Rural Municipalities of Alberta

Understanding Municipal Financial Reserves

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Financial Reserves: Just the Facts

- Financial reserves are an effective tool to support municipal asset management planning, as they allow for funds to be set aside to manage assets throughout their lifecycle.

- Municipal financial reserves are not a measure of wealth, but rather are a planning tool used in different ways and to different extents by municipalities.

- Municipalities are not permitted to run deficit budgets, so reserves allow municipalities to save money for major infrastructure projects while abiding by their legislated financial management requirements.

- While municipalities can finance capital projects through debt, the amount of debt municipalities may incur is limited. Additionally, due to interest requirements, debt results in higher costs for municipalities and less efficient use of tax dollars.

- Municipalities are required to develop three-year operating and five-year capital plans. The development of long-term planning requires that municipalities have the ability to set aside funds for use on major projects in future years.

What are Financial Reserves?

Alberta's municipalities have several legislated purposes, including "to provide services, facilities or other things that, in the opinion of council, are necessary or desirable for all or part of the municipality" (*Municipal Government Act*, s. 3(b)). To provide such services, municipalities are responsible for purchasing, constructing, operating and maintaining infrastructure. The type and size of a municipality's infrastructure responsibilities will vary among municipal type and can range from relatively small pieces of equipment to multi-million-dollar roads, bridges, water/wastewater systems, and recreation facilities. In general, municipalities have three options to pay for such infrastructure and service delivery responsibilities: taking on debt, spending as revenue is gathered, or setting aside a portion of revenue to save for large projects.

Because municipalities have limited revenue sources (primarily property taxes/user fees and grants provided by other levels of government), and limited ability to take on debt to finance large-scale projects (municipalities are limited to accumulating debt in the amount of 1.5 times their revenue), a common approach for municipalities to finance large-scale projects is to gradually set aside a small portion of their revenues over multiple years to pay for major infrastructure projects. This approach minimizes the use of financing, which allows municipalities to stay within debt limits and ultimately saves municipal taxpayers money by reducing interest costs. In a municipal context, funds set aside for such projects are known as "reserves."

Put simply, financial reserves are a means to pay for the construction or purchase of assets in the future, and to fund asset depreciation to ensure aging infrastructure can be maintained to continue providing necessary levels of service. The *Municipal Government Act* (MGA) does not specify any requirements or restrictions related to accumulating or managing reserves. Basically, municipal councils may set aside whatever proportion of revenues they choose as reserves for whatever purpose they see fit. Municipalities will often pass a council policy establishing what types of reserves may be established, how reserve creation, funding and withdrawals are to occur, if and how reserve funds can be re-designated, and other related administrative processes.

It is important to note that although there are no specific requirements or standards around how and to what extent municipalities are to utilize reserves, Alberta Municipal Affairs includes the use of reserves in their sample municipal financial statements as an example of a common municipal financial best practice. In fact, Alberta Municipal Affairs' *A Quick Guide to Municipal Financial Statements* explains that reserves are a standard component of a municipality's accumulated surplus, which is a technical term for the financial resources a municipality has available to provide future services. This further indicates that while not required, financial reserves are a standard practice carried out by all types of municipalities across the province.

There are two broad categories of financial reserves used by municipalities:

Unrestricted Reserves

Unrestricted reserves are best described as an emergency savings account held by a municipality to use for unexpected expenses incurred at a later date. Funds from an unrestricted reserve could be used to repair or replace an asset that fails unexpectedly, or simply to give council flexibility to allocate funds to future projects as needs arise.

Restricted Reserves

Restricted reserves are funds set aside by a municipality for a specific future project, or as a contingency for excess costs in a specific area. Restricted reserve funds should not be perceived as a measure of a municipality's wealth, as they may be the product of many years of saving and advance planning to fund the purchase or construction of a major asset, or to carry out projects identified in a municipality's long-range capital plan.

Reserves and Planning

In addition to allowing municipalities to accumulate the funds needed to support large-scale infrastructure projects, the use of financial reserves is an effective tool to support municipal planning. Rather than make sudden financial decisions supported by borrowing, reserves require municipalities to think ahead and consider when a certain asset may need to be replaced, expanded, or built for the first time to meet an emerging service need.

The approach of saving through reserves supports two important planning processes in Alberta:

MGA Planning Requirements

Section 283.1 of the MGA requires municipalities to develop at minimum a three-year operating plan and five-year capital plan each year. The intent of this requirement is to encourage municipalities to make day-to-day and annual budgeting, spending and service delivery decisions with guidance from a long-term plan. The use of reserves can support municipalities in developing realistic and achievable capital plans, and can ensure they have contingency funding in the ability of unforeseen economic instability that may impact taxation revenues.

Asset Management

Although municipalities in Alberta are not mandated to develop and follow an asset management plan, asset management is becoming widely seen as a best practice to support informed and accountable municipal decision-making. An important aspect of asset management is making long-term budgeting decisions with service levels and asset deterioration in mind. Not preparing for the inevitable repair or replacement of deteriorating assets through the use of reserves could lead to a crisis situation in which municipalities have limited funds available to address a sudden infrastructure failure and are forced to borrow heavily, increase taxes, or significantly reduce service levels. Using reserves to support the proper management of tangible capital assets and addresses their depreciation over the course of their useful life by setting aside funds for their maintenance and continued operation as they amortize.

Financial Reserves in Alberta

The use of municipal financial reserves in Alberta is a complex topic. Over the years, provincial officials and taxpayer organizations have identified financial reserves as a sign of municipal wealth and linked them with the perception that municipalities collect tax revenues in excess of their service delivery costs as a justification for advocating for lower municipal property tax rates.

However, a closer look at these reserves in Alberta tells a different story. Firstly, it is crucial to keep in mind that a major defining characteristic of the MGA is that it affords municipalities with "natural person powers," which means that municipalities have the same capacity, rights, powers and privileges of a natural person, except where altered by the MGA. This means that, like a person, a municipality can spend and save the money they collect as they see fit. Much like individuals are encouraged to practice sound financial management by saving for large or unforeseen future costs, or changes in their earning power, municipalities can do the same.

Rather than assuming the costs of a project up-front and using revenue collected to pay back a loan, reserves can be considered the opposite approach; the money is essentially already spent, is restricted for a specific future use, and even accumulates interest prior to being used.

Secondly, the assumption that a high level of reserves equals a high level of municipal wealth is an oversimplification and typically not accurate. When comparing the reserves in several municipalities in isolation, it is easy to assume that the municipality with the largest reserve amount must be "richer" than the others. However, ignoring municipal expenses or liabilities only tells half the story. This is particularly true of restricted reserves. According to RMA's 2013 *Apples to Apples: Rural Municipal Finances in Alberta*, "annual budgeted contributions to restricted reserves are considered a liability and are carried as such on municipal balance sheets. They are an indication of council's commitment to a future project and should not be considered part of a surplus." In other words, reserves are not a source of no-strings-attached wealth for a municipality, but rather every dollar placed into a reserve is a dollar not being spent on infrastructure or service delivery in the year it was collected in order to allow for the payment of a big-ticket item in a future year, or for future maintenance of depreciating assets. Rather than assuming the costs of a project up-front and using revenue collected to pay back a loan, reserves can be considered the opposite approach; the money is essentially already spent, is restricted for a specific future use, and even accumulates interest prior to being used.

A second reason that reserves are a poor measure of municipal wealth is that they can vary significantly from year to year in a municipality. For example, if a reserve for a new recreation facility has been growing gradually for ten years, a municipality's level of reserves will be much higher in the year before the recreation facility is constructed and the reserve funds expended than in the year following. In this situation, the municipality's wealth has not changed, but rather their reserve funds have been converted into a tangible capital asset (the recreation facility).

Critics of municipal spending often use reserves to argue that rural municipalities are wealthier than their urban neighbours due to higher levels of reserves. However, a closer look at publicly-available data from Financial Information Returns submitted annually by all municipalities indicates that reserves are a financial tool used by all municipal types. In 2018, the overall accumulated reserves for Alberta's municipal districts were 1.30 times their collective expenses incurred in the calendar year. The ratio for urban municipalities (summer villages, villages, town and cities) was a nearly identical 1.24.

Municipalities of all types, sizes and financial resources are working hard to practice strong financial management and accumulate reserves.

Another way to compare rural and urban reserve levels is to consider the levels of reserves municipalities have in relation to the net book value of their tangible capital assets. This is a useful measure as it hints at the amount of money a municipality will set aside in reserves in a given year as a portion of the overall value of the infrastructure the municipality is responsible for, all of which will presumably require replacement or upgrading at some point in its life. This figure is also nearly identical for urban and rural municipalities. As of 2018, rural municipalities had an average of 26.6% of the net book value of their assets in reserves. Urban municipalities had an average of 27.3%. What both of these figures indicate is that municipalities of all types, sizes and financial resources are working hard to practice strong financial management and accumulate reserves. The practice of planning through financial reserves is hardly a rural-only issue, and the total amount of reserves is only relevant in relation to the expenses and infrastructure responsibilities of a municipality, which is the same point made in *Apples to Apples*.

Another common critique of reserves is related to the use of restricted and unrestricted. Unrestricted reserves are often questioned due to the perceived lack of plan for how they will be spent. While unrestricted reserves can serve an important contingency purpose in the event of an unforeseen infrastructure failure or emergency, RMA recommends municipalities seek to prioritize restricted reserves as they better support long-term planning and accountability. In examining the proportion of restricted and unrestricted reserves in rural municipalities between 2014 and 2018, the following pattern emerges:

Year	**Restricted**		**Change in restricted % from previous year**	**Unrestricted**		**Change in unrestricted % from previous year**
	Dollars (millions)	% of total		Dollars (millions)	% of total	
2014	1,781.22	85.9	N/A	291.82	14.1	N/A
2015	2,033.07	89.0	+3.1	250.23	11.0	-3.1
2016	2,127.13	89.2	+0.2	257.65	10.8	-0.2
2017	2,215.55	89.5	+0.3	260.47	10.5	-0.3
2018	2,279.71	90.3	+0.8	244.50	9.7	-0.8

While the change is gradual, rural municipalities are growing the proportion of their overall reserves that are restricted every year, increasing accountability and supporting long-term planning. Additionally, according to BuildForce Canada's *Construction and Maintenance Looking Forward: Alberta Highlights 2018-2027* report, non-residential growth across sectors should begin to increase modestly in 2019, and more substantially beginning in 2024 as anticipated renewed oil and gas investment returns. This indicates that construction costs may increase in the coming years, which is all the more reason for municipalities to plan ahead through the use of reserves.

A final important consideration of reserves is that they are an alternative to debt. Taking on debt to finance major projects has always been a viable tool for Alberta's municipalities, but carries risk, especially if large amounts of debt are taken on resulting in very high debt servicing costs. The table below shows the annual long-term debt compared to debt limits for Alberta's rural municipalities.

Year	Total Debt (millions of $)	Total Debt Limit (millions of $)	% of Debt Limit Used
2014	419.9	2,883.0	14.5
2015	423.8	2,948.5	14.4
2016	422.9	2,888.5	14.6
2017	452.8	2,912.0	15.5
2018	458.6	2,892.5	15.9

What this information shows is that debt is a tool that rural municipalities use at a consistent level to finance capital projects, but in general it is used in a conservative way, and well below the legislated limits. Even at only 14.5% of their legislated debt limit, rural municipalities paid a collective $59.4 million in debt servicing costs in 2018. When considering efficient use of municipal tax dollars, this figure further brings into perspective the value of municipal reserves to allow municipalities to save and avoid significant debt servicing costs. In fact, municipal reserve funds will typically accumulate interest prior to being, used, so they generate additional municipal revenue.

If municipalities were not allowed to accumulate reserves, and 2018 reserve amounts were transferred to debt, total rural municipal debt and debt servicing costs would increase by a shocking 650% and actually exceed legislated debt limits. Of course, it is highly unlikely such poor financial management would occur. What is more likely is that municipalities would build fewer major infrastructure projects and provide residents with a lower level of services because they are unable to raise the funds needed through saving or debt.

Financial Reserves in Municipalities

There is no single approach to financial reserves, as options vary by municipality. Many municipalities in Alberta have developed a policy outlining the purpose of these reserves, as well as categories and decision-making related to contributing to and withdrawing from them. A close look at a selection of these policies allows for a general picture of how many municipalities approach reserves to emerge.

Reserve Categories

The categorization of reserve funds varies by municipality. Some municipalities have a small number of categories with broad infrastructure types within each. For example, one municipality divides their restricted reserves into four categories:

- Asset management
- Risk mitigation
- Externally restricted
- Other as required

While these categories are broad, each includes sub-categories that better guide the purposes for which funds are reserved. For example, the "asset management" category includes sub-categories such as lifecycle plans (for scheduled replacement of certain assets), as well water and wastewater, county facilities, environmental needs, and others. Each sub-category has its own target reserve amount, which is presumably reviewed and amended by council as part of a regular policy review.

A second municipality approaches reserves slightly differently, with no sub-categories, but sixteen distinct categories ranging from a "gravel pit reclamation reserve" to an "economic development reserve" to a "bridge replacement reserve." The policy outlines how each reserve is funded and projects for which it can be used. For example, the bridge replacement reserve receives funds specifically allocated in the operating budget or any amortization from the "engineering structures – road" fund.

Reserve Responsibilities

Council is generally responsible for approving the formation of financial reserves and the approving the processes by which reserves are funded and withdrawn. Administration is responsible for reporting all reserve transactions to council and ensuring reserves are managed in alignment with the policy and legislative requirements. This includes maintaining a continuity schedule of each reserve and monitoring whether actual reserve amounts are sufficient for projects that are budgeted to be funded through reserves.

Funding Sources

Municipal financial reserves can be supplied from several sources. Reserve accumulation can be built into a municipality's property tax rate to allow for regular collection of reserve funds for future projects, but reserves can also be filled through other non-tax related municipal processes. For example, the MGA requires developers to set aside land within a subdivision as a reserve for various types of public use (common examples include school reserves, municipal reserves and environmental reserves). However, MGA s. 661(b) allows for municipalities to receive money in place of reserve land from developers (commonly referred to as “cash in lieu”). In rural areas, where low population densities and development types often make small reserve lands ineffective, municipalities commonly collect cash in lieu to support larger-scale projects meeting the intent of the reserve funds, but serving a community beyond the space under development. These funds are typically stored in a restricted reserve until they are used.

A second example of non-tax-based reserve funding sources are off-site levies (OSLs). An off-site levy allows a municipality to recover the capital costs of certain types of municipal infrastructure from developers based on the degree of benefit the development will receive from the infrastructure. Therefore, the imposition and collection of an OSL can be a valuable cost recovery tool for a municipality in constructing new or expanded infrastructure. An OSL is a charge imposed by a municipality and collected from a developer as a condition of development or subdivision. Municipalities are required to store off-site levy funds in specific restricted reserves until such time as they are used to fund a capital project. As levies collected from a single developer are typically not enough to fund a project, levy funds may sit in reserve until such time as an adequate amount is required or until development has progressed far enough to justify the new capital project. Section 648 of the MGA and the *Off-Site Levies Regulation* provide strict requirements for how off-site levies are to be collected and used.

Municipalities also have additional revenue sources to fund reserves, such as cash received through the sale of surplus assets and land, approved budget contributions, carryover of approved budgeted funds that were not expended in a given year, and investment income.

Reserve Case Studies

Alberta's municipalities are diverse, and so are the way they utilize reserves. Some municipalities have no financial reserves and rely on grant funding and financing to fund all capital projects. Most municipalities in this category are villages and summer villages, although some towns and rural municipalities have very low reserve levels as well. On the other end of the spectrum, some large cities set aside multiple billions of dollars in restricted reserves, likely for major transit projects. For most municipalities, reserves fall somewhere in the middle: they are an important part of budgeting and allow for capital planning but must be filled gradually so as not to sacrifice short-term service delivery. The case studies below are based on financial data, budgets and plans from actual municipalities to provide examples of the roles reserves can play in municipal planning.

Rural Municipality

This mid-sized rural municipality has a population of approximately 8000 and manages just over 1000 kilometres of roads, along with six hamlets. The municipality has a significant amount of linear property, with 2.3% of the province's share despite hosting 0.18% of the province's population. This figure indicates significant oil and gas activity in the municipality along with a small and sparsely distributed population.

Rural municipalities with these characteristics typically dedicate much of their budget to road construction and maintenance, as roads are needed to provide industry access to the linear (and associated machinery and equipment) property scattered throughout the county, as well as to residents living on farms and rural acreages. These needs are evident in the municipality's budget, as 58.6% of the municipality's 2019 capital plan budget was dedicated to road projects. Of the capital budget dedicated to roads, 75.6% of funds came from various restricted reserves held by the municipality, with the remainder of funds coming from a combination of grants, borrowing and property taxes. In the water and wastewater categories, roughly 50% of project costs derive from restricted reserves.

What this shows is that contributing to and accessing restricted reserves is a significant part of this rural municipality's planning and spending processes. With a large inventory of roads and a heavy reliance on unpredictable linear tax revenue, building reserves allows for a fairly consistent source of funding to be available for broad project categories (such as roads) while allowing the council flexibility to make year-to-year decisions on what specific projects to fund within that category based on the most recent information available related to road condition, traffic and service levels. If required road project costs are less than the budgeted amount in a given year, the reserve can be replenished, allowing for infrastructure to be repaired when required to maintain proper service levels.

Town

This large town has a population of approximately 17,000. The town's population has grown by approximately 14% from 2014 to 2018, leading to some increased pressure on services and infrastructure.

This growth is reflected in the municipality’s increasing inventory of tangible capital assets, as well as growth in debt and debt limit in recent years. The growth in tangible capital assets indicates increased infrastructure investments to support a growing population (as does the increased use of debt), while the increased debt limit is reflective of growing municipal revenues, as under the MGA’s *Debt Limit Regulation*, a municipality’s total debt may be no more than 1.5 times its revenue. Although increasing in recent years, the town’s overall debt is still within its debt limits.

In addition to debt, the municipality has also used restricted reserves to fund capital projects. Restricted reserve levels have maintained a consistent level over the prior three years, but according to the town’s long-term corporate plan, reserves are expected to decline significantly following the 2019 budget year, after which they will gradually increase. The reason for the decline is that a large portion of the restricted reserves will be used for a downtown redevelopment project which has been planned for several years and for which much of the reserve contributions have been targeted. Rather than borrow further for this significant project, council chose to prepare in advance knowing that the nature of the project would require a significant single-year capital commitment.

Municipal Reserve Policies

Many municipalities have policies outlining how they use reserves and their role in supporting proper planning and effective service delivery. Rather than relying only on the summary nature of this report, the excerpts below from actual municipal policies provide examples of how reserves are used in different types of municipalities and why they are so important:

Town of Stony Plain

Reserves are vital to municipal financial health. Having healthy levels of reserve enable the Town of Stony Plain to:

- Plan for future operating and capital needs of the municipality
- Plan for contingencies
- Help to avoid interest expense for debt
- Generate investment income
- Deal with the ebb and flow of cash management throughout the fiscal year

Healthy reserves result from having policy surrounding their management as well as effective long-term planning to determine correct reserve levels. Standards in a reserve policy should support standards in a long-term planning policy and vice-versa.

Town of Canmore

Canmore is sustainable only if both its capital infrastructure assets and its financial assets can be maintained over the long term. It is the policy of the Town of Canmore to establish reserve funds to ensure the long-term financial stability and flexibility for the Town of Canmore, to position it to respond to varying economic conditions and changes affecting the Town’s financial position, and to ensure the organization has the ability to continuously carry out its responsibilities.

Parkland County

The ongoing commitment of funds to restricted surplus provides for property tax stabilization, contingency funding, and reduces the need for debt financing. Established guidelines ensure consistent and effective management of the designated funds pertaining to the restricted surplus.

Strathcona County

A Reserve Policy is a prudent business practice that will enhance Strathcona County's financial strength, flexibility, cash flow management, and ability to achieve the Council Vision and the Strategic Plan priorities. A Reserve Policy is required to establish, maintain and manage Reserve funds that:

- maintain and improve Strathcona County's working capital requirements;
- provide for future funding requirements; and
- provide stabilization for fluctuations in operating and capital activities.

Financial Reserves Support Healthy Communities

By properly monitoring the age and condition of infrastructure and developing a long-term plan for maintenance and replacement, municipalities will increase accountability and efficiency in both managing their assets and improving their service levels. Municipal financial reserves are necessary to ensure that municipalities can invest in needed infrastructure that support Alberta's economy and healthy, thriving communities, as well as have the strong financial foundation in place to adapt to changes in the economy and continue to provide the services that residents and industry relies on.