

Financial Review of the City of Brampton

Jim McCarter
Interim Auditor General
City of Brampton

January 26, 2015

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Mayor Linda Jeffrey and City Council
City Hall, City of Brampton
2 Wellington Street West
Brampton, Ontario L6Y 4R2

Dear Mayor Jeffrey and Councillors:

On December 17, 2014, I was appointed Auditor General on an interim basis for the City of Brampton in accordance with By-law 378-2014. My mandate under this By-law was to review the City's finances in order to provide a high level overview of the City's fiscal state and report to City Council by January 30, 2015.

I am pleased to transmit my report on my review of Brampton's financial condition as was requested under the By-law.

Sincerely,

A handwritten signature in black ink, appearing to read 'Jim McCarter', with a stylized flourish at the end.

Jim McCarter
Interim Auditor General
City of Brampton

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1. Executive Summary

Brampton's liquidity position is excellent as the City has significant cash and marketable security investments with which to meet its financial obligations in the short term. However, the City's financial flexibility has deteriorated over the past five to 10 years, and there are a number of issues that City decision-makers need to keep in mind on a go-forward basis.

In Brampton's 2013 Annual Report, City officials described Brampton's financial status as being in "solid financial position," "debt-free" and "placing us among the elite." Readers of the Annual Report would be justified in concluding that when it comes to Brampton's finances, there are no worries. However, I believe there are some financial storm clouds on the horizon and some difficult decisions may be necessary.

There are three issues in particular that I want to highlight:

- ▶ The City has grown dramatically over the past decade. Population and the number of households have increased by 39% and 31%, respectively, and property tax revenue has more than doubled. However, the City's total discretionary reserve funds have stayed essentially at the same level as they were at a decade ago. While there have been increases in a number of the smaller reserve accounts, one of the largest discretionary reserves that had been funded from the proceeds from the sale of Brampton Hydro in 2001 has declined substantially. Increasing the City's operating and capital reserves warrants consideration.
- ▶ Canadian municipalities are being challenged to maintain their aging and growing infrastructure in a state of good repair. A number of municipalities I reviewed have recently become much more proactive—both fiscally and operationally—in addressing this long-term issue. The adage "pay me now or pay me later" very appropriately defines the essence of cost-effective life-cycle infrastructure maintenance. Brampton's finances will become increasingly more affected as time goes on unless more funds are put aside to address this growing issue.
- ▶ Operating expenses, including the City payroll, have been increasing at a much faster rate than population or household growth, even after adjusting for the effects of inflation. Two-thirds of every dollar spent on City operations goes to pay salaries and benefits. In a municipal environment, payroll expenses tend to be more non-discretionary as they are largely driven by union and other long-term commitments. Managing the rate of growth in operating expenses will be a challenging but necessary task unless property tax increases are going to be relied upon to do virtually all of the heavy fiscal lifting.

My sense is that senior City management is well aware of these issues. However, finding fiscally responsible and long-term solutions to these challenges—while ensuring that citizens pay their fair share for the services they receive, including the ongoing cost of keeping the City's infrastructure well maintained—will not be an easy task.

Good decisions require good information. City decision-makers will need comprehensive but easy-to-understand information on the critical issues and on the costs and implications—both financial and non-financial—of the strategies available to address these issues. This will prove invaluable not only in encouraging well-informed debate of the issues but also in communicating the ultimate decisions to those in the community who will be most affected.

2. Review Mandate, Timing and Approach

On December 17, 2014, the City of Brampton's Council passed By-law 378-2014 entitled "Auditor General By-law – Fiscal Review," which appointed Jim McCarter as an Auditor General on an interim basis with the following specific mandate:

to review the City's finances in order to provide a high level overview of the City's fiscal state with some general indication as to whether the fiscal state of the City has changed, and the nature of any changes, for approximately the last five years.

With respect to the scope of the work, the By-law stated that given the limited review time frame, the report should be relatively high level in nature but should be adequate to provide a reasonable assessment of the trend in Brampton's finances and where things currently stand from a fiscal perspective.

With respect to the timing of the review, the By-law noted that "work will commence as soon as possible after Council approval, and will be completed by January 30, 2015."

I was able to start my work at Brampton's City Hall on December 18, 2014. City officials were cooperative in providing me with an office and a computer with access to the City's administrative intranet. They also quickly pulled together a number of the documents that I needed to start my review. Throughout my work, I received good co-operation from staff in the Finance area as well as others in the various operating divisions whom I needed to speak to as part of my review. Standard & Poor's (S&P) was also very helpful in meeting with me to discuss its recent credit ratings review.

Given that the Council by-law was passed shortly before the Christmas break with the requirement that my report be drafted, printed and issued by January 30th, my review cannot be described as being extremely detailed in nature. However, I was able to complete the work required to enable me to gain a good understanding of Brampton's financial condition and its fiscal flexibility both currently and relative to the last five to 10 years.

This report is for Brampton's City Council. In drafting the report, I took into consideration the fact that six of the 10 Councillors were newly elected and that understanding the complexities of the ninth-largest city in Canada is easier said than done. I therefore made a deliberate attempt to convey in "laymanese" enough explanatory and background information to facilitate an understanding of some of the complex and multi-faceted issues facing the City.

3. Brampton's Financial Condition—Some Good News

Substantial Cash and Investments

Ontario municipalities, and especially Brampton's peer municipalities in the GTA, have one thing in common—they generally all have significant cash and investments. Brampton is no exception. Because actual infrastructure expenditures have been significantly less than forecast over the past two years, Brampton has been able to increase its liquid reserves by almost \$190 million over that time, to \$829 million by the end of 2013.

To put this in perspective, this is theoretically enough money to pay for the City's cash operating expenses for more than a year without a dollar of revenue coming in. However, this does not mean that City decision-makers can be complacent in addressing the looming fiscal challenges. As further discussed in Section 5 of this report, while \$829 million sounds like a lot, it does not leave as much fiscal "room" as one might assume.

Debt-free (Until Recently)

Until the construction of the South West Quadrant (SWQ) building and the related contractual 25-year lease-to-own obligation, Brampton was able to finance its growth without the use of external debt. This was undoubtedly a positive factor, both when considering the City's financial condition and future fiscal flexibility, and in comparison to some of its GTA municipal peers.

While the SWQ facility long-term liability, along with the obligation relating to the Powerade Centre, are estimated by S&P to approximate debt equivalent to about \$215 million, I believe the City still has the financial capacity to issue significant external debt should it so desire.

S&P's Credit Rating

Any municipality receiving a triple ("AAA") credit rating from S&P would undoubtedly consider it a "feather in their cap", and Brampton is no exception. Its AAA credit rating is a definite positive when assessing the City's current financial condition.

However, the City needs to be cognizant of the recent concerns expressed by S&P. In its last ratings review and in its February 2014 update, S&P specifically raised the issue of the downward trend in Brampton's operating surpluses and noted the City did not compare favourably to the other municipalities it rated AAA with respect to this important metric. It also noted that this was a key factor in its recent decision to downgrade Brampton's rating from "AAA stable" to "AAA negative." S&P noted that "if Brampton's operating surpluses do not improve materially", this could have an impact in future ratings reviews.

Brampton's Underlying Economics

Economic projections indicate that Brampton's economy is well diversified, in that it is not dependent on a limited number of large employers, and the City can expect reasonably stable growth in new households and businesses over the next few years. This bodes well for continued growth in both the residential and industrial/commercial assessment base.

Revenue-raising Capacity from Property Taxes

The extent to which Brampton can increase its revenues or decrease its expenditures has a definite impact on its fiscal flexibility and therefore its overall financial condition. In essence, what latitude does Council and City management have to "manage" their annual operating results or absorb unexpected adverse economic events or natural disasters?

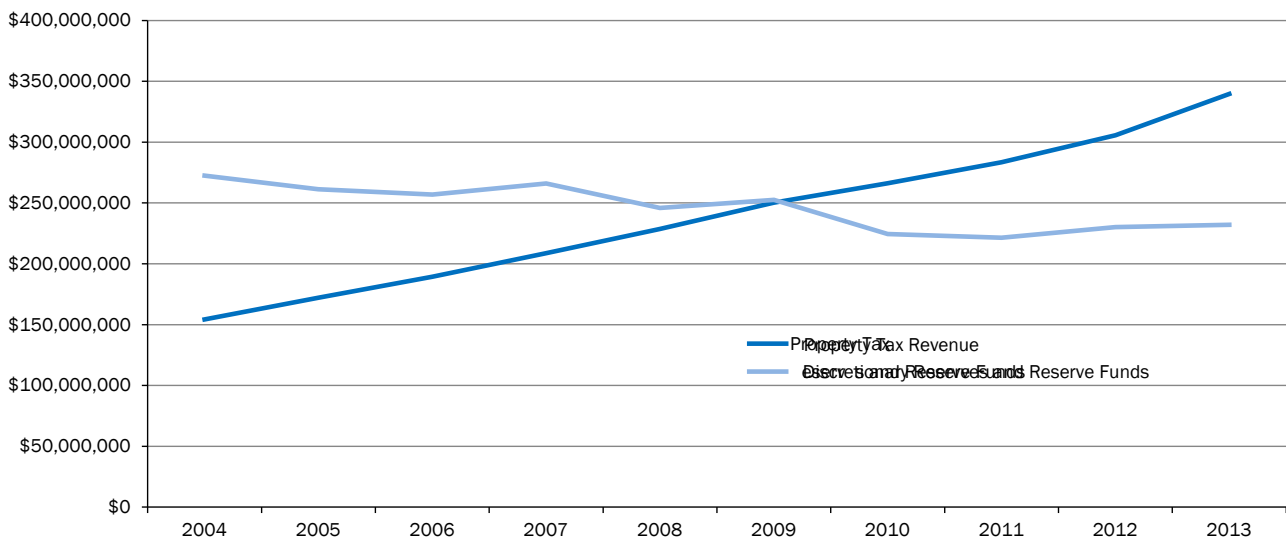
Canadian municipalities have somewhat more financial flexibility on the revenue side than the expenditure side. On the revenue side, a definite positive for Brampton is that it generates almost all of its revenue from internal sources (namely, property taxes and various user fees and fines), as opposed to getting a significant portion from other levels of government. On the other side of the coin, however, its ability to significantly increase revenue from property taxes, user fees and fines is limited. This is especially the case for user fees such as transit fares, which are often seen as being closely linked to inflation. There is somewhat more latitude with respect to property taxes, which I will discuss in more depth in Section 6 of this report.

4. The City's Financial Flexibility Has Deteriorated

In looking at the trends in Brampton's financial condition over the last 10 years, there are clear indications that the City has significantly less fiscal flexibility than it had 10 or even five years ago. Ten indicators that illustrate this are:

1. Technically, Brampton can now no longer say that it is debt-free. The City has a contractual 25-year lease-to-own commitment to pay the builder of the new SWQ building \$8.2 million annually. This is essentially debt. S&P estimated that Brampton's tax-supported debt, including the Powerade Centre guaranteed loan, stood at about \$215 million, which it considered to be at a level that is higher than most of its similarly rated peer municipalities.
2. As a municipality grows and its property taxes increase year after year, one would expect that its discretionary reserves would similarly grow to ensure that it retains the same financial flexibility to withstand any unexpected adverse economic, fiscal or other events, such as the 2008/09 economic downturn. As can be seen from the following chart, while property taxes have more than doubled in the last 10 years, the City's discretionary reserve balances have actually decreased.

Property Tax Revenue vs. Discretionary Reserves and Reserve Funds, 2004–2013

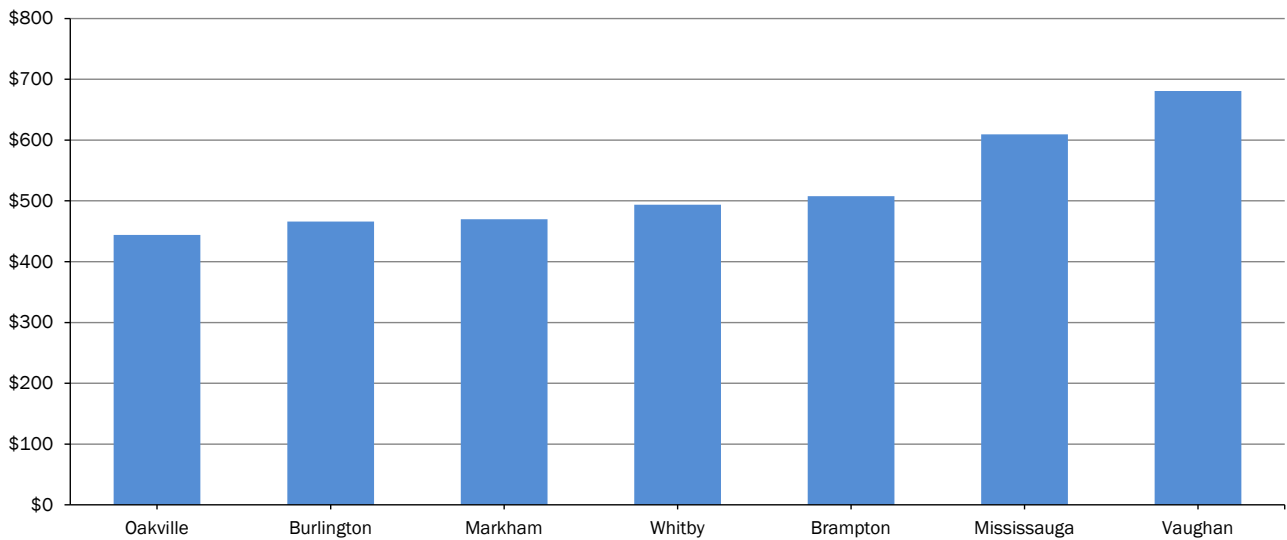


3. Going back a decade, City officials made the following observation in the 2004 Budget:

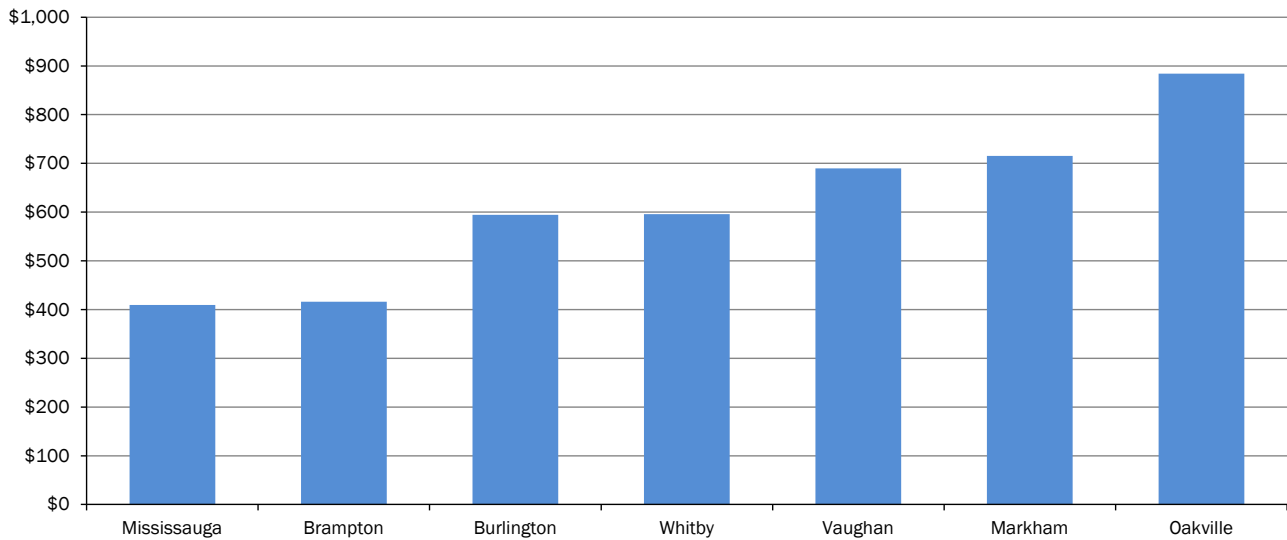
The City’s reserve funds remain at a very healthy level compared to other municipalities, whether on a per capita basis, or relative to City expenditures.

Our review indicated that Brampton was, in fact, at or near the top of the pack compared to other GTA municipalities with respect to these metrics in 2004. However, by 2009, as the following charts indicate, Brampton was at the midpoint compared to seven other GTA municipalities, and by 2013, it was tied for the lowest amount of reserves per capita.

Total Discretionary Reserves and Reserve Funds Per Capita, 2009

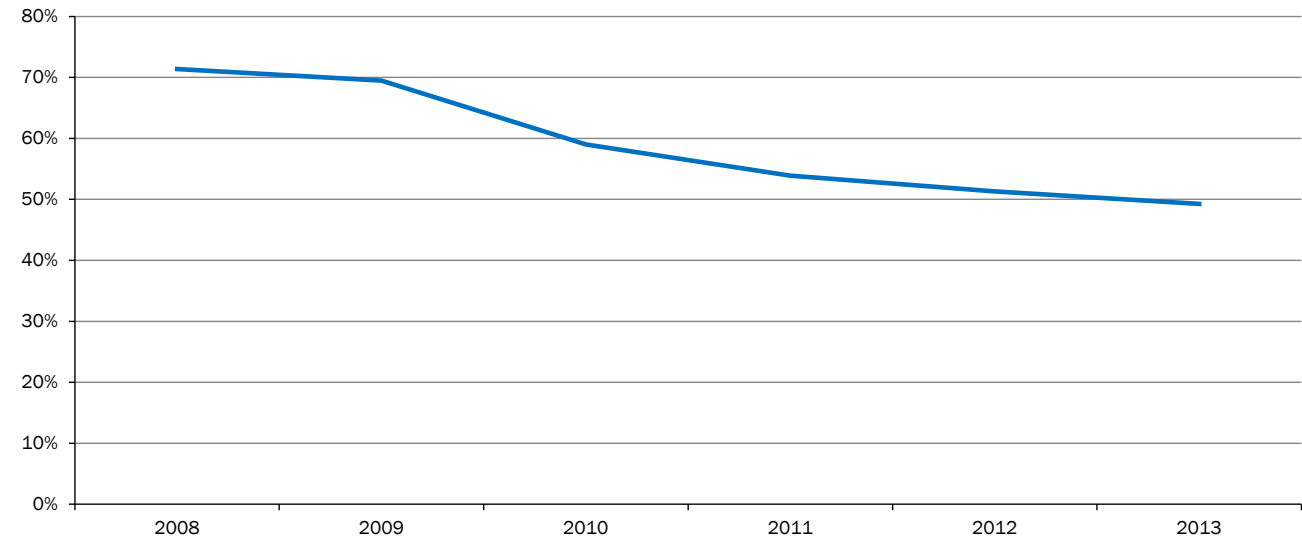


Total Discretionary Reserves and Reserve Funds Per Capita, 2013



The following chart indicates that in recent years, discretionary reserves as a percentage of total operating expenses (which was one of the metrics the City referred to in 2004) have steadily decreased.

Total Discretionary Reserves and Reserve Funds as a Percentage of Total Expenses (Net of Amortization), 2008–2013



4. Drilling down into the specific discretionary operating reserve accounts, a couple of the larger and more liquid reserve accounts in 2004 have decreased rather substantially, including one large reserve account that was funded by part of the proceeds from the 2001 sale of Brampton Hydro. Offsetting these decreases have been increases to some reserves where the City may have less spending discretion, such as the Peel Memorial Hospital fund.
5. With respect to capital reserves, senior officials have indicated to Council that the City's tax-based capital reserves are almost fully depleted and must rely largely on annual contributions from the operating budget for replenishment. Given operating expense pressures, in the last few years the annual operating budget contribution to capital has been significantly lower than annual funding requirements.
6. While Brampton's current cash and investments are significant, over the past decade they have declined as a percentage of the City's annual cash operating expenses and on a per capita basis. In 2004, cash and investments were 3.3 times annual operating expenses and \$1,695 on a per capita basis using Brampton's 2004 population. In 2013, they were 1.8 times operating expenses and \$1,486 per capita.
7. In looking at financial flexibility, the expenditure side of the equation is also important. In this regard, Canadian municipalities are generally seen as not having much flexibility to reduce expenses, especially in the short term. Consequently, the relative level of operating expenses has an impact on financial flexibility. Over the past decade, as discussed in more detail in Section 8 of this report, Brampton's operating expenses have increased at a faster rate than both inflation and the growth in the City's population and households.

8. Brampton's operating results have been generally declining over the past few years even though the economy has been improving. In its 2014 update report, S&P indicated that the need for Brampton to demonstrate better operating results was a critical factor in the decision to downgrade Brampton's 2013 credit rating from "AAA stable" to "AAA negative." S&P noted that "Brampton's operating performance in the past five years has been substantially below that of its Canadian peers."
9. One issue that the whole municipal sector is struggling with is the fiscal challenge of keeping existing and aging infrastructure in a state of good repair. Brampton is no exception, and this issue is discussed in some depth later in this report. The City annually estimates what the required capital expenditure would be if it could make all the repairs and rehabilitation improvements necessary. The expenditure shortfall is referred to as the estimated "infrastructure gap." As a percentage of the City's total tangible capital assets excluding land, the infrastructure gap has increased from 11.6% of total assets in 2009 to 13.1% in 2013.
10. The development charge (DC) reserve account balance provides a good indication of the amount of new-growth infrastructure that is needed. This infrastructure has been approved over the years by Council for go-ahead but has not yet been completed or, in many cases, even started. The deficit in this account has increased from an estimated \$181 million five years ago to \$239 million at the end of 2013.

In conclusion, the above indicators and metrics serve to illustrate that Brampton's financial flexibility to undertake new initiatives, fund reserves and make investments in both new-growth and existing infrastructure has not kept pace with the City's growth over the past five to 10 years.

5. Liquidity Position – Cash and Investments

Brampton undeniably has a very healthy liquidity position, totalling almost \$830 million. As discussed earlier, at first glance one might conclude that Brampton has enough cash and marketable investments to pay all of its operating expenses for over a year even if it took in no revenue whatsoever. Another way of looking at this is that, if the applicable contractual arrangements for the financing of the SWQ building enabled an early buyout, the City could extinguish this 'debt' and still have ample liquidity left over.

However, Council should be aware that the full \$830 million is not available to be spent because a certain amount needs to be held in reserve or is otherwise committed. A round-dollar back-of-the-envelope calculation would look something like this:

Balance at December 31, 2013	\$ 830 million
Less:	
Deferred revenues	\$ 230 million
Hydro Legacy Fund	\$ 100 million
Day-to-day operating expenses	\$ 100 million
Payables > receivables	\$ 50 million
"Free" liquidity	\$ 350 million

By way of explanation, deferred revenues are funds received from external parties, such as the federal government or developers, which must be spent in a specified manner or the money will technically have to be returned. The Hydro Legacy Fund cannot be spent without clear authorization from City Council, since the fund was originally intended to be an endowment fund, meaning that only the interest that the fund earns can be spent each year—the initial capital is to be preserved. At a minimum, the City would likely require \$100 million to ensure sufficient cash balances were always on hand to meet its day-to-day and unexpected shorter-term obligations. Finally, with supplier accounts payables typically exceeding customer accounts receivables by around \$50 million, a cash balance of this amount would be needed to pay these accounts.

6. Property Taxes—The Key Revenue Source

Some Background Information

About 77% of total property taxes are paid by residential property owners, while the non-residential sector contributes 23%. It is important to understand that the final property tax bill is comprised of three components:

1. The city portion, which in Brampton's case covers the City payroll, infrastructure needs, local transit, fire protection and a multitude of other City services such as recreational facilities, parks and libraries. It constitutes about 40% of the total tax bill.
2. The regional portion covers services such as water and sewage, as well as the cost of the regional police. Regional charges constitute about 40% of the total tax bill.
3. The education portion, which tends to be relatively flat from one year to the next, contributes to funding the elementary and secondary education system in Ontario. It constitutes the remaining 20% of the property tax bill.

It is only the city portion of the total tax bill that Council and senior officials are responsible for determining (although the Mayor and six Councillors do sit on the Region of Peel council). The City essentially just gets advised of the region and education amounts to be added to the City's property tax assessment billings each year.

Some relevant observations with respect to the recent history of Brampton's property taxes are:

- ▶ Over the last five years, the rate at which the City's portion of the annual property tax has increased has ranged from a low of 2.9% in both 2010 and 2014 to a high of 4.9% in both 2012 and 2013 (adjusted in 2013 for the hospital levy). The average rate of increase over the five years was 3.9%.
- ▶ In 2008, Council approved an additional 2% infrastructure levy. For 2009 and 2010, the levy was not charged due to the economic downturn, but a 1% infrastructure levy has been approved every year since 2011. The intent of this levy is to have the amount transferred from the operating budget to capital reserves to help fund the rehabilitation of the city's growing and aging infrastructure capital assets.

- ▶ Assessing where Brampton stands relative to other GTA municipalities in levying property taxes is not clear-cut. An annual survey by a consulting firm comparing property taxes across a number of Ontario municipalities indicated the following:
 - ▶ Brampton's residential tax for a single detached house of 1200 sq. ft. was consistently at the midpoint compared to 11 other GTA municipalities over the past few years.
 - ▶ Brampton's residential tax for a 3000 sq. ft. home was consistently at the low end compared to the other 11 GTA municipalities.

However, another municipality recently published a chart that showed that Brampton was in the top half among 16 GTA municipalities with respect to the amount of tax per \$1,000 of assessed value. With respect to the average percentage increase in property taxes from 2011 to 2014, another municipality's website chart placed Brampton in fifth place among 13 GTA municipalities, at 4.2%. (This is higher than the 3.9% rate noted previously—this other municipality's chart may have included the hospital levy. If 3.9% had been used, Brampton would have been at the midpoint.)

- ▶ It is also important to understand that an annual percentage increase announced early in the year may, in fact, turn out to be different once the actual assessment data for the year has been finalized. Sometimes this benefits residential ratepayers, and sometimes it benefits businesses. We were advised that in the years leading up to 2012, residential ratepayers usually benefited while businesses did not, but in the past two years, it went the other way. So while a 2.9% residential increase was announced in 2014, the average residential ratepayer ended up with an actual increase in 2014 property taxes of around 3.4%

I presented this background information for two reasons. First, I felt it would be of interest to Council, especially given that there are a number of newly elected Councillors. Second, this background is pertinent to an assessment of Brampton's financial condition, as it provides some context for Brampton's revenue-raising capability.

With respect to implementing a fair and equitable system of property tax administration, there are two principles that warrant highlighting.

- ▶ First, current residents should not be unduly impacted by the cost of growth-related new infrastructure requirements. Essentially, this cost should be almost entirely funded by developers, with the cost ultimately being passed on to the purchasers of the properties and not to the existing ratepayer base.
- ▶ Second, taxpayers should pay not only their fair share of the costs incurred to deliver the services they utilize during the year but also an amount adequate to maintain the existing community infrastructure in a state of good repair. In essence, there should be minimal inter-generational transfer of such costs.

From a legal perspective, municipalities have significant flexibility. From a pragmatic perspective, given Canada's stable housing market and the demand for housing in the GTA, property values are such that there is little likelihood of the City not collecting the property tax levied each year. In essence, while even an unusually high increase in any one year might result in some disgruntlement, there is little risk that the taxes will not be collected. This is a positive from a fiscal sustainability perspective.

In short, Brampton, like all GTA municipalities, has significant flexibility to raise property taxes as it sees fit. As far as it affects Brampton's financial condition, flexibility and sustainability, this is a definite plus. Pragmatically speaking, however, other factors—such as comparisons to nearby municipalities, the overall economic environment, where a municipality stands with respect to its current reserves, and how well its existing infrastructure has been maintained—are equally important factors.

Property Taxes – A Sensitive Issue

When it comes to taxes, and especially to raising taxes, I suspect municipal politicians have a more difficult task than their counterparts at the federal or provincial levels.

I say this because most people would probably not know within a couple of thousand dollars just how much income tax they pay each year. Income tax gets deducted from their pay slip, and it is the net amount that they get a cheque for or that gets deposited in their bank account that they remember. They are well aware of what this figure is but are much less familiar with what were the deductions from their gross pay or who 'gets' this money. If a provincial or federal tax is increased, while they quickly see they have less money to spend, it is not readily apparent what level of government or for what purpose the increased withholdings were for.

Property tax is a different story. People get a tax bill every year with information that sets out exactly by what percentage their tax is being increased and how much they must pay. I suspect most residents know within a hundred dollars or so the amount they pay each year in property tax and have a pretty good recollection of what percentage their property tax was increased by last year.

I suspect that what Council decides to recommend for 2015 will be a mix of "what do we really need" tempered by "what will our residents and the business community accept as being reasonable." Given my view that the City's financial condition has deteriorated over the last five to 10 years and that infrastructure renewal needs will increasingly become more of a pressure point, a slightly more aggressive but well-communicated property tax strategy may warrant consideration by Council. I noted several other municipalities that had been quite proactive and transparent in communicating their tax increase or use-of-debt message and have used videos and layman-oriented website and written communications to explain the rationale for and long-term implications of certain actions.

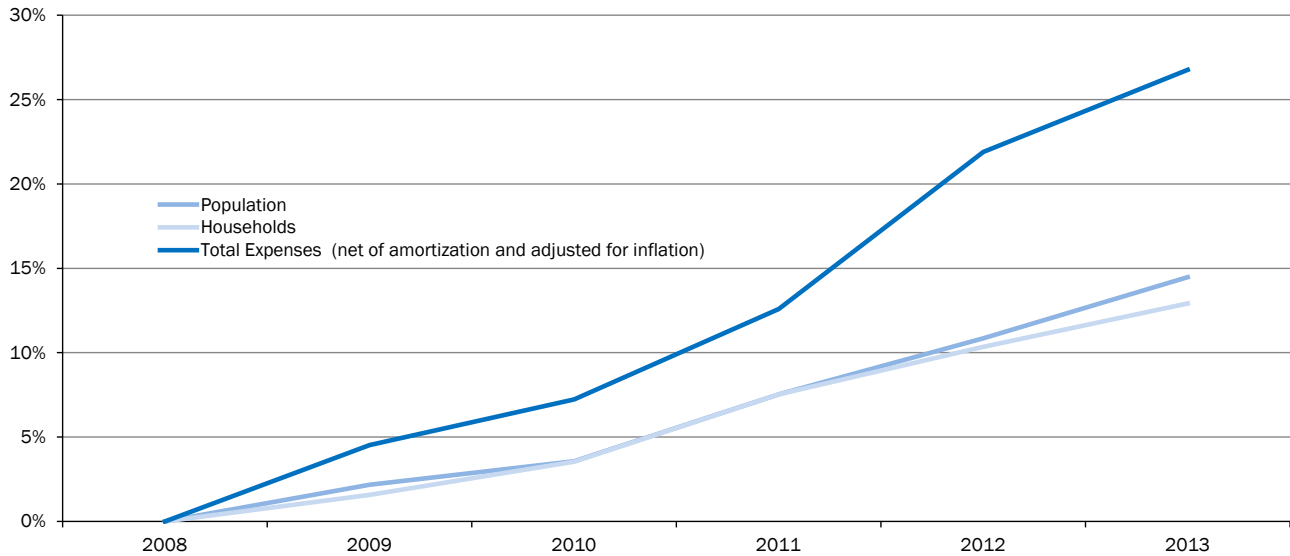
7. Managing Operating Expenses

In assessing financial flexibility, municipalities are more constrained when it comes to the expenditure side of the equation. For instance, they typically have little latitude on the services they provide. In Brampton's case, the region provides certain common services such as water, police services and waste collection. However, residents have the reasonable expectation that all other community services, such as transit, parks and other recreation facilities, fire protection and libraries, will be provided and funded out of their City property taxes.

In looking at Brampton's ability to manage their expenditures and what the trend has been in the last five to 10 years, there are two factors that I believe are having an increasingly limiting effect on Brampton's financial flexibility. They are:

1. As shown in the following chart, total operating expenditures (net of amortization and after adjusting for inflation) are increasing at a rate significantly in excess of Brampton's growth rate in population and household formation.

Cumulative Percentage Increases in Population, Households, and Total Expenses (Net of Amortization and Adjusted for Inflation), 2008–2013



Payroll costs account for about two-thirds of total cash operating expenses. The major components of the other one-third are comprised of items that, to some extent, are somewhat outside the immediate control of the City or contractual in nature. They include costs relating to utilities, bus and vehicle fuel, lease payments, janitorial and other service contracts, and the day-to-day repairs on the city's facilities and equipment. For about 10% of operating expenses—including transfers to capital and other reserves, and internal loan repayments—there is more discretion but, as discussed earlier, transfers to the reserve accounts are already at levels below what is likely required.

2. With almost three-quarters of Brampton's staff being unionized, payroll expenses—at least in the short term—are largely non-discretionary, in that headcounts, classification increments, annual wage increases and benefit changes are built into collective agreements.

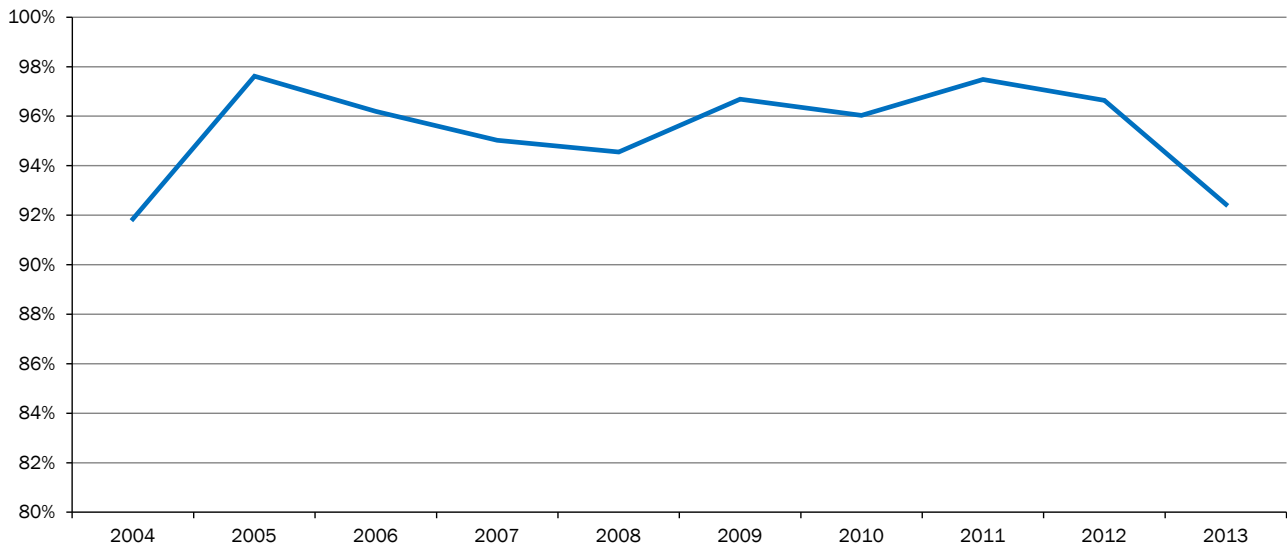
We requested an analysis of certain components of payroll expenses over the last five years to see if any area in particular had increased. The analysis indicated that payroll costs relating to transit services had been increasing at a much higher rate than the rest of the City payroll. We were informed that this resulted from the impact of recent federal and provincial grants to expand local transit services. While this helped to fund the purchase of additional buses and infrastructure improvements, the City is responsible for the cost of the additional transit staff.

S&P, in its recent credit-rating report on the City of Mississauga, noted, "Wages and benefits accounted for almost 71% of adjusted operating expenditures and exert a significant stress on operating budgets." Clearly, the impact of a city's payroll costs on a municipality's operating results is on the S&P radar screen.

An interesting comparison is that payroll expenses comprise two-thirds of total cash operating expenses while property taxes comprise two-thirds of total revenues. Over the 10 years from 2004 to 2013, the amount of property taxes that Brampton collected has increased by 120%. Coincidentally, payroll costs have increased by an almost identical 121% over the same 10-year period.

As can be seen in the following chart, even though the City has been successful in collecting significantly more property taxes over the years, over 90% of total property tax revenues each year have consistently gone to fund the City's payroll costs.

Salaries and Benefit Costs as a Percentage of Total Property Tax Revenues, 2004–2013



Managing the growth in operating expenses and especially in the City payroll is something that Council and City management will need to pay increasing attention to if they are to make any significant headway in improving annual operating results and replenishing City reserve levels, unless they plan on relying almost entirely on property tax increases.

8. Maintaining the City's Infrastructure

In assessing a municipality's financial condition, it is not enough to focus only on the "dollars and cents" typically represented by such fiscal measures as the annual surplus, net financial position, liquidity levels, reserves and others that accountants like to use. At the end of the day, people are interested not so much in the past—which these accounting measures tend to portray—but in the future. They want to know whether their municipality can continue to provide the level of services they require while at the same time keeping annual increases in the property taxes they pay at a reasonable level.

A critical element in a municipality's ability to deliver the expected services is the extent and quality of its infrastructure assets. In Brampton's case, these would include arterial highways and local roads, recreation and park facilities, transit assets such as buses and shelters, community fire stations and libraries, as well as less visible but still important assets like municipal works yards and administration buildings.

In reviewing the response to a recent report by the C.D. Howe Institute on the quality of municipal financial reporting, the Municipal Finance Officers' Association of Ontario stated that assessing financial sustainability "requires more than only looking at the current financial position but adding the future requirements, particularly as it relates to the replacement of capital tangible capital assets." I agree.

Brampton has a growing backlog of needed maintenance, repair and replacement of infrastructure assets that is estimated to be in the hundreds of millions of dollars and that is going to have to be funded over the next decade if the City is to maintain its existing infrastructure assets in a state of good repair. Beyond dealing with an aging infrastructure base, high-growth municipalities have the added challenge of bringing a significant amount of new assets onto the books each year as a result of new-growth infrastructure constructed by the city or by developers and contributed to the city. Over time, all these new assets will require routine maintenance and repair, and eventually often outright replacement.

But Brampton is not alone in needing to commit substantially more funds to keep its existing and growing assets in a state of good repair. The repair and replacement of aging municipal infrastructure assets is an issue virtually all Canadian municipalities are struggling with. In its response to the C.D. Howe report mentioned earlier, the Municipal Finance Officers' Association of Ontario noted the following:

The municipal sector, like federal and provincial governments, has been remiss in not addressing their infrastructure replacement issues until recent years. As a result, they find themselves very much in a catch-up position. Had every municipality budgeted and set aside funds for replacement and depreciation every year, they would find themselves in a much stronger cash position today. Since they did not, many municipalities are now budgeting for higher reserve contributions to address looming needs. That, of course, comes at a cost of higher taxes.

A recent report issued by S&P that discussed the Canadian municipal environment also noted that most municipalities across the country were facing aging-infrastructure pressures. Based on a number of GTA municipal annual reports I reviewed, it seemed that determining how to successfully fund the required infrastructure repair and replacement deficit was a key issue that almost every GTA municipality was grappling with from a long-term fiscal-planning perspective

Some of the comments made by the GTA and other local municipalities in this regard were:

- ▶ **Markham:** "Markham will transfer up to 25% of tax revenue from net annualized growth in assessment to the Life Cycle Replacement and Capital Reserve Fund to maintain and refurbish our existing infrastructure."
- ▶ **Hamilton:** "Council has made the growth in the Capital Levy as a percentage of the Total Property Tax Levy a priority. The Capital Levy has steadily increased as a percentage of the total levy over the last five years and currently sits at 12.4% from a low of 11.9% (2009)."
- ▶ **Halton:** "A key objective of the 2015 Budget is to continue to invest appropriately in the state-of-good-repair of the Region's assets and to maintain the overall condition of the assets as the Region's infrastructure continues to age and expand."

- ▶ **Mississauga:** “Repairing and rehabilitating aging infrastructure requires an increased focus on funding the City’s asset renewal needs”.
- ▶ **Oakville:** The town of Oakville disclosed in its 2013 Annual Report that it spent 11.5% of its budget on infrastructure maintenance and that 45 cents of every \$1 of the year’s tax increase went to “infrastructure renewal.”
- ▶ **Toronto:** “Managing the SOGR (state of good repair) backlog is a key strategic objective and priority for the City. With growing capital demands accompanied with renewal needs of an aging infrastructure the emphasis continues to be protection and preservation of existing infrastructure.”
- ▶ **Vaughan:** “Vaughan’s infrastructure funding contributions are not adequate to sustain future requirements...An infrastructure funding strategy and significant investment decisions are essential to begin addressing the backlog of unfunded projects and future infrastructure requirements.”

Brampton has also started to address the “where’s the money going to come from” infrastructure maintenance and replacement question. For instance, in 2008, Council approved a 2% infrastructure levy to help fund infrastructure repair and replacement. The levy was implemented for 2008 but not for the following two years due to the economic downturn. Since 2011, a 1% infrastructure levy has been included as a final adjustment to the approved tax increase annually. As well, \$1 million from new assessment tax revenue has been transferred to the capital reserve for a number of years now.

However, even with this levy, Brampton’s reserves, and particularly its capital reserves, have not kept pace with the growth the City has experienced in recent years. Its unfunded tax-based infrastructure backlog has been growing, with the 2014 backlog being \$120 million and the 10-year estimated requirement being over \$300 million. My sense in reviewing some of the actions taken by other municipalities in the GTA and surrounding areas is that a number have recently become more aggressive than Brampton in taking action to ensure that, over the long term, funds will be available to ensure their infrastructure assets can be well maintained.

Examples of some of the specific actions taken by other municipalities include:

- ▶ Establishing a formal policy whereby a fixed percentage of the annual surplus will automatically be earmarked to help fund the asset repair and replacement reserve. For one municipality, the percentage was as high as 75% of the year’s operating surplus being applied to capital reserves.
- ▶ Automatically increasing the capital levy transferred from the operating budget by 0.5% a year until the levy reached a target percentage. Another city set a target of increasing its capital contributions from its current operating budget by 10% annually.
- ▶ Implementing an incremental increase through a capital Infrastructure and debt repayment levy equal to 2% of the City’s prior year tax levy.
- ▶ Establishing a separate, tax-supported capital budget that is focused on maintaining existing infrastructure in a state of good repair, and keeping new-growth capital projects separate given that new infrastructure should be funded almost entirely by DC revenues.

- ▶ Establishing a target of capital transfers from the operating budget being equivalent to the annual amortization expense in the financial statements
- ▶ Transferring an amount from the operating budget to the capital reserve when new infrastructure is approved, with the amount based on life-cycle-replacement principles.
- ▶ Adding an inflationary adjustment to the infrastructure replacement reserve each year to supplement the transfers that are typically based on historical cost information.
- ▶ Allocating a fixed percentage of new property-tax-assessment revenue growth to the capital reserve each year.

My objective in outlining some of the strategies that other municipalities are using to ensure that funds will be available to maintain their aging infrastructure assets is to provide the City's decision-makers with some of the different approaches being taken on an issue that Brampton is not alone in needing to proactively address.

The last point I wanted to discuss relates to the question of "how much is enough." In communicating the infrastructure-gap issue to their residents, several municipalities used the rationale that the annual amortization (sometimes called "depreciation") expense in the financial statements was a good benchmark with which to gauge whether enough funds were being set aside to fund repairs and replacement of existing infrastructure.

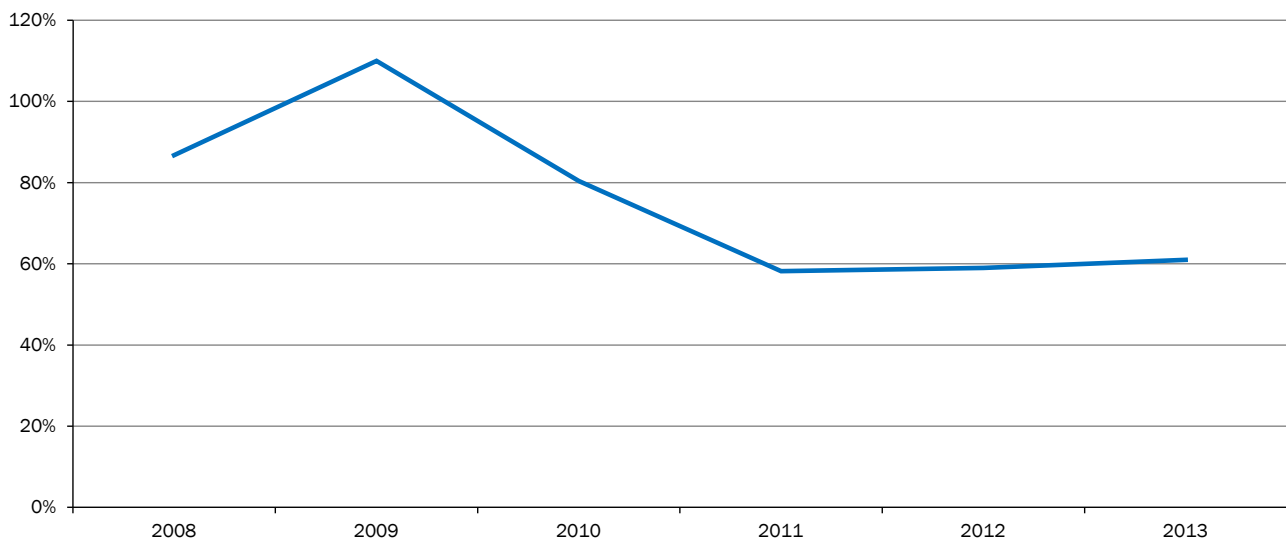
Amortization is an accounting term that warrants some explanation. When a new asset is purchased, it is recorded at its original cost. But we know that assets wear out over time and that the value of that asset generally decreases as time goes on. The accounting term for the cost associated with this annual deterioration in an asset's value is "amortization." It essentially recognizes as an expense that proportion of the asset's original cost that is used up during the year.

I believe the amortization expense is a reasonable proxy amount for how much should be set aside each year to keep existing infrastructure assets in good condition and, in many cases, fund their eventual replacement. Admittedly, amortization is based on historical cost as opposed to the amount that replacing the asset would actually cost in today's dollars. As such, the amount might be on the low side, but nevertheless it is a reasonably good and easy-to-use benchmark.

In Brampton's case, the amounts budgeted for asset repair and replacement in recent years have been significantly less than the annual amortization expense in the financial statements. Senior officials have advised City Council that annual tax-supported contributions for repair and replacement fall significantly short of annual depreciation and that the gap is increasing as new infrastructure is being added at a greater pace than funds allocated for future replacement.

As the following chart shows, five years ago, approximately 80% of the amortization amount was being appropriated, but this figure has slipped to 60% over the last two years.

Annual Contribution to Capital Reserve Funds as a Percentage of Amortization, 2008–2013



To sum up, there are three points that I want to reiterate:

1. All Canadian municipalities are being challenged with the issue of “where the funds will come from” to maintain their aging infrastructure assets. Brampton is no exception and has estimated needs in the hundreds of millions of dollars that will have to be addressed over the next decade.
2. A number of GTA and area municipalities have recently implemented specific measures to deal with this issue before it becomes too late. Brampton has made a start but needs to do more.
3. From a fairness point of view, those taxpayers who are benefiting from the use of these infrastructure assets today should bear the cost of keeping them in a state of good repair. It is inequitable if these costs are being passed on to future new residents or future generations of Bramptonians. Other municipalities have recognized this and, when this has impacted property taxes, have made sure that this message is being communicated to their residents.

I do want to acknowledge that I did note in Brampton’s recent Strategic Plan that City officials recognized the need for a formal infrastructure maintenance funding strategy and had established this as a corporate priority.

9. Some Perspectives on the Use of Debt

The primary mandate for my review was to provide a high-level overview of the City’s current fiscal state along with a general indication of whether Brampton’s financial condition has changed over the past five to 10 years. However, in discussions on the terms of my review, it was also mentioned that any thoughts I had on whether the City should be issuing debt would also be appreciated. While I will not

be opining on whether Brampton should issue debt or not—this is a decision for Council—I would like to provide some perspective on the issue.

By way of background and putting aside the issue of whether the financing of the SWQ building constitutes debt, Brampton has had no debt since 2002, when the existing debt at that time of approximately \$2.3 million was paid off from proceeds from the sale of Brampton Hydro.

Under the Ontario Municipal Act, debt is typically issued by municipalities in the form of debentures and can only be issued for capital (infrastructure) purposes. It cannot be used to fund a City's day-to-day operating expenses. Also under this Act, a lower-tier municipality such as Brampton can only issue debt through its upper-tier regional municipality, which in Brampton's case is the Region of Peel. By way of example, in 2014, the Region of Peel issued 10-year debentures on behalf of the City of Mississauga at an interest rate of 2.76%. I understand that the Region has advised its lower-tier municipalities that the Region can require up to 18 months advance notice if the municipalities want the Region to issue debentures on their behalf.

A municipality generally has two types of capital infrastructure investments:

- ▶ New-growth infrastructure is primarily, but not entirely, funded by DC revenues. Under provincial legislation, a small percentage of new-growth capital is to be funded from the existing tax base, and existing taxpayers may initially help fund new-infrastructure-related operating costs. The legislation essentially states that this is acceptable as long as the existing taxpayers are not being unduly charged for this. As DC charges are not received until building permits are issued, much of the related new-growth infrastructure must be pre-funded by the City.
- ▶ The repair, rehabilitation and often the eventual replacement of existing infrastructure assets are entirely funded out of the property tax base. As was discussed in more detail in Section 8 of this report, these infrastructure assets depreciate over time, and the annual amortization amount is a good indicator for how much should, on average, be set aside to keep the assets in a state of good repair.

Assuming funding from another level of government cannot be counted on, funding for infrastructure comes from four sources:

1. Use DC funding. Under provincial legislation, new infrastructure is to be funded primarily, but not entirely, by DC charges that are ultimately paid by the purchasers of new properties.
2. Use existing reserves. If a municipality has had the fiscal resources to have built up its reserves over the years, it can use its reserves to help pay for the necessary rehabilitation of existing assets to keep them in a state of good repair and to pay the tax-supported share of new infrastructure not funded by DC charges.
3. Use property taxes. This can sometimes require a significant increase in the property tax rate, especially if a municipality's existing infrastructure has not been maintained in accordance with life-cycle asset-management best practices, necessitating significant investments to rehabilitate these assets.
4. Use debt financing. If debt is used for new-growth infrastructure assets, the repayments are primarily funded by future DC receipts but also partly from the property taxes being received

each year from the new residential and business property owners. The term of this debt typically matches the number of years of expected DC revenues. Where debt is used to fund the rehabilitation of a City's existing infrastructure, repayment comes from tax-supported revenues, with the term of the debt often being linked to the useful life span of the assets.

There is also a fifth option—defer the needed infrastructure investments until such time as the operating funding is available. The obvious benefits of this strategy are that reserve levels are maintained, property tax increases can be minimized, and a municipality may be in the position to say that it is “debt-free.” All of this undoubtedly goes over very well with the city's residents—at least in the short term.

However, there are downsides to this option:

- ▶ Deferring new-growth infrastructure typically results in planned municipal growth not happening or at least being slowed down, since development cannot occur as planned if needed infrastructure (e.g., roads, fire stations) is not in place. On the fiscal side, both the expected DC revenues and the related property taxes to be received from the new residents and businesses will be delayed to reflect the reduced pace of development (offsetting this to some extent will be the operating costs of the new-growth infrastructure).
- ▶ Deferring needed investments in existing infrastructure (such as needed repairs) generally results in the deferred work costing much more in the long run. The adage “pay me now or pay me (a lot more) later” is particularly applicable.

In looking at examples of other municipalities that chose to issue debt to fund infrastructure, there is a clear commonality in the reasons they gave for their decision:

- ▶ **Halton:** “Debt financing is utilized for significant upgrade and rehabilitation initiatives, ensuring the operating impacts from the significant capital program remain smooth and the timing of revenue from tax/rate payers is appropriately matched with the benefit of the infrastructure.”
- ▶ **Toronto:** “Without debt-financing, present taxpayers could be paying for the entire cost of a project that will operate for many years and provide a benefit to future residents.”
- ▶ **Mississauga:** “In order to repair and rehabilitate our infrastructure without placing additional pressure on property taxes, it was necessary to issue debt for the first time in over 30 years.”

Turning to Brampton with respect to the four options noted previously for financing its infrastructure investments, where does Brampton stand? My review indicated that Brampton's capital reserve levels currently provide little flexibility, and City officials have communicated to Council that the current level of reserves are not adequate to fund the required future infrastructure investments. While some increase to the property tax rate to help catch up on the necessary infrastructure investments is one option, it may be insufficient to provide all the necessary funding.

This leaves the possibility of issuing some debt in the form of debentures through the Region of Peel. City officials have broached this issue with Council and have recommended debt-funding limits that seemed reasonable based on a comparison with several other GTA municipalities and are well below the maximum limits the Province has established in legislation for municipal debt.

I believe that taxpayers would want the City to finance infrastructure projects in whichever manner costs them the least. I was informed that the decision to finance the new SWQ building through a 25-year lease-to-own P3 financing contract carries a financing rate of 7.2%. Furthermore, the decision to go this route was largely driven by Council's direction that no external debt could be used to finance the construction through a design-build process.

I was advised that, if the building had been financed by a loan through a provincial government agency, the City's borrowing rate would have been around 4.8% at that time. One of the benefits of a well-designed P3 contract is that the construction risk can be transferred from the City to the builder. There is certainly some inherent value in this. Although assessing which was the most-cost effective financing option is beyond the scope of my review, I would suggest that the use of debt as one financing option for future major construction projects should at least be "on the table" as a possible alternative.

A key reason for the P3 lease-to-own approach was that the City wanted to remain debt-free and I understand this financing was considered at that time to not technically constitute debt. S&P considers this financing to be debt-like in nature (as do I). It stated in its most recent report that, as a result of the SWQ capital lease obligation and the guarantee relating to the Powerade centre, it estimated Brampton's tax-supported debt to be about \$215 million, which was at "a level which we believe is higher than most of its similarly rated peers."

A final point relates to my earlier comment about Brampton's excellent liquidity position of \$829 million in cash and investments. Could these funds be used to pay for infrastructure investments rather than borrowing the necessary funding? As discussed earlier, although Brampton has \$829 million in liquid assets, less than half of this is what one might call "free cash," given Brampton's deferred revenue and other financial obligations, including previous decisions made by Council.

We also noted that of the \$829 million in cash and investments, approximately \$415 million was earning interest at financial institutions at rates below the inflation rate. As such, the municipality may be losing purchasing power on some of its cash balances as opposed to using a portion of them to fund infrastructure and other capital or social projects or moving them to longer-term qualified investment vehicles with higher returns.

At the end of the day, whether to borrow or not may well come down to making an objective, well-informed assessment of the consequences of not making the planned capital investments in new growth infrastructure and/or deferring the investments needed to keep Brampton's existing assets in a state of good repair. If the consequences—both financial and non-financial—are seen as being too detrimental over the long term, then issuing debt to partially fund new infrastructure investments may turn out to be a cost-effective and equitable way of ensuring that the cost of services inherent in a city's infrastructure are being borne by those who benefit.

10. Capital Budgeting Methodology

The general practice of Canadian municipalities is to prepare two budgets each year. The first is the current or operating budget, which typically covers expenses such as salaries and wages, externally provided services, rent and utilities, and various supplies ranging from winter road salt to fuel for transit

buses to office supplies for administrative staff. The operating budget is relatively straightforward, including all costs that are expected to be incurred over the year to run the day-to-day operations of the city. Generally, the expense categories and even the amounts do not change significantly from one year to the next, aside from inflationary and cost-of-living increments and the cost of increased services relating to population growth.

The second is the capital budget, which addresses major new capital infrastructure such as roads; new facilities, such as recreation centres, libraries and fire stations; the rehabilitation and replacement of the City's existing infrastructure assets; and smaller items that generally last longer than one year, such as buses, trucks, computer equipment and street lights.

The capital budget can fluctuate significantly from one year to the next. There are several different methods of preparing a capital budget. One method is to include only the actual capital costs that the municipality expects to incur during the year. For example, a municipality may decide to go ahead with a major \$40 million arterial highway to several new subdivisions that will be constructed over the next seven years. In year one, the expected costs associated with some preliminary design work and site preparation are estimated to be about \$3 million.

Under this method, while the Budget would provide information to City Council on the expected total seven-year cost of the road, the current year's capital budget amount would include only \$3 million. Council would be asked to approve both the current year's expected capital expenditure as well as give the go-ahead for the seven-year project. Future years' funding for the project would be approved on a year-to-year basis.

The second method of preparing the capital budget is to include the full seven-year \$50-million cost of the road in the current year's capital budget that is submitted to Council for approval. There are pros and cons to both approaches.

Brampton has historically used the second method in preparing its annual capital budget. There have been two recent events that I believe may have been impacted by Brampton's long-standing practice of including the full multi-year cost of major infrastructure projects in its reserve and capital fund accounting. The two are:

- ▶ S&P's observation that Brampton's DC reserve account is in a \$246 million deficit; and
- ▶ a \$750-million infrastructure capital fund project backlog that the City recently received some unfavourable media coverage on.

With respect to the first item, the city's DC reserve accounts have been in a significant net deficit position ranging between \$225 million and \$325 million over the past year or so. S&P's most recent credit rating review revised Brampton's rating downward from "AAA stable" to "AAA negative" and mentioned three reasons that constrained the City's rating. One reason was the \$246-million deficit in the DC reserve account.

The large DC-reserve-account deficit does not mean that the City had actually incurred this amount of cash construction costs in advance of receiving the DC receipts from the developers (development charges are paid to the City when the building permits for the new subdivision associated with the new infrastructure are issued). Rather, the deficit balance represents Council-approved capital projects that have, for the most part, not been substantially completed or, in many cases, even started. If Brampton

had budgeted for only those DC-related capital expenditures that it actually expected to spend money on during the year, the DC-reserve-account deficit would likely have been significantly lower.

I reviewed the annual Financial Information Returns submitted to the Ministry of Municipal Affairs by a number of other GTA municipalities and noted no other municipality that had a deficit in its year-end DC-reserve-account balance.

On the second issue referred to above, recent media coverage implied that the City had over \$750 million in missing or unaccounted for capital projects. Information provided by City officials indicated that the total was \$766 million, of which approximately \$482 million was for projects approved between 2011 and 2013 and \$284 million was for projects approved in 2010 and earlier.

In actual fact, the \$750 million was neither missing nor unaccounted for. Rather, as with the DC reserve account, it represented approved capital projects that had never been substantially completed or, in many cases, even started. Over the years, there had apparently been inadequate ongoing follow-up of the status of previously approved capital projects until this issue was brought to Council's attention by City management.

In discussing this issue with senior financial management I was advised that the capital budgeting process is being changed for the 2015 Budget. Essentially, the amounts relating to the 2015 capital projects being submitted for Council review and approval will include only those procurements that are expected to be contractually committed for during the 2015 fiscal year. Council will also be apprised of the full multi-year expected cost of the project. I believe this is a good change.

11. Final Thoughts

The purpose of this report has been to present a high-level overview of where I believe Brampton stands with respect to its financial condition. I have also outlined what I believe to be the most significant longer-term fiscal challenges facing the City, along with some quantitative and qualitative perspectives concerning these challenges.

The City has excellent liquidity in the form of its sizable cash and investment balances. However, it does not have the fiscal flexibility or strength that it had relative to its size compared to 10 or even five years ago. Given the City's current strong liquidity position, it is hard to argue that it must take immediate and urgent action to address this issue. But the adage "pay me now or pay me later" is appropriate, and the risk of significant delay is that you end up with a "pay me now or pay me (a lot more) later" situation.

My mandate was to conduct a financial review and report on the results of my review. I was not specifically asked to address the question of "where we go from here." However, I do want to offer a few final thoughts on some issues that I believe Council might have some interest in as it begins its 2015 Budget deliberations.

- ▶ **Paying Your Fair Share:** Residents and businesses should pay for the full cost of the services that they receive today. This is especially important when considering the annual wear and tear on the City's existing infrastructure such as roads, recreation centres and libraries, fire stations, transit buses and facilities, and all other City assets. If insufficient funds are

being spent on maintaining these assets in a state of good repair, future generations and the expected 300,000 new residents over the next 15 years will have to bear a disproportionate share of these costs.

- ▶ **Managing Annual Operating Expenses:** Even after considering the impact of inflation, the rate of growth in operating expenses has significantly exceeded the rate of growth in the City's population and household formation over the last decade. While the City's significant growth over the past 10 years has resulted in an increase of 120% in property tax revenue, virtually all of this extra revenue has gone to fund the increase in the City payroll over the same time period. With two-thirds of every operating-expense dollar being spent on the City's payroll and almost 75% of City staff being unionized, it will be a challenge to slow the historical rate of growth in operating expenses that has occurred over the last decade.

S&P's latest credit review noted an improvement in annual operating results as one factor it would be looking for to upgrade the City's rating from "AAA negative" to "AAA stable." If this is to be achieved along with making the necessary infrastructure investments and building up the City's reserves, some progress in slowing the rate of growth over the past decade in operating expenses will likely be necessary. Otherwise, it may be left almost entirely to property tax increases to provide the additional funding that will be needed.

- ▶ **Using Property Taxes:** As noted in Section 6, when it comes to increasing taxes, I believe municipal politicians have a more difficult task than their provincial or federal counterparts. In my review of other neighbouring municipalities, I noted that a number are making an effort to distinguish property taxes levied for day-to-day city operating expenses from those levied to fund infrastructure investments. I suspect taxpayers will be more likely to accept a tax increase to keep the City's assets—which they use every day—in good condition, as opposed to using the tax increase to pay municipal salaries.

If Council is of the view that an increase in the current 1% infrastructure levy is warranted, establishing something along the lines of an Infrastructure Heritage Fund might be worth considering. The City could provide an annual update on the Fund's receipts and infrastructure expenditures in summary form on its website or in Brampton's Annual Report to demonstrate to taxpayers that their infrastructure-related tax dollars are being spent as intended.

Such a distinction would also provide the advantage (or disadvantage) of making it clear that the rest of any tax increase was being used solely to fund the City's day-to-day operating expenses, which taxpayers might assume should be increasing at a rate somewhat in line with inflation and the growth in population over the past year.

- ▶ **Timing Tax Increases:** Brampton's significant liquid cash and investment balances provide flexibility in the sense that minimal or even no tax increases can likely be tolerated—at least in the short term—and Brampton will still be able to "pay the bills." On the other hand, City officials and Council may be of the view that tax increases above last year's 2.9% or above the 3.9% average over the past five years are going to be needed and that it is only a matter of when. If so, one benefit of doing this earlier rather than later is that this increases the go-forward revenue base, which is one factor taken into consideration in determining the required following year's tax rate. Also, a higher starting base may allow future years' percentage increases to be moderated.

- ▶ **Using Debt:** As I discussed in Section 9, the City certainly has the financial capability to issue some debt. Council should be driven by the fiscal metrics of the various alternatives in deciding whether to issue debt or not. As the City Manager quite aptly put it in my discussions with him, “Smart debt is OK.” My comments should not be interpreted as a formal recommendation to issue debt, but merely that a debt-free philosophy should not override doing what will ultimately keep the most dollars in the taxpayer’s pocket.
- ▶ **Communicating:** When it comes to tax increases and the state of the City’s financial condition, people expect the full picture to be communicated to them—the good news along with any not-so-good news. In communicating the full picture, I believe Brampton has a couple of characteristics that differentiate it from most other Canadian municipalities.

The first is that it is one of the few cities in Canada where almost half the residents’ mother tongue is not English or French, and, not surprisingly given this, more than one-third of its residents speak another language at home. After English, the two most-spoken languages are Punjabi and Urdu. The second differentiating characteristic is that, of the 10 largest cities in Canada, Brampton has the youngest average age, at 34.

These characteristics create both a challenge and an opportunity. The obvious challenge is that just getting your message out in English will likely not be sufficient.

On the opportunity side, the City has the chance to explore innovative ways of communicating that reflect the ethnic diversity of its residents. It is interesting to note that TV audiences for foreign languages such as Punjabi and Urdu have grown to the point where GTA-based cable companies now offer dedicated channels for these languages, so I suspect that there may be other communication venues that can be explored in this regard.

A second opportunity is that, with such a young population, communications using social media and other mobile- and Internet-based communication vehicles are more likely to result in an acceptable payback. I noted with interest that Mississauga recently decided to produce a video that communicated the rationale behind its recent property tax increase.

In conclusion, the above observations should not be interpreted to be formal recommendations—they are not. Rather, they are intended to be food for thought—no more and no less.