	39.3%	50%	55.7%
Working Capital	\$2.6m		\$17.1m
Working Capital Ratio	3.7%	10%	10.1%
Tax Rate Stabilization	\$0.7m		\$8.1m
Debt Charges	\$4.0m		\$8.8m(2)
Ratio	5.8%	10%	5.6%
DC Balances (3)	-\$17.4m		\$41.1m

(1) Subject to year-end adjustments

(2) Includes approved but not issued city debt and loan guarantees (Sports Village, OSA)

(3) Net of capital Commitments

The municipality is in a stronger financial position, however there is a significant funding gap between the funds that are currently being identified for infrastructure repair and replacement and the funds that are available.

In recognition of the need to continue to manage the City assets in a safe and responsible manner, Council updated the strategic plan, entitled Vaughan Vision 2007, with a commitment to long-term financial stability, which would include planning for funding future infrastructure repair and replacement costs of capital assets and the continuance of fiscally prudent financial policies.

Finance staff again recognized the challenge and initiated a comprehensive long-range financial planning study, which compliments and builds on the long-range financial planning work conducted in 1994. This most recent Study was able to obtain much more detailed information with respect to municipal infrastructure, life cycles, replacement costs, etc. The resulting Study addressed in this report has been carried out within the overall perspective of the Vaughan Vision. The Study provides a context within which to make financial decisions. This is analogous to the planning department's decisions, which are not made in isolation, but in the context of an official plan. Financial decisions are no different and must be made in the context of the City's overall financial plan.

The Long-Range Financial Planning Study

The long-range financial planning study began with a steering committee led by Finance. A methodology and framework was created and the following objectives were determined:

- Develop a financial planning "what if" model integrating both operating and capital
- Analyze Vaughan's current financial position
- Analyze infrastructure repair and replacement spending & funding requirements
- Analyze reserve adequacy requirements

- Establish policies to guide Vaughan in making fiscally sound decisions

A formal RFP was prepared and Hemson Consulting was engaged to begin the long-range financial planning study through the steering committee.

The Long-Range Financial Planning Model

The first step in developing fiscally prudent long-range financial policies is to forecast the future funding requirements in a formal model that can be utilized for analysis purposes. The long-range-financial planning model provides a vehicle to articulate Vaughan's long-term financial requirements and trends. The model projects a 25-year trend, incorporating both operating and capital requirements, and brings together information from all sources. The "drivers" and assumptions that have been developed and on which the analysis is based (e.g. inflation, population, etc) has been fully researched and reviewed with all parties. The model also provides the ability to adjust key assumptions, parameters, and base data to determine the outcomes of different scenarios.

The model and the Study exclude some infrastructure such as Water and Wastewater infrastructure and development charge reserve forecasts. These are funded entirely from utility rates and/or developer contributions and therefore do not impact Vaughan's operating budget or tax rate. It is also necessary to stress that long-range financial planning is not intended to predict specific outcomes. It is a tool that is useful in determining trends, orders of magnitude and comparing alternatives.

The most significant component of the model was the development and inclusion of major asset inventory lists and their associated life cycle forecasting. (Life cycle forecasting is described in more detail later in this report). Life cycle forecasting was a significant and major accomplishment and is an on-going annual requirement to update the model. It required extensive input and collaboration with departments on a citywide basis.

Departmental review sessions were conducted to communicate cumulative outcomes and ensure departmental "buy-in" on the forecast, assumptions and drivers. This process resulted in a long-range forecast based on logical and supportable assumptions.

An analysis of Vaughan's current financial position including a review of infrastructure replacement requirements was conducted and key financial policies and funding options were developed. The result was a comprehensive study, which required a collaborative effort between finance and all City departments.

Long-Range Operating Forecast

The focus of the operating forecast was to identify the gap between the City's forecasted expenditures and revenues. Projections are based on assumptions, drivers and operating budget detail, which roll up to summary reports resembling those in the current operating budget document. The operating forecast began with a 25-year growth projection based on data in the recent development charge background study. This was critical as a large portion of operating pressures stem from the operating requirements of growth capital projects. As mentioned above, finance staff and consultants in conjunction with city departments developed forecast drivers and assumptions, which when applied in combination to specific model elements provided more realistic projections. All major aspects of Vaughan's operating budget are incorporated in the operating forecast, including estimates for the operating and maintenance of all new capital facilities and infrastructure required to support growth. It also incorporates the tax-supported portion of the capital program including contributions to reserves, capital from taxation and debt repayment.

Long-Range Capital Forecast

New infrastructure requirements in the long-range financial planning model are also based on the recently approved development charge background study, which lays out Vaughan's new infrastructure for the next decade. This information, in conjunction with departmental input, is used to forecast three key attributes in the long-range financial planning model:

- The value and timing of the mandatory discount share of new infrastructure (10% co-funding)
- The starting point for new infrastructure component replacement
- Incremental operating costs associated with the timing of new infrastructure

The infrastructure replacement forecast, based on life cycle forecasting, is the largest component of the model and computes the timing and amounts necessary to fund infrastructure replacement. The basis for the infrastructure replacement forecast is life cycle forecasting, which schedules asset replacement based on the asset's estimated useful life, referred to as "life cycle". All asset life cycles were received from departments based on the best information available and their professional experience. Life cycle forecasting also identifies the amount of funds that should be set aside annually to fully fund the assets repair and replacement. This process involved working jointly with key city department staff to:

- Gather infrastructure inventories
- Determine infrastructure components to better predict replacement requirements
- Determine installation dates and estimate life cycles
- Calculate future replacement timing and values
- Calculate annual provisions necessary to fund replacement requirements

One exception to the above lifecycle forecasting process is roads repair and replacement. The roads requirement is based on the Engineering study approved by Council revealing \$9 million annually is required for road repair and replacement. The \$9 million funding requirement is included in the long-range financial planning model and entirely funded from long-term debt, as is the current practice. Engineering is currently implementing an asset management system that will provide updated amounts required for roads repair and replacement. These figures will update the road needs study and will be incorporated into the model when available.

The majority of Vaughan's infrastructure has been captured in the long-range financial planning model including community centres, park facilities, uplands, heritage houses, fleet etc. Notwithstanding there is some minor outstanding data, the model is an important tool in that it forecasts trends over future periods.

Outcomes and Results

Infrastructure Repair and Replacement of Capital Assets

As mentioned earlier in this report, the need to identify and quantify future infrastructure repair and replacement costs was one of the primary objectives of the study. The study identified the following as it relates to infrastructure repair and replacement:

- Infrastructure spending requirements are significantly under funded
- A considerable amount of Infrastructure is currently past their estimate useful life
- Infrastructure reserve balances are not adequate to sustain future requirements
- Maintenance costs are increasing
- The risk of failure and service disruption of infrastructure continues to climb

One of the primary objectives of the Study is to consolidate and summarize key financial outcomes, results and trends and to identify long-term implications and their aggregate affects. As indicated, a primary concern for any high growth municipality is infrastructure renewal and the

model identifies this as a significant challenge, which intensifies as Vaughan transitions into a larger more mature municipality. The prevailing theme throughout the Study is that infrastructure repair and replacement is significantly under funded.

For those assets that are funded through reserves, an infrastructure reserve adequacy study was performed. It estimates the required infrastructure reserve balances required based on life cycle forecast of the assets. The outcome indicates that existing infrastructure reserve balances are short by approximately \$90 million, and will continue to increase over time without additional funding. The value of infrastructure items past their estimated life cycle is approximately \$28 million and will continue to escalate to \$111 million within 10 years without additional funding. The outcomes described above are illustrated in the chart below.

Infrastructure Reserves	Reserve Balance	Reserve Adequacy	Surplus (Deficit)	Items Past Life-Cycle
Building & Facilities	9,682,115	53,073,529	(43,391,414)	14,970,768
Vehicle Replacement	8,115,101	9,377,104	(1,262,003)	3,051,061
Parks Infrastructure	1,763,411	34,151,028	(32,387,617)	8,549,049
Fire Equipment Replacement	1,137,679	12,503,985	(11,366,306)	837,887
City Playhouse	83,309	83,309	-	-
Uplands Reserves	(121,752)	1,370,728	(1,492,480)	446,323
Heritage Fund	(45,913)	694,195	(740,108)	390,241
Total	20,613,950	111,253,878	(90,639,928)	28,245,329

Notes: Reserve balances estimated as at Dec. 31, 05 based on Dec. 19th proposed 2006 budget

In addition to the above outcomes other important trends are illustrated in the model:

- Infrastructure aged 30-55 yrs old will increase from 6% to 38% by 2020. As infrastructure ages, more funding will be required to fund replacements
- Over \$250 million is required in infrastructure funding, excluding roads, within 10 years. This exceeds current funding levels by more than \$100 million.
- More than \$12 million in incremental infrastructure funding is initially required and even at this increased funding level; infrastructure-spending requirements will not be met until 2008.
- The approved roads rehabilitation requirement is approximately \$9 million per year. Issuing 5% interest 10 year debentures at 5% for this requirement results in annual LTD payments progressively increasing from \$4 million to \$17 million over 10 yrs.

Clearly, an infrastructure funding strategy is needed to at least begin to address the items past their life cycle and to meet future infrastructure spending requirements. Infrastructure funding strategies are addressed later in this report.

Operating Outcomes and Results

The model's operating forecast incorporates the above mentioned required reserve contributions to fund infrastructure repair and replacement spending requirements. In addition, operating impacts of new facilities, estimates for assessment growth, user fees, and other municipal revenue sources, as well as other operating pressures are also included in the model to ensure a complete operating forecast and trend.

The overall trend for the operating forecast is that costs will increase significantly over the next 25 years. In the absence of alternative revenues or program changes, the City's net operating requirements funded through property taxes will grow in 25 years from \$92 million in 2005 to over \$280 million. The most significant impact is in the first few years' projection and is primarily due to funding the infrastructure spending requirements and reserve contributions.

Vaughan is one of the fastest growing municipalities in the GTA and growth is a significant factor. Growth impacts the long-range financial planning study in 3 areas as follows:

- As required under legislation, municipalities are required to fund the mandatory discount share of new infrastructure. (10 % co-funding of development charges). Over the next 5 years, Vaughan will incur an estimated \$11 million in co-funding requirements.
- As new facilities are constructed, operating costs must be funded. It is forecasted that net operating costs associated with new infrastructure will add about \$10 million in net operating costs over the next 5 years, excluding any inflation impacts.
- There are also various municipal operations that are not directly tied to the addition of new infrastructure, but require additional resources to deal with increased demand. The long-range financial planning model projects more than \$20 million over the next 25 years.

In addition, a notable portion of the levy increase is attributed to the inflation assumption and its impact should not be underestimated. Even at the moderate rate of 2% inflation per year, which is assumed in the forecast, the cumulative impact can potentially increase costs over a 25-year period by almost 65%.

Plan To Address Infrastructure Funding Requirements

Given the magnitude of the figures presented above, it is recommended that Vaughan institute a systematic plan to address existing and future infrastructure funding requirements. It was determined that a 3-part plan is best suited for this challenge as follows:

- 1) Rethink infrastructure placement and replacement
- 2) Advocating for assistance from other levels of government.
- 3) Implement an infrastructure repair and replacement funding strategy

Rethink Infrastructure Placement and Replacement

Since it is evident that funding infrastructure repair and replacement is a significant challenge, it is necessary to rethink what new infrastructure is recommended and in the way that existing infrastructure is eventually replaced, if at all. It is unknown at this time to what extent that infrastructure spending can be reduced through this approach, but it is prudent to review and rethink current and forecasted infrastructure requirements in an effort to reduce the forecasted financial burden that the municipality continues to face.

Therefore, it is recommended that staff undertake a review of infrastructure placement and replacement at a more manageable spending level. This will require a review to re-examine what infrastructure we put in place and consider alternative infrastructure choices. In addition, it is also recommended that the future repair and replacement funding implications be identified and provided as part of the 2007 capital budget submissions for new infrastructure projects. This will help illustrate the economic impact associated with future infrastructure repair and replacement spending.

Advocate Assistance From Other Levels of Government

Infrastructure renewal has become a common topic in the media and Provincial and Federal governments are beginning to recognize its importance. The Federal and Provincial government's recent willingness to share a portion of the gas tax demonstrates this fact. Although appreciated by Municipalities, the gas tax alone does not provide a complete funding strategy and unless additional stable long-term funding is secured and/or appropriate financial tools created, the funding gap will continue to grow and burden municipalities with large tax increases or deteriorating infrastructure. Therefore, as part of the plan, it is recommended that staff continue their efforts to advocate for additional infrastructure repair and replacement financial assistance from other levels of government.

Infrastructure Repair and Replacement Funding Strategy

Finance staff undertook an evaluation of different options in an effort to address the infrastructure repair and replacement-funding shortfall, while being cognizant of the tax rate increase impact. It is evident from the magnitude of the infrastructure repair and replacement shortfall presented above, that full funding for infrastructure repair and replacement based on life cycles and maintaining appropriate reserve balances results in significant tax rate increases in the first few years. Therefore, Finance developed options that first address the infrastructure spending requirements over the next few years. This is important since it is critical that the City be in a position to fund infrastructure spending for replacement as the need arises. This was deemed to be the most immediate challenge to be met. Infrastructure spending requirements are defined as all incremental infrastructure funding required to be spent when infrastructure exceeds its life cycle. In effect, this means funding any monies that need to be spent to repair and replace infrastructure based on life cycles including items currently past their life cycle.

Infrastructure Repair and Replacement Funding Strategy Options

In developing the Infrastructure Repair and Replacement Funding options, staff first identified the option limitations These are described below:

Infrastructure Repair and Replacement Funding Strategy Option Limitations:

- Options are independent of operating budget tax rate increase requirements
- Options primarily focus on addressing the incremental infrastructure spending requirements
- Options do not fully address the reserve adequacy shortfall within 10 years
- Further options review required once infrastructure spending requirements are met

Infrastructure Repair and Replacement Funding Strategy Option Parameters:

- Infrastructure spending requirements met by 2012
- Compliant with the Municipal Act debt limitations

Keeping in mind the above limitations and parameters, finance staff developed the following 4 options for an infrastructure repair and replacement funding strategy for the Committee's consideration:

1. Fund now through tax increases based on life cycle costing
2. Fund over time through fixed annual increases
3. Fund all incremental infrastructure spending requirements through long-term debt
4. Hybrid – fixed tax increases, LTD, and reduced infrastructure spending requirements

It is important to reiterate that all of the above options to address infrastructure repair and replacement funding, and their associated tax rate increases, are in addition to the tax rate

increases required for normal operating budget requirements such as collective agreement impacts, new facility operating costs, inflation, and other operating budget pressures. Each of these 4 Infrastructure Repair and Replacement Funding Strategies are discussed in further detail below.

Option 1 - Fund now through tax increases based on life cycle forecasts

This option calculates the infrastructure funding requirements on a go forward basis based on life cycle costing and identifies adequate funds to be set aside each year for infrastructure replacement. This funding option does not consider any existing reserve adequacy shortfall that would require further financing. This is achieved through an initial significant tax rate increase followed by the required annual tax rate increases as per the life cycles of assets. This option meets the spending requirements and begins full reserve contributions by 2008. The first year tax rate impact of this option is a 13.7% increase with a cumulative 10 year tax rate increase impact of 18.6%, both excluding roads. This option provides a quick solution to address the infrastructure repair and replacement funding shortfall.

Option 2 – Fund over time through fixed annual increases

This option meets both the spending requirements and begins full reserve contributions by 2011. This is achieved through a fixed 3% annual tax increase, beginning in year 1, with a cumulative 10 year tax rate increase impact of 30.0%, both excluding roads. With these fixed annual tax rate increases, the existing reserve adequacy shortfall would eventually be eliminated. However, infrastructure contributions would not be linked to life cycle costing requirements and the appropriate tax rate increase would require frequent review to ensure they are consistent with the funding requirements.

Option 3 – Fund all incremental infrastructure spending requirements through LTD

This option addresses incremental funding for infrastructure spending requirements for overdue and future items as their life cycles expire through funding all requirements with the issuance of long-term debt. This option addresses infrastructure spending requirements immediately. The first year tax rate impact of this option is a 3.8% increase with a cumulative 10 year tax rate increase impact of 11.7%, both excluding roads.

Although this option produces a more attractive 10-year cumulative tax rate impact than other options, it has 3 significant pitfalls that need to be considered. Firstly, the cost of funding the infrastructure spending requirements is significantly more than any other option. The cost of interest on incremental infrastructure spending requirements over the next 10 years is approximately \$33 million, an astounding 30% increase in costs. Secondly, this option breaches the current approved debt policy limit of 10% of own source revenues. Thirdly, reserve adequacy is not applicable as this option reflects a change in philosophy since building reserves is not required; it is only necessary to issue debt to fund infrastructure spending requirements. This may have an impact during recessionary periods where cash flow is a concern and the ability to access reserve balances may be required in combination with exercising the maximum line of credit at the bank. (Cash flow is addressed later in this report)

Option 4 – Hybrid– fixed tax increases, LTD, and reduced infrastructure spending requirements

This option also provides full funding for both the spending requirements for overdue and future items as their lifecycles expire and increases reserve balances to begin funding for future items that have not yet past their lifecycles. The difference is that in option 4 this is achieved through a hybrid combination of a fixed 3% annual tax increase, a one-time \$10 million debenture, and a 5% reduction in infrastructure spending requirements. This combination accelerates meeting the current infrastructure requirement as compared to option 2 and meets the spending requirements by 2010. As noted earlier in this report, it is currently unknown as to the extent infrastructure spending can be reduced but the selected 5% reduction seems reasonable.

The chart below compares and summarizes the 4 options described above.

LRFP - Infrastructure Option Matrix					
Option Measures	Current Status	Opt 1 Fund Now	Opt 2 Fund Over time 3%	Opt 3 Issue LTD	Opt.4 Hybrid 3%/\$10M/95%

In addition to Budget Operating Increases

1st Year Tax Increase	0%	13.7%	3.0%	3.8%	4.4%
1st Year Tax Increase (Incl. Roads LTD)	0%	14.6%	3.9%	4.7%	5.2%
10 Yr Cumulative Tax Increase	0%	18.6%	30.0%	11.7%	31.4%
10 Yr Cumulative Tax Increase (Incl. Roads LTD)	0%	30.8%	42.2%	23.9%	43.6%
Infrastructure Spending Requirements Met by	Never	2008	2011	2006	2010
Estimated LTD ratio (Incl. Roads) 10 yr avg.	5.4%	5.4%	5.4%	8.6%	6.0%
Highest Ratio	6.7%	6.7%	6.7%	13.0%	7.3%
Est. Additional Reserve Adequacy Shortfall -10 yr (millions)	(\$67)	\$0	\$7	N/A	\$29
10 Year Incremental spending requirement (millions)	\$111	\$111	\$111	\$111	\$111
10 Year Cost of spending (millions)	\$111	\$111	\$111	\$144	\$114

Reserve Adequacy and the Need for Discretionary Reserve Balances

Stabilize Future Spending Requirements Including Infrastructure Repair and Replacement

Minimum discretionary reserve balances are required to help stabilize and smooth out a multitude of future spending requirements. As noted earlier in this report, Council approved in 1995 a policy of a 50% discretionary reserve balance as a percent of own source revenues. This ratio is a strong indicator of Vaughan's financial stability; it provides financial flexibility and the ability to finance operations internally. Insufficient reserves can negatively impact credit ratings, which in turn could affect interest rates used for borrowing debentures. Discretionary reserve balances also include the infrastructure reserve balances that are required to address the future costs of infrastructure repair and replacement as reflected in this report. These are part of the reason why the 50% discretionary reserve balance was recognized in 1995, and continues to be recognized as an important financial policy and performance measure indicator for the municipality.

Cash Flow Considerations During Economic Downturns

Discretionary reserve balances also serve as a safeguard against unanticipated economic downturns, which will place significant pressure on the City's cash flows. The most significant would be an increase in tax arrears. Municipalities must remit to the Region and the Province the amount of funds that they have requested, regardless if the funds have been collected or not. In total the City billed \$477M in 2005. Of this the City of Vaughan only required \$92M to meet its cash flow requirements. The balance, \$385M must be forwarded, whether collected or not. Any reduction in the collection of taxes causes a cash flow concern that the City must address. The City can draw on its internal cash resources and bank financing. Cash resources are limited by the funds the municipality has set aside. Bank financing is limited by legislation. To illustrate the importance of cash flows and the seriousness of a recession, a model was developed to demonstrate the affects of a recession. Using data similar to the recession experienced in the

early 1990's, the result was that discretionary reserves and Vaughan's available line of credit would be completely exhausted in order to meet our obligations and sustain municipal operations. This further highlights the importance of cash management and the need to maintain a discretionary reserve balance at a minimum of 50% own source revenues.

Relationship to Vaughan Vision 2007

This Study addresses two (2) main Goals identified in the Vaughan Vision under Manage Our Resources. These are:

1. Ensure Short-Term and Long-Term Financial Stability;
2. Revitalize Infrastructure

Conclusion

Sustainability is critical if municipal governments are to continue to provide services to its residents. To be sustainable municipalities must have a solid financial platform from which to provide continuity of services and a sound financial strategy into the future. This Study builds on the work that was done previously and identifies a significant challenge that Vaughan must address. Vaughan is not alone; many other municipalities in Ontario face this same challenge.

Vaughan's immediate challenge is to develop a funding strategy that meets the funding requirements as they arise. The Study indicates that there is currently \$28M "past due" based on life cycle replacement and that this amount will increase to \$111 million within 10 years if not addressed.

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