



**STAFF REPORT**  
**Financial Planning**

Title: Capital Budget & Capital Overhead Policy Updates Approval  
Report Number: CORP2019-025  
Author: Brad Witzel  
Meeting Type: Finance & Strategic Planning Committee Meeting  
Council/Committee Date: May 13, 2019  
File: N/A  
Attachments: Appendix A: FC-012 Capital Budget Policy  
Appendix B: FC-018 Capital Overhead Policy  
Ward No.: City Wide

**Recommendation:**

1. That Council approve CORP2019-025;
2. That Council approve the Financial Control Budget Policy updates contained in Appendix A: FC-012 Capital Budget Policy;
3. That Council approve the Financial Control Budget Policy updates contained in Appendix B: FC-018 Capital Overhead Policy;
4. That Council approve the year-end allocation of any annual Capital Project Overhead Revenue (Acct #610101) surplus, 100% to the Capital Infrastructure Reinvestment Reserve Fund (CIRRF);
5. That Council direct staff to review the Capital Project Overhead Rates (%) in advance of each three-year budget cycle, with the next review occurring before the 2024-2026 budget.

**A. Executive Summary**

The Council for the City of Waterloo is committed to demonstrating financial leadership and sustainability. The budget process is guided by various Financial Control – Budget related policies which can be found at [www.waterloo.ca/budgets](http://www.waterloo.ca/budgets). During each budget cycle, staff review the budget related financial control policies and recommend revisions where appropriate. For the 2020-2022 budget cycle, two budget policies require updates. These proposed policy changes were reviewed by the Audit Committee at their May 2, 2019 meeting.

**B. Financial Implications**

For the 2020-2022 budget cycle, staff are recommending changes to two key budget related policies. These changes are being brought forward in advance of the 2020-2022 budget development as they will have implications as to how the 2020-2022 capital budget is developed. It is being recommended that the Capital Budget Policy (FC-012) be updated to use a rolling five year average of the third quarter, Toronto construction price index for inflating capital expenditures. Currently the policy states that the most current third quarter index be used as the inflationary index. A rolling five year average will assist in smoothing out the inflationary index used by the capital budget avoiding material changes in the index year over year.

Additionally, it is being recommended that the Capital Overhead Policy (FC-018) be updated to reflect the various changes as identified by staff through the capital overhead policy review including;

- a flat capital overhead rate of 4% be implemented for applicable projects
- that Environment & Parks Services (EPS) be added as an applicable Division for applying capital project overhead
- that staff review the policy in advance of each three-year budget cycle ensuring that the capital overhead rate (%) being charged is still reflective of the staff efforts required to internally manage capital project.

In addition a capital project overhead revenue 'true-up' of \$400,000 will be incorporated into the 2020-2022 operating budget. This revenue item has historically experienced a surplus. This level of revenue 'true-up' is believed to be sustainable based on the 2017 & 2018 Actuals and the projected average capital project overhead recovery planned in the 2019 approved capital budget and 2020-2028 capital forecast.

**C. Technology Implications**

N/A

**D. Link to Strategic Plan**

(Strategic Priorities: Multi-modal Transportation, Infrastructure Renewal, Strong Community, Environmental Leadership, Corporate Excellence, Economic Development)

This report links to the Corporate Excellence pillar and the Guiding Principle: Fiscal Responsibility within the strategic plan.

**E. Previous Reports on this Topic**

- CORP2019-003 2019 Proposed Budget - Financial Control Budget Policy Updates Approval – January 21, 2019

**F. Approvals**

<b>Name</b>	<b>Signature</b>	<b>Date</b>
<b>Author:</b> Brad Witzel		
<b>Director:</b> Filipa Reynolds		
<b>Commissioner:</b> Keshwer Patel		
<b>Finance:</b> Filipa Reynolds		

CAO



## Capital Budget & Capital Overhead Policy Updates Approval CORP2019-025

### Background

During each budget cycle, staff review the budget related financial control policies and recommend revisions where appropriate. For the 2020-2022 budget cycle, two budget policies require updates. These changes are summarized below and the proposed policies can be found under Appendix A: FC-012 Capital Budget Policy and Appendix B: FC-018 Capital Overhead Policy.

These proposed policy changes were also reviewed by the Audit Committee at their May 2, 2019 meeting.

### 1) FC-012 Capital Budget

The purpose of this policy is to govern the items that will assist in creating the capital budget. The following proposed policy updates are being recommended in advance of the 2020-2022 capital budget development:

- Capital budget inflationary index
  - current: based on the third quarter, Toronto construction price index
  - **proposed:** five year rolling average of the third quarter, Toronto construction price index for the current capital budget period and 2% for the forecast period
- Clarification also included around the type of capital expenditures that are inflated
  - current: policy states that expenditures funded by the Capital Reserve Fund (CRF) and Capital Infrastructure Reinvestment Reserve Fund (CIRRF) are inflated
  - **proposed:** All expenditures
    - while CRF & CIRRF are the city's main capital funding sources, all funding sources within the capital budget are inflated

**Rational for Recommended Changes:**

Staff are recommending that the capital budget inflationary index of the third quarter, Toronto construction price index be replaced with a **rolling five year average** of the index. Similar to the Development Charge by-law, the city's capital budget has historically utilized the non-residential Toronto construction price index for capital budget inflationary purposes. The non-residential Toronto construction price index has been used as it aligns with our DC by-law process, best captures area contractor pricing (GTA contractors often bid on City of Waterloo RFT's) and avoids including factors not likely to be experienced in our local market (e.g. if the construction price index for Canada or Ontario was used).

Based on the current policy, the 2019 capital budget and the 2020-2028 capital forecast were inflated by a rate of 2.96% annually which was the non-residential third quarter, Toronto construction price index for Q3-2017 (*data typically released in Nov/Dec resulting in 1 year lag for capital budget purposes*).

On November 15, 2018 Stats Can released the non-residential third quarter, Toronto construction price index for Q3-2018 of 5.18%. Under the current policy, an inflationary factor of 5.18% would be used to inflate all base capital project cost annually across the entire 10 year period.

While the third quarter, Toronto construction price index is a helpful factor when considering capital cost, it does have some limitations for capital budget inflationary purposes. For starters it's based on historical data (similar to other indexes) and not necessarily a prediction of future capital increases to be experienced. Also as mentioned above, there is a timing challenge in terms of when the index data is released and when the city's capital budget development process occurs (during the spring and summer vs. the fall when the data is released).

As such staff are recommending that a rolling five year average of the index be used for the current capital budget period (1 year or 3 year) and that an inflationary factor of 2% be used for the forecast period (9 year or 7 year). This modified approach to inflating base capital project cost will assist in smoothing out the inflationary index changes year over year and avoid material capital budget changes as a direct result of inflation.

Based on the report CORP2019-025 recommendations, the 2020-2022 capital budget will be inflated by **2.94% annually** (rolling five year average of the 2014 Q3 index – 2018 Q3 index). And the 2023-2029 capital budget forecast will be inflated by **2% annually**.

Table 1: Historical Non-Res Toronto Construction Price Index as of Q3:

Year-Area	Q3 Year-over-Year % Change
Q3-2018 Toronto	5.18%
Q3-2017 Toronto	2.96%
Q3-2016 Toronto	3.24%
Q3-2015 Toronto	1.81%
Q3-2014 Toronto	1.51%
<b>Five Year Average</b>	<b>2.94%</b>

## 2) FC-018 Capital Overhead

The purpose of this policy is to define overhead, the corresponding overhead rate charged to capital projects and where the overhead will be recovered in the operating budget. The following proposed policy updates are being recommended in advance of the 2020-2022 capital budget development:

- Capital overhead fee (%)
  - current: 6% overhead fee for applicable projects < \$1,500,000 and 3% overhead fee for applicable project > \$1,500,000
- **proposed:** 4% overhead fee for all applicable projects
- Applicable projects
  - current: projects with a Project Implementation Division from Integrated Planning and Public Works (IPPW) or Facility Design Management Services (FDM)
  - **proposed:** projects with a Project Implementation Division from Integrated Planning and Public Works (IPPW), Facility Design Management Services (FDM) or Environment & Parks Services (EPS)
    - due to the 2018 organizational adjustments, EPS is being added to the policy
- Capital Project Overhead Revenue Budget
  - current: the corresponding revenue in the operating budget will be assigned to the implementation division
  - **proposed:** the corresponding revenue in the operating budget will be assigned to Corporate Transactions with any annual surplus being allocated 100% to the Capital Infrastructure Reinvestment Reserve Fund (CIRRF) at year-end

**Rational for Recommended Changes:**

During the 2019 capital budget deliberation process, Council requested staff look at the current capital overhead policy and the applicable overhead rates for small projects (< \$1,500,000) and large projects (> \$1,500,000). This review had already been initiated by staff and the report CORP2019-025 recommendations are being brought forward in advance of the 2020-2022 capital budget development.

**Part 1: Review Framework / Objectives:**

The first step in the review was to set a review framework and objectives. To what extent should capital projects pay 'capital overhead' to reimburse the tax base operating budget for a portion of project management staff support? What are we presently doing? What are other local municipalities doing? What are staff recommendations for the 2020-2022 budget?

**Part 2: Definition and Current Policy:**

What is Capital Overhead (COH)? A fee applied via a percentage to reimburse the operating budget for internal resource support. Costs include and not limited to: staff related expenses to manage projects, process & release of payments, design etc...

Currently overhead is being applied at a rate of 6% for small projects (< \$1,500,000) and 3% for large projects (> \$1,500,000).

Are these rates recovering the correct amount of funds to reimburse the operating budget? Are large and small projects a true reflection of the effort required to manage projects? What administrative challenges do different rates present? Are there opportunities for improvement as part of the 2020-2022 budget process?

Prior to 2015, the city had various overhead rates based on the type of service being provided. Staff found this practice difficult to administer, there was confusion around which overhead % to apply and the policy wasn't being applied consistently. As such on August 10, 2015 the policy was revised to the current 6% for small projects (< \$1,500,000) and 3% for large projects (> \$1,500,000).

Table 2: Previous Overhead Rates:

Service Offered	Overhead Rate
<b>Total Service</b>	
Surveying	
Inspection	15%
Engineering Design	
Contract Administration	
<b>Design by Consultant</b>	
Inspection	9%
Contract Administration	
<b>Inspection &amp; Surveying</b>	5%
<b>Review of Reports</b>	
Sub-Watersheds	4%
Engineering Drawings	
Contracts	
<b>Inspection or Surveying</b>	3%
<b>General Administration</b>	
Processing or releasing pre-approved payments	3%
Viewing video tapes	
Preliminary evaluation	
<b>Administration Only</b>	2%

Part 3: Internal Resource Support Required:

Prior to determine the amount of overhead revenue required to reimburse the operating budget annually, we needed to determine the amount of internal resource support provided to capital. A review of staffing in Engineering Services, Facilities & Design Management and Environment & Parks Services was undertaken. An estimated percentage of time spent on capital projects was developed for each applicable position. For example project managers would attribute 100% of their time to capital projects, managers would attribute 50% of their time to capital projects and technologists would attribute 25% of their time to capital projects.

Using the above estimated percentages the estimated project management cost to be recovered are approximately \$1.4 million. This amount was based on best estimated percentages for staff directly responsible for managing the large majority of capital projects. A more comprehensive review could expand or decrease which staff should be included in the recovery calculation and to what extent they are to be recovered. However with the 2020-2022 capital budget development being under taken in the spring and summer of 2019, the capital overhead percentage(s) to be applied to applicable projects need to be known by staff at the development stage as any changes will have implications to capital project sheets, capital envelopes and require significant re-work later.

#### Part 4: Local Comparisons:

To assist in the review, staff consulted with local municipalities to learn more about their capital overhead recovery practices. The findings will be highlighted below, however in general our process is in-line with many of the local municipalities and overall varying approaches are being applied.

##### Region of Waterloo

- fully recovers the Design and Construction (D&C) team costs through capital
- the staff costs/recovery percentage applied is 3%

##### City of Kitchener

- recovery level varies by division
- some Engineering positions are recovered 100% from capital, while others like Facilities Management only recover a portion (10%) from capital projects

##### City of Cambridge

- currently only fully recovers contract positions through capital
- various positions like surveyors/inspectors recover a portion of their time from capital (approx. 40%)

##### City of Guelph

- recovers some positions through capital
- currently undertaking a review of capital overhead ensuring appropriate operating budget recovery from capital

#### Part 5: Capital Overhead Options:

Using the estimated percentages the estimated project management cost to be recovered are approximately \$1.4 million, staff used this figure to model a few overhead scenarios using the 2019 approved budget and 2020-2028 capital forecast.

##### Option #1 – Current Overhead Rates

- using the current overhead rates of 6% for small projects (< \$1,500,000) and 3% for large projects (> \$1,500,000) capital overhead revenue projected is:
  - \$1.5 million on average over the 10 year period
  - \$0.99 million low point in 2022
  - \$2.8 million high point in 2020
  - *\*based on current capital budget figures, subject to change based on when funding is actually released*

## Option #2 – Alternative Overhead Rate 3%

- using an alternative approach, staff modeled a flat overhead rate of 3% for all applicable projects. Under this option capital overhead revenue projected is:
  - \$1.46 million on average over the 10 year period
  - \$0.95 million low point in 2022
  - \$2.7 million high point in 2020
  - *\*based on current capital budget figures, subject to change based on when funding is actually released*

## Option #3 – Alternative Overhead Rate 4%

- using an alternative approach, staff modeled a flat overhead rate of 4% for all applicable projects. Under this option capital overhead revenue projected is:
  - \$1.65 million on average over the 10 year period
  - \$0.98 million low point in 2022
  - \$3.3 million high point in 2020
  - *\*based on current capital budget figures, subject to change based on when funding is actually released*

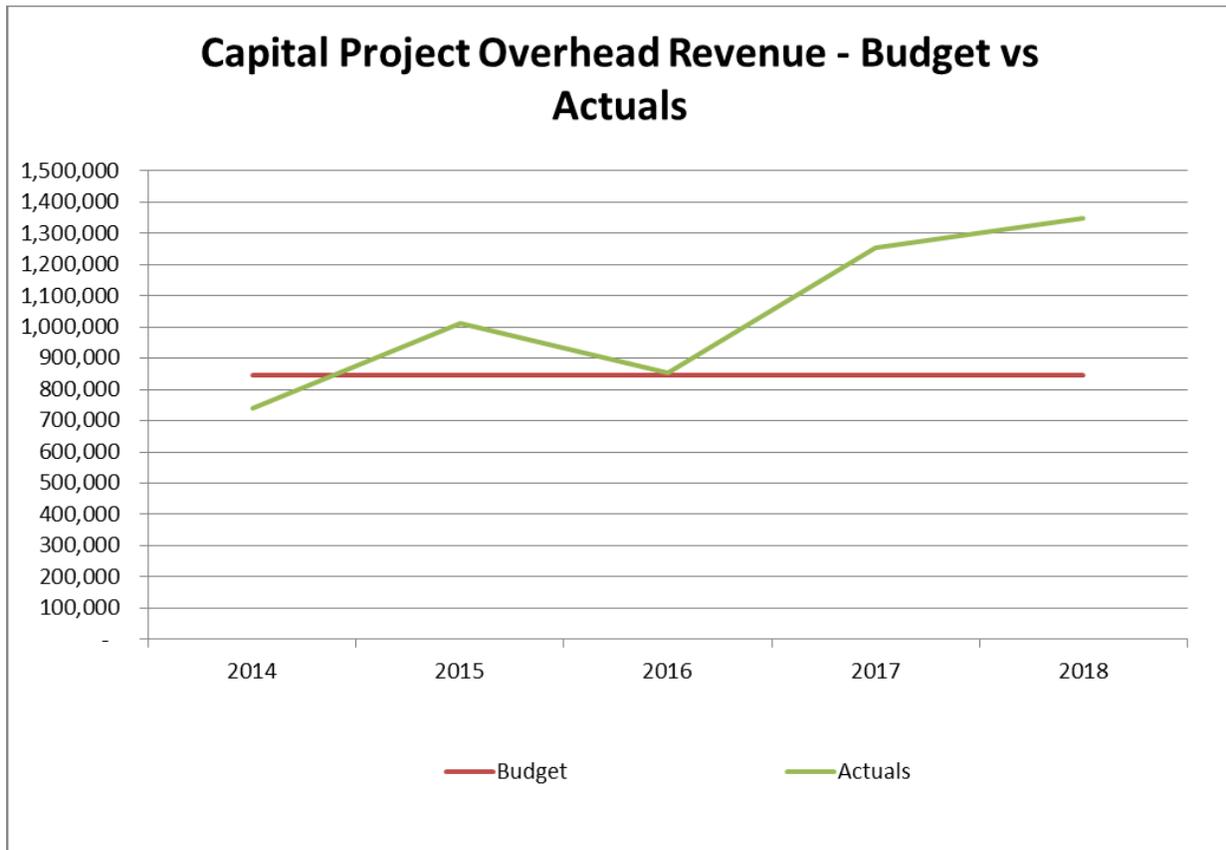
Part 6: Capital Overhead Budget vs. Historical Actuals:

In addition to reviewing the current overhead rates ensuring the appropriate amount of internal operating budget recovery is occurring, staff also took this opportunity to review the Capital Project Overhead Revenue budget vs. historical actuals. This revenue item has historically been a surplus driver. As such, an opportunity for a revenue ‘true-up’ exists as part of the 2020-2022 operating budget.

Table 3: Capital Project Overhead Revenue - Budget vs. 2014-2018 Actuals:

Capital Project Overhead Revenue	2014	2015	2016	2017	2018	5 Yr Avg
Budget	845,942	845,942	845,942	845,942	845,942	845,942
Actuals	738,902	1,012,110	852,951	1,255,153	1,346,990	1,041,221
(Surplus)/Deficit	107,040	(166,168)	(7,009)	(409,211)	(501,048)	(195,279)

Chart 1: Capital Project Overhead Revenue - Budget vs. 2014-2018 Actuals:

Part 7: Review Findings:

After review of our current capital overhead recovery process and a review of local comparators, it has been determined that our current practice of charging capital projects a capital overhead fee to reimburse the operating budget for the use of resources is appropriate and required. Operating and tax base capital funding dollars originate from the same source; the tax payer; as such the capital overhead allocation is not intended to support either operating or capital more favorably but rather an exercise to ensure we are reflecting the true cost of both operating and capital.

Ensuring we have set the capital overhead recovery at the appropriate rate / level is equally important in the context of non-tax base capital funding (Enterprises or Development Charges). Projects funded by Enterprises such as City Utilities or Development Charges also use internal project support. These capital projects and non-tax base funding sources also need to pay an appropriate capital overhead fee ensuring they are also reimbursing the operating budget for the effort project managers; managers etc... spend on those capital projects. Without an appropriate capital project overhead fee, these non-tax base areas wouldn't provide the necessary reimbursement to the operating tax base.

Table 4: Summary of Capital Expenditures by Funding Sources:

Summary of Capital Expenditures by Funding Sources				
FUNDING SOURCE	2019 (\$)	2019 (%)	2020-2028 (\$)	2020-2028 (%)
City Reserve Funds (Tax Base)	28,595,016	27%	209,125,835	38%
Development Charges Reserve Funds	36,267,377	34%	141,970,934	26%
Business Enterprises	16,331,896	16%	127,003,121	23%
Other/Grants/Debt	24,133,240	23%	71,473,792	13%
<b>Total</b>	<b>105,327,528</b>	<b>100%</b>	<b>549,573,681</b>	<b>100%</b>

Part 8: Recommendations:

After consideration of the options, staff are recommending that the flat 4% overhead for all applicable project option be used moving forward. In comparison to the current 3% and 6% options, this option is easier to administer and provides greater consistency. Alternatively the flat 4% overhead option in comparison to the flat 3% option is a better representation of the staff time spent managing capital projects and ensures the appropriate level of capital overhead is recovered annually from all capital sources.

As such, it's recommended;

- That Council approve the Financial Control Budget Policy updates contained in Appendix B: FC-018 Capital Overhead Policy;
- That Council approve the year-end allocation of any annual Capital Project Overhead Revenue (Acct #610101) surplus, 100% to the Capital Infrastructure Reinvestment Reserve Fund (CIRRF);
  - *this year-end surplus allocation recommendation is being brought forward to account for the increases and decreases in capital project overhead revenue across the 2019 approved capital budget and 2020-2028 capital forecast.*
  - *under each of the overhead options, the annual amount of capital project overhead revenue recovery will vary based on the amount of eligible capital projects budgeted and ultimately funded.*
  - *to avoid implementing fluctuations in the base operating budget for capital project overhead recovery, staff are recommending instead that any surpluses generated by the Capital Project Overhead Revenue (Acct #610101) be allocated 100% to the Capital Infrastructure Reinvestment Reserve Fund (CIRRF).*
  - *this will direct any surpluses back to capital, assisting with the city's existing infrastructure pressures*
  - *also to allow for ease of tracking the capital project overhead revenue, it is recommended that the existing capital overhead recovery budgets be transferred from the implementation divisional budgets to Corporate Transactions*

- That Council direct staff to review the Capital Project Overhead Rates (%) in advance of each three-year budget cycle, with the next review occurring before the 2024-2026 budget.
  - *while the recommendations in this report and policy changes will provide the necessary capital overhead recovery on an annual basis ensuring the operating budget is appropriately reimbursed, will be easier to administer compared to the current method of having different rates for different projects and captures applicable projects that were no longer being covered via the policy due to recent organizational adjustments, staff are aware that the appropriate level of capital project overhead support required is likely to change over time.*
  - *to account for future changes, staff are recommending that the capital overhead policy and applicable rates (%) be reviewed in advance of each three year budget cycle*
  - *the next review would occur before the 2024-2026 budget*

**Appendix A: FC-012 Capital Budget Policy**

# CORPORATE POLICY



Policy Title: **Capital Budget**  
Policy Category: **Financial Control**  
Policy No.: FC-012  
Department: Corporate Services  
Approval Date: Feb. 17, 2007  
Revision Date: ~~Jan. 21,~~  
~~2019~~ May 13, 2019  
-Author: Julie Koppeser  
Attachments:  
Related Documents/Legislation:

Key Word(s): Budget, Capital

## **POLICY STATEMENT:**

The Council for the City of Waterloo is committed to demonstrating financial leadership and sustainability. This policy assists in formalizing a defined and transparent process for the development and funding of capital projects.

## **PURPOSE:**

The purpose of this policy is to govern the items that will assist in creating the capital budget.

## **DEFINITIONS:**

### **Capital Project:**

A capital project is an item identified and funded through the Council Approved Capital Budget or an item funded through the Financial Requests Outside the Budget Process.

### **Overhead:**

A fee applied via a percentage to reimburse the operating budget for internal resource support. Costs include but are not limited to: staff related expenses to manage projects, process & release of payments, design etc...

### **Internal Resource Support:**

Internal Resource Support can include but is not limited to: design services, project management, contract administration, and review of reports.

## **Mandatory Policy, *Municipal Act*: No**

Policy Administration Team, Review Date: November 6, 2018 April 12, 2019

Corporate Management Team, Review Date: November 14, 2018 April 24, 2019

**SCOPE:**

This policy applies to all members of the City's organization including members of Council, full, part-time and contract staff.

**POLICY COMMUNICATION:**

Council will receive this policy for approval. If approved, the policy will be posted on the city's intranet. Staff will be advised of the policy via distribution to the Operational Leadership Team and Corporate Management Team.

**POLICY:**

1. That projects appearing in the Capital Budget adhere to the minimum balance threshold identified in the Council approved policy, Definition of Capital (FC-010).
2. Projects will be reviewed and use the criteria below to assist in the decision making of identifying which projects would be automatically funded post Budget Approval (Routine projects) and which projects would need to return to Council with a report before funding is released (Non-Routine projects):
  - a. **Financial Materiality**
    - i. Projects receiving funding greater than \$2.5M over the 1 year period (one year budget approval)
    - ii. Projects receiving funding greater than \$5M over the 3 year period (multiple year budget approval)
  - b. **High Public/Council Interest**
  - c. **Request by Council**
3. That all reserve funds financing capital expenditures must, at a minimum, have a positive balance, with the exception of Development Charges reserve funds which are permitted to carry a negative balance to be recouped over the course of Background Study projection.
4. That all expenditures ~~in~~within the current capital budget ~~funded through the Capital Reserve Fund or Capital Infrastructure Reinvestment Reserve Fund~~ be inflated according to the five year rolling average third quarter, Toronto construction price index ~~and~~ updated with each budget process and that expenditures within the capital budget forecast be inflated by 2%.
5. That reserves and reserve funds that provide funding for the capital budget will receive annual transfer allocations as approved within the base Operating Budget or as approved by Council.
6. All proposed capital expenditures accessing Industrial Land Account (ILA) funding are subject to a staff report request to Council and Council approval, prior to commencement of the project, unless approved as Routine.
7. For Capital Project Overhead charges related to projects, refer to the Capital Overhead policy (FC-018).

**COMPLIANCE:**

In cases of policy violation, the City may investigate and determine appropriate corrective action.

**Appendix B: FC-018 Capital Overhead Policy**

# CORPORATE POLICY



Policy Title: **Capital Overhead**  
Policy Category: **Financial Control**  
Policy No.: FC-018  
Department: Corporate Services  
Approval Date: February 17, 2007  
Revision Date: ~~January 21,~~  
2019May 13, 2019  
-Author: Brad Witzel  
Attachments:  
Related Documents/Legislation:

Key Word(s): Budget, Capital

## **POLICY STATEMENT:**

The Council for the City of Waterloo is committed to demonstrating financial leadership and sustainability. This policy assists in formalizing a defined and transparent process for capital projects.

## **PURPOSE:**

The purpose of this policy is to define overhead, the corresponding overhead rate charged to capital projects and where the overhead will be recovered in the operating budget.

## **DEFINITIONS:**

### **Overhead:**

A fee applied via a percentage to reimburse the operating budget for internal resource support. Costs include and not limited to: staff related expenses to manage projects, process & release of payments, design etc...

### **Service Delivery Division:**

Division that identifies the need and subsequently budgets a capital project.

### **Project Implementation Division:**

Division that implements and manages the capital projects on behalf of other divisions.

### **Grant:**

A gift in monetary or in kind terms by another government, agency or organization for specified purposes which are usually defined by specified qualification of terms.

## **Mandatory Policy, *Municipal Act*: No**

Policy Administration Team, Review Date: ~~November 6, 2018~~April 12, 2019

Corporate Management Team, Review Date: ~~November 14, 2018~~April 24, 2019

**SCOPE:**

This policy applies to all members of the City's organization including members of Council, full, part-time and contract staff.

**POLICY COMMUNICATION:**

Council will receive this policy for approval. If approved, the policy will be posted on the city's intranet. Staff will be advised of the policy via distribution to the Operational Leadership Team and Corporate Management Team.

**POLICY:**

**~~Projects Equal to or less than \$1,500,000~~**

~~That capital projects with a Project Implementation Division from Integrated Planning and Public Works (IPPW) or Facility Design Management Services (FDM) will have a 6% overhead fee charged to them.~~

**Projects ~~Greater than \$1,500,000~~**

That capital projects with a Project Implementation Division from Integrated Planning and Public Works (IPPW), ~~or~~ Facility Design Management Services (FDM) or Environment & Parks Services (EPS) will have a 34% overhead fee charged to them.

**Grant Funding**

Overhead will not be charged on grant funding where overhead is considered an ineligible expense. Examples include however are not limited to Federal Gas Tax Fund, Ontario Community Infrastructure Fund.

**Overhead Fees**

Overhead fees will be charged when the project is approved and the funding is released. The corresponding revenue in the operating budget will be assigned to Corporate Transaction~~the implementation division~~. Any annual Capital Project Overhead Revenue (Acct #610101) surplus will be allocated 100% to the Capital Infrastructure Reinvestment Reserve Fund (CIRRF) at year-end.

**COMPLIANCE:**

In cases of policy violation, the City may investigate and determine appropriate corrective action.