Evaluation of Financial Projections

Application to Amalgamate the Municipality of the County of Pictou, the Town of Pictou, the Town of New Glasgow, and the Town of Stellarton

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February 19, 2016

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Ms. Elaine Wagner
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Ms. Wagner:

On behalf of Levy Casey Carter MacLean Chartered Accountants, please accept our evaluation of the financial projections on the possible amalgamation of the Municipality of the County of Pictou and the Towns of New Glasgow, Pictou and Stellarton; Case M07050.

Yours truly,

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Glossary

Board	Nova Scotia Utility and Review Board
County	Municipality of the County of Pictou
New Glasgow	Town of New Glasgow
Pictou	Town of Pictou
Stellarton	Town of Stellarton
Applicants	Participants in the amalgamation application
Province	Province of Nova Scotia
NM	Proposed New Municipality
Raymond Chabot Grant Thornton	RCGT

Executive Summary

Our firm has been engaged by the Nova Scotia Utility and Review Board to evaluate and report on the financial projections filed as evidence in the voluntary application to amalgamate the Towns of Pictou, Stellarton and New Glasgow and the Municipality of the County of Pictou.

Projections, by their very nature, are prepared using estimates and predictions so are subject to uncertainty. In this regard we have reviewed the financial projections to evaluate their overall strengths and weaknesses and evaluated the reasonableness of assumptions used in their preparation.

Based on our analysis the Applicants appear to have prepared the projections appropriately and used educated and reasonable assumptions. While actual results of the proposed municipality would differ from these projections due to the inherent limitations of using estimates and predicting results, we find the projections are a reasonable portrayal of what the financial situation of the NM could be if the Applicants were to amalgamate.

We have also evaluated whether the projections indicate the Applicants are viable in the short term under the status quo and whether they would be viable under an amalgamated new municipality. Barring any unforeseen unrecorded liabilities, the projections indicate the amalgamated municipality would be viable in the short term and, primarily due to funding provided by the Province, it would be in a better financial position than the status quo.

If the Applicants were to amalgamate they would realize benefits including economies of scale of a larger combined municipality, a projected increase in infrastructure expenditures, and additional funding available through the letter of intent with the Province of Nova Scotia. As such, from a financial perspective, the residents of the Applicants would appear to be best served if the application to amalgamate were approved by the Board.

Introduction

On August 27, 2015 the Towns of Pictou, Stellarton, and New Glasgow as well as the Municipality of the County of Pictou filed a conditional application with the Nova Scotia Utility and Review Board to voluntarily amalgamate into a single municipal unit. We have been engaged by the Board to provide consulting services to the Board's counsel and staff regarding evidence submitted during the application process. Our primary engagement is to provide analysis and assess the financial projections filed by the parties.

In conducting our financial analysis, we have reviewed all related documents and exhibits posted to case M07050 on the Board's website with the following objectives:

- Analyze and assess the financial projections filed by the parties;
- Evaluate and critique the assumptions made by the parties in preparing their projections;
- Outline the relative strengths and weaknesses of the respective projections filed by the parties;
- Evaluate the financial viability of the proposed new municipality after amalgamation, as compared to the status quo.

To achieve these objectives, we have paid particular attention to the following documents which are posted on the Board's website under case M07050:

- Exhibit P-1 – Application
- Exhibit P-2 – Grant Thornton Governance Report
- Exhibits P-5 to P-8 – Consolidated Financial Statements of the Applicants
- Exhibit P-20 – Human Resources Report by Raymond Chabot Grant Thornton
- Exhibit P-28 – Letter of Intent with the Province of Nova Scotia
- Exhibits P-32 to P-36 – Projections of Status Quo and New Municipality

In addition to evidence filed with the Board for this application, we have also considered the following external documents:

- Nova Scotia Municipal Government Act
- Nova Scotia Financial Reporting and Accounting Manual

Other than the external documents listed above we have limited our analysis to evidence filed with the Board in relation to this amalgamation application.

Analysis and Assessment of Financial Projections

When considering our analysis of the projections we selected a number of indicators that we felt are important when evaluating the viability of the projected entity. They include but are not limited to:

1. Whether there is a surplus or deficit and how the tax rates are affected.
2. If transfers are being made to reserve funds.
3. If infrastructure expenditures are occurring and how they are being financed.

We have provided commentary throughout our report on each of these considerations in our analysis.

Status Quo Projections

Tax revenues in the status quo projections are calculated in such a way that there will be sufficient funds to cover estimated expenditures, the financing of long term borrowings and transfers to reserves. This is a different approach than how tax revenues were calculated in previous dissolution applications. In those applications, tax rates were assumed to remain the same as were currently set by the Applicants and, in combination with other assumptions used, there would either be a surplus or a deficit. In this case, rather than having a static tax rate for all five projected years, the tax rates fluctuate from year to year to accomplish a nil surplus after the financing of long term borrowings and transfers to reserves.

As explained in detail starting on page 19 of Exhibit P-29, this is how municipal councils determine what tax rates to set at the beginning of each fiscal year. While this methodology is used by municipal councils to help determine tax rates, it is unlikely that they would make significant changes to the tax rates each year. With the projections being prepared using fluctuating tax rates, it is difficult to compare the status quo projections to the NM projections as tax revenues differ across the models.

Therefore, to analyze the status quo projections, we have reviewed the tax rates presented throughout the projection period. To accomplish this, we have included Table A, which is a summary of information on the "Taxes" tab in Exhibits P-33 to P-36.

Table A
Projected Status Quo Property Tax Rates
(Per $100 Assessed Value)

	2015/16	2016/17	2017/18	2018/19	2019/20
Residential					
Pictou	1.63	1.66	1.67	1.63	1.64
New Glasgow	1.82	1.81	1.81	1.82	1.84
Stellarton	1.82	1.82	1.82	1.82	1.82
County	0.81	0.81	0.82	0.82	0.81
Commercial					
Pictou	4.33	4.42	4.45	4.34	4.35
New Glasgow	4.39	4.36	4.38	4.40	4.45
Stellarton	4.15	4.15	4.16	4.16	4.15
County	1.82	1.82	1.84	1.86	1.82

As can be seen from Table A, other than the Town of Pictou, the status quo projections indicate fairly static property tax rates for the Applicants. With this said, it is unlikely that the Applicants would change the tax rates each year as projected above, especially when in some cases they fluctuate up and down more than once.

The largest fluctuation relates to the Town of Pictou's tax rates. Its residential rate decreases by $0.04 per $100 assessed value from year three to year four. This primarily relates to reducing transfers to the fire reserve in year four and because year three had a large balloon payment made to eliminate the Hector debt.

Since tax revenues have been calculated to ensure all estimated transfers are made, one would assume that the transfers made are sufficient. To determine whether this is the case, we have selected a number of commonly used municipal indicators that are used by the Government of Nova Scotia when evaluating municipal units across the Province. We have summarized these municipal indicators for the projected 2020 fiscal year in Table B, below.

Table B
Comparison of Municipal Indicators - 2019/20

	Operating Reserves	Debt Service Ratio	Five Year Capital Purchases	Five Year Contributions to Capital Reserve
Pictou	1.8%	9.2%	131.5%	5.3%
New Glasgow	3.4%	8.9%	68.7%	0.0%
Stellarton	16.7%	9.9%	109.8%	9.6%
County	49.5%	1.5%	141.6%	0.0%
New Municipality	13.6%	5.6%	162.1%	5.7%
Recommended	> 10%	< 15%	> 100%	> 10%

The operating reserve is a fund that is built up in years with an excess surplus so that the municipal unit can continue operating efficiently in years with a deficit. The Operating Reserves Percentage indicator recommends that operating reserve be greater than 10% of one year's operating expenditures.

The summary in Table B shows that the operating reserves of both Stellarton and the County are sufficient whereas the operating reserves for Pictou and New Glasgow are not, and are in fact much lower than the recommendation of 10%. This indicates that if those Towns were to experience a year with a deficit they may be in financial distress and could have difficulty paying its liabilities. The amalgamated municipality, on the other hand, will have a sufficient operating reserve by the end of the five year projection period.

The Debt Service Ratio is meant to evaluate how much of a municipal unit's revenue is being used to finance debt, with a recommendation that it be below 15%. All of the projections have a ratio of less than 15% which indicates they would be able to obtain additional long term financing for the purpose of infrastructure repairs and upgrades.

The Five Year Capital Purchases Percentage is meant to indicate whether a municipality is investing in its infrastructure faster than their current assets are aging. A recommendation of greater than 100% is recommended, which ensures that more funds are spent to maintain and construct capital assets then those assets are deteriorating. Other than New Glasgow, the status quo projections are all over 100% which indicates they are at a minimum maintaining their current level of infrastructure. The NM projections five year capital purchases percentage is significantly better than the status quo projections because it incorporates significant additional infrastructure over and above the status quo projections.

A capital reserve is meant for the purpose of saving for future capital expenditures. Transfers to this fund mean a municipal unit is planning for its future. In the case of all projections, including the NM projections, there are insufficient transfers being made to the capital reserve. While this may be reasonable in the case of the NM projections due to the substantial infrastructure upgrades it makes throughout the five year projection period, it is a negative aspect for all projections.

New Municipality Projections

Throughout our analysis we refer to differences between what is presented in the status quo projections and what is presented in the NM projections. When we compare the status quo projections to the NM projections, we are referring to the combination of all four status quo projections.

Tax Revenues and Surplus

Similar to the status quo projections, rather than use static tax rates for all years in the projection period the NM projections have adjusted tax revenues to whatever amount they need to be to meet all expenditures, payments on long term borrowings and transfers to reserve funds, less revenues from other sources.

There have been numerous adjustments made to the amalgamated projections to reflect the benefits and disadvantages of amalgamation, which are shown in the Supplemental to Schedule F, G, H found on the last page of Exhibit P-29. These include the availability of funding from the

Province of Nova Scotia through the letter of intent signed between them and the Applicants. As a result of this funding, and due to how tax revenues are calculated, the NM has lower tax revenues than the combined tax revenues of the status quo projections. This suggests that the NM would either be able to slightly decrease tax rates, spend more on infrastructure or be able to transfer more to reserves.

It is difficult to determine the exact impact this would have on tax rates because, as seen in Table A in our status quo analysis, the Applicants currently all have different tax rates. In addition to this, the voluntary application was made on the conditions that there would be no material change in tax rates and that current service levels would be maintained. Finally, it would be up to the council of the NM to set tax rates and determine how any excess surplus would be treated.

Infrastructure Spending and Long-Term Borrowings

Similar to tax revenues; infrastructure spending and long-term borrowings are different from the amounts listed in the status quo projections. To show how infrastructure spending has increased in the amalgamated municipality, we have provided Table C, below.

Table C
Infrastructure Spending - Status Quo Projections vs NM Projections

	2015/16	2016/17	2017/18	2018/19	2019/20	Total
Pictou	$ 1,408,298	$ 4,577,451	$ 320,000	$ 305,000	$ 445,000	$ 7,055,749
New Glasgow	2,196,900	955,000	1,195,000	1,040,000	1,090,000	6,476,900
Stellarton	1,535,003	2,058,959	1,138,653	998,500	1,735,000	7,466,115
County	3,444,108	3,610,000	3,610,000	480,000	180,000	11,324,108
	8,584,309	11,201,410	6,263,653	2,823,500	3,450,000	32,322,872
NM projections	16,062,755	19,481,093	10,250,790	6,662,290	6,307,290	58,764,218
Increase	$ 7,478,446	$ 8,279,683	$ 3,987,137	$ 3,838,790	$ 2,857,290	$ 26,441,346

The NM projections have included additional infrastructure spending in excess of what was spent in the status quo projections because of the availability of the letter of intent funding and the economies of scale expected on amalgamation. We show how these additional infrastructure upgrades are expected to be financed in Table D by comparing the differences in the status quo projections with those in the NM projections.

Table D
Infrastructure Spending - Sources of Financing

	2015/16	2016/17	2017/18	2018/19	2019/20	Total
Additional borrowings	$ 2,357,607	$ 1,531,670	-$ 322,928	$ 416,673	-$ 304,327	$ 3,678,695
Operations	(103,628)	(3,850)	(89,000)	(54,000)	31,000	(219,478)
Gas tax funds	(147,462)	988,400	858,950	963,950	1,203,950	3,867,788
Capital reserve	752,766	1,462,562	950,677	109,646	255,934	3,531,585
Building Canada Fund	831,065	183,061	744,398	1,423,500	773,333	3,955,357
Other	3,788,098	4,117,840	1,845,040	979,021	897,400	11,627,399
	$ 7,478,446	$ 8,279,683	$ 3,987,137	$ 3,838,790	$ 2,857,290	$ 26,441,346

Of the over $26 million in additional infrastructure spending that is included in the NM projection, only $3.7 million of additional long term borrowings are expected. Although this causes subsequent debt repayments of the NM to be higher than the status quo projections, the NM is still expected to maintain healthy outstanding debt and debt service ratios, as shown on page 18 of Exhibit P-29.

A caution is that if some of these funding sources, such as the Building Canada Fund, are not obtained there will either be a direct decrease in infrastructure spending or additional long-term borrowings that will have to be obtained.

Transfers to Reserve

Municipalities can have numerous reserves that are meant for different purposes. At a minimum, municipalities will typically have an operating reserve; which is meant to be drawn on in years when there is a deficit, and a capital reserve fund, which is meant to fund future infrastructure and other capital projects.

We would want to see transfers being made to reserve accounts because it indicates the town or municipality has an excess surplus that they can allocate to these reserves and it shows they are planning for the future. In the case of these projections, because of how the tax revenues are calculated, it appears that all transfers estimated by the Applicants are being made throughout the five year period.

With that being said, annual transfers to reserves decrease from over $1 million in year one to approximately $675,000 in year five. When viewing the projections, this reduction in transfers could initially cause concern but in this case may be reasonable. The NM projections anticipate significant infrastructure expenditures so it is reasonable that there would be a reduction in transfers to the capital reserve.

As far as the operating reserve, transfers have decreased to just $20,000 per year in years four and five. Once again, this may be reasonable if the operating reserves from the Applicants are considered sufficient. To help evaluate this, we have turned to the Province's municipal indicator for operating reserves. We have included Table E, which calculates the operating reserve percentage based on the formula provided on the Government of Nova Scotia's website.

Table E
Operating Reserve Percentage Calculation - NM Projections

	Year 1	Year 2	Year 3	Year 4	Year 5
Available Operating Reserves					
Pictou	$ 93,114	$ 93,114	$ 93,114	$ 93,114	$ 93,114
New Glasgow	613,676	613,676	613,676	613,676	613,676
Stellarton	1,198,265	1,198,265	1,198,265	1,198,265	1,198,265
County	3,239,648	3,239,648	3,239,648	3,239,648	3,239,648
NM transfers to operating reserve	220,066	166,998	166,998	20,000	20,000
NM accumulated surplus	$Nil	$Nil	$Nil	$Nil	$Nil
	$ 5,364,769	$ 5,311,701	$ 5,311,701	$ 5,164,703	$ 5,164,703
Operating Expenditures					
Operating expenditures	$ 49,421,424	$ 50,087,022	$ 50,657,723	$ 51,834,508	$ 53,021,457
Less: Education contribution	(7,446,285)	(7,722,454)	(8,009,498)	(8,307,861)	(8,618,006)
Less: Correctional services	(7,782,783)	(7,965,482)	(8,122,975)	(8,310,824)	(8,503,287)
Less: Regional housing deficits	(525,800)	(513,378)	(523,645)	(534,117)	(544,800)
Principal repayments on debt	1,640,612	1,852,752	2,088,120	1,950,614	2,057,261
Transfers to all reserves	1,003,834	987,949	718,863	831,506	676,000
	$ 36,311,002	$ 36,726,409	$ 36,808,588	$ 37,463,826	$ 38,088,625
Operating reserve percentage	14.8%	14.5%	14.4%	13.8%	13.6%

The table shows operating reserve percentages of between 13.6% and 14.8%, which is higher than the Province's recommended minimum operating reserve percentage of 10%. This indicates that the operating reserves of the NM will be sufficient and so decreased transfers to the operating reserve are reasonable and do not reflect a struggling municipality.

Letter of Intent Funding

One thing to note is that most of the letter of intent funding is only for the first five years of an amalgamated municipality so the projections look better than how they would look after the five year projection period. Since the majority of this funding, other than equalization funding, is meant to reimburse costs related to amalgamation or to increase infrastructure spending, the impact on the statement of operations in future years is likely minimal.

Conclusion on Projections

The NM projections appear to show a healthy and viable amalgamated municipality that would be able to maintain the current service levels that are provided to residents under the status quo. Due to the letter of intent funding, increased infrastructure expenditures, and added economies of scale on amalgamation, the projections indicate that, from a financial perspective, residents of the Applicants would be benefited by an amalgamated municipality.

Overall Strengths and Weaknesses of the Projections

We have analyzed the information included in the applicants Final Report found in Exhibit P-29 and, based on that information, the projections appear to be prepared with an appropriate level of due diligence. Projections by their very nature use estimates to predict future operations and thus actual results can and will deviate from the projections.

With that being said, there are still a number of considerations we would like to point out to the Board, which we discuss below.

Comparability of Projections

When preparing pro-forma financial statements there are two primary ways they can be prepared. The first is to prepare them to forecast, as accurately as possible, what the future operations of the entity would look like. The second, is to prepare the projections to reflect a proposed change so they can be easily compared to another set of financial projections.

The second option may be less representative of future operations but it is easier to pinpoint the effect the proposed change has on the projections. The decision on how to prepare the projections should be based on which of the two questions the projections are trying to answer:

1. To determine whether the proposed NM would be viable if amalgamation occurs, or
2. To evaluate the advantages or disadvantages of the NM when compared to the status quo

To accomplish the first goal, the projections should be prepared to most accurately represent the expected future operations of the NM. To accomplish the second goal, the status quo and NM projections should be prepared as consistently as possible, with only significant changes between the projections being included.

In this case, the projections have been prepared to answer the first question. While this is appropriate when considering the viability of the municipality, it can be difficult to pinpoint whether the NM projections are better than the status quo projections.

For the majority of assumptions used in these projections, such as with the tax revenues and infrastructure costs, the projections were prepared with a focus of the first goal, to give a realistic picture of the future operations of the NM. In other instances, such as for the time period selected, the projections have been prepared to meet the second goal of having the status quo and NM projections be as comparable as possible. We explain these differences in greater detail below.

Tax Revenues

Tax revenues appear to be calculated to best represent the financial operations of the NM if amalgamation were to occur. Rather than maintain the same tax rates that are in effect with the status quo projections, the NM projections have altered tax revenues to what the NM would need to operate. While this may be what the NM council would do, it makes it difficult to compare the NM projections to the status quo projections other than to note that a decrease in tax revenues would indicate a decrease in the tax rates in the NM.

As explained in great detail starting on page 19 of the Applicants Final Report in Exhibit P-29, tax rates are set at the beginning of the year to cover budgeted expenditures, payments on long-term borrowings, and reserve transfers for the upcoming year. While this, once again, is likely to more accurately represent the future financials of the NM, it makes it difficult to compare the NM projections to the status quo projections without additional analysis on the tax rates.

Although it may be difficult to compare the status quo projections with the NM projections, it is clear that tax revenues of the NM are lower than tax revenues of the status quo projections. What this implies is that, if the costs and transfers in the NM projections are accurate, the tax rates of an amalgamated entity can either decrease tax rates, increase infrastructure spending, or increase transfers to reserves. As it would be up to the council of the proposed NM to determine tax rates it is difficult to determine what this impact would be.

Since this amalgamation application has been made on a conditional basis, with one of the conditions being there be no material change in the tax rates, we can only conclude that the NM would not cause a significant change in tax rates.

Infrastructure Costs

The status quo projections have included the cost of infrastructure upgrades based on the five year capital investment plans set by the Applicants whereas the NM projections have included costs over and above these based on estimates of the NM preparer. While increased infrastructure spending may realistically be what the NM council would consider, it makes it difficult to compare the NM projections to the status quo.

The result of having differing infrastructure costs in the status quo vs NM projections is that the benefit of economics of scale on amalgamation and the letter of intent funding is not as clear because there is an increase in debt financing and amortization as a result of additional infrastructure costs.

We feel the projections would have been better served if infrastructure costs were consistently presented across the status quo and NM projections. Although their exclusion may mean the projections are less representative of expected future operations of the NM, it would have enabled users of the projections to better appreciate the impact that amalgamation would have on the financial results. The fact that additional infrastructure upgrades could be done in the NM would be seen through an increased surplus and through improved municipal indicators.

Time Period of Projections

When comparing projections it is important that the timing of all projections be for the same period because comparing projections with differing years would be of limited value. To this end, the status quo projections have been prepared using the fiscal 2016 budget as the base year and projecting years 2017 to 2020. For consistency and comparability, the NM projections use this same time period even though, per information request 14 in Exhibit P-11, the proposed amalgamation date is not until November 1, 2016.

This causes a few issues when evaluating the NM projections. The first is that year one of the projections is based on the 2016 budget numbers but the proposed amalgamation date means the first fiscal year of the NM would be fiscal 2017. This means that a year of inflationary increases have not been factored into the projections.

The second issue is that the NM projections are prepared using a full year but, based on the proposed amalgamation date, the first year of operations would only be for the six month period ending March 31, 2017. Preparing the projections in this manner mean they are much more comparable to the status quo projections but, due to timing, would not accurately reflect the operations of the NM if the application is approved.

And finally, the timing of these projections does not align with the letter of intent funding. For example, the majority of funding from the Province is to commence in fiscal 2018, but once again the first year of operations of the NM would be for the six month period ending in fiscal 2017.

Another example of issues with the timing of the projections relates to infrastructure costs. There are infrastructure costs included in year one of the status quo projections, which are also included in year one of the NM projections. The issue with this is that year one in the status quo projections is for fiscal 2016, which will be over before the proposed amalgamation will even occur. This means that infrastructure costs that are included in the NM projections could have already been completed prior to the proposed amalgamation.

With this said, these projections are still relevant to the Board when making its decision because this is just a timing difference and in most other respects the projections have been prepared reasonably.

Letter of Intent Adjustments

As seen in previous municipal amalgamation applications, the Province has agreed to provide funding to the Applicants as an incentive for amalgamation to occur. These incentives have been listed in the letter of intent signed between the Province and the Applicants, found in Exhibit P-28, which we have summarized in Table F, below.

Table F
Breakdown of the Letter of Intent Funding (Excluding Water Utility)

	Pre-2018	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	Total
Operating Funding								
Equalization	$ -	$ 2,372,240	$ 2,372,240	$ 2,372,240	$ 2,372,240	$ 2,372,240	$ -	$ 11,861,200
Roads	-	241,200	241,200	241,200	241,200	241,200	-	1,206,000
Post-transitional	-	300,000	300,000	300,000	300,000	300,000	-	1,500,000
Pre-transitional	700,000	-	-	-	-	-	-	700,000
Capital Funding								
Roads	-	-	897,400	897,400	897,400	897,400	897,400	4,487,000
Special capital	-	896,800	896,800	896,800	896,800	896,800	-	4,484,000
	$ 700,000	$ 3,810,240	$ 4,707,640	$ 4,707,640	$ 4,707,640	$ 4,707,640	$ 897,400	$ 24,238,200

The projections have included some of these funds differently than as laid out in the letter of intent. For example, the letter of intent states that the Province will pay up to $300,000 annually for each of the five projected years for a maximum of $1.5 million in funding for post-amalgamation costs. The NM projections have included this entire $1.5 million of funding in the first two years of the projections, with $816,188 included in year one and $683,812 included in year two. As the letter of intent states that this funding would only be received in maximum annual installments of $300,000, this causes a timing difference in the projections.

This issue is mitigated because the funding is only meant to offset actual post-amalgamation costs incurred. In other words, the intent of this funding is to reduce or eliminate the costs of amalgamation so that there is effectively no impact on the finances of the NM. However, since the majority of post-amalgamation costs would be incurred in the first two years of the proposed NM, there is a timing difference between when the costs are incurred and when the Province provides reimbursement funding for those costs. This results in the NM projections overstating funding in years one and two and understating funding in years three through five. Additionally, if the amalgamated municipality's post-amalgamation costs are in excess of $300,000 per year, the NM will have to carry the burden of those excess costs.

Further to this, the letter of intent offers $700,000 for pre-amalgamation expenses but the projections suggest funding would be in the amount of $750,000. Once again, this has a minimal impact since this funding is meant to offset actual costs so overall there should be a minimal impact on the proposed NM.

Payroll Estimates and Severance Costs

The Human Resources Report prepared by Raymond Chabot Grant Thornton in Exhibit P-20 has suggested that, if amalgamation were to occur, the NM could operate with 18 less employees than currently employed by the Applicants. Further to this, Frank Demont of Demont Law has stated the following on page 19 of his Human Resources Report in Exhibit P-31:

> *It is not within the purview of this report nor the responsibility of the author (or for that matter the Steering Committee, the UARB or the existing councils) to select the employees of the NM. Without knowing which of the 18 employees will remain with the NM, the ability to provide a specific severance cost is impossible.*

Whether or not any employees are laid off would be up to the municipal council of the proposed NM. As a result there can be no guarantee that either the severance costs or reduction in payroll costs factored into the NM projections would accurately represent the payroll and severance costs that the NM would realize. However, it is reasonable to believe that council of the proposed NM would base their decision on the Human Resources Report by RCGT so, as a result, the adjustments made in the NM projections can also be considered reasonable.

While Demont Law's Human Resource Report did emphasize the inability to determine actual severance costs, it did list four separate estimates ranging from $637,000 to $879,000 based on various methodologies. Demont Law goes further to suggest the Steering Committee should use the average of $757,750 rounded up to $800,000. The projections have included severance costs of $758,000.

NM Projections versus Combined Status Quo Projections

On the last page of Exhibit P-29, the Applicants have listed adjustments made to the NM projections to reflect changes that would occur on amalgamation, such as receipt of the letter of intent funding. However, even after taking these adjustments into account, it was very difficult to tie the combined status quo projections into the NM projections so we spent a great deal of time reconciling the status quo projections to the NM projections.

Our findings were that, other than a couple items mentioned below, all revenues and expenditures that were presented in the status quo projections were also included in the NM projections but were just presented differently. As examples, the status quo projections had the costs of education, police corrections and housing deficits netted against revenue whereas the NM projections broke these expenses out separately to show greater detail. Another example is that in some projections, payments to the Wellness Centre were treated as recreation and cultural services and in others they were treated as extraordinary or special items.

Overall, even though it was difficult to tie the combined status quo projections into the NM projections, all revenues and expenses in the status quo projections were accounted for in the NM projections, other than a nominal amount of additional interest that was recorded in the NM projections.

Reliability of Input Data

The very nature of projections means that historical information is used to analyze past trends to predict future operations. We have listed below some of the inherent weaknesses in using projections.

Historical Information

When preparing projections, the most recent financial results are typically used to estimate trends that could occur in the future. Even though historical information is usually an appropriate approach in predicting future trends, users should be cautioned that there may be significant differences between actual results and the projected results. In the case of the Applicants, their recent fiscal years have not been overly volatile so using historical trends seems appropriate.

Management Input

When compiling projections it is important that management not only consider historical data but also consider future expectations. An example in the NM projections is how management have incorporated the letter of intent funding. Although this funding was not received in the recent historical results, management has included this funding in the projections because they know it will be available if amalgamation occurs.

However, the use of management expectations also adds a level of risk. If assumptions made by management appear to be inconsistent or to contain a bias, the financial projections could differ significantly. In previous amalgamation applications the projections were prepared by an external independent accounting firm that could question management assumptions throughout the preparation of the projections. In this case the entire projections have been prepared internally by the Applicants and have not had the same level of scrutiny.

Budgeted Figures used for Base Data

Once trends are established they need to be applied to a base year to estimate future projections. Since the fiscal 2016 year had not yet concluded the fiscal 2016 budget was used as the base year. The fiscal 2016 budget would have been prepared during the fiscal 2015 year so actual results may significantly vary from the budgeted results. This means that all estimates and assumptions used in preparing the projections are calculated on a budget that is also prepared using estimates and assumptions. Since we do not have the information available to compare the fiscal 2016 budget to how the actual 2016 fiscal year is progressing, we are unable to determine whether the base year data used is appropriate.

Audited Financial Information

When financial information is audited there is a level of assurance that can be placed on that information. In this case, the 2016 budget is unaudited and the 2015 audited financial statements have not been provided.

Consistency and Accuracy of Assumptions

Throughout our analysis on these projections we have reviewed the assumptions used in both the status quo and amalgamated models. We have not found any major assumptions that deviated across models and the rational was clearly laid out for why certain assumptions were used. In instances where assumptions deviated from historical trends there were notes included with the support that explained why the assumption deviated from historical trends.

Overall, we feel this is one of the greatest strengths of these projections as it shows that effort and due diligence was used in their preparation. While we do point out a few assumptions in the next section of our analysis, we feel these projections are a reasonable approximation of what the NM could look like if the Board were to approve the application.

Exclusion of Environmental Liabilities

In previous amalgamation applications, an external engineering firm was retained to provide commentary on the state of infrastructure as well as any infrastructure upgrades required to meet Provincial requirements. In this case, the bulk of the comprehensive infrastructure review was performed internally so there has been limited external verification of the upgrades necessary within the boundaries of the Applicants.

Of primary concern is whether there are environmental liabilities that have not been identified. Examples in previous applications included issues such as mold and asbestos in municipally owned buildings.

Any potential liabilities that could result from these assets are not reflected in the financial projections. Although these liabilities are excluded from all projections, the addition of these type of liabilities could have a material impact on our analysis.

Reduction in Repairs

If all of the additional infrastructure upgrades are done as per the NM projections, or if redundant assets are disposed of, there would likely be a decrease in the cost of annual repairs and maintenance. The projections include the cost of upgrading the Town’s assets but they have not factored in any decrease in the annual maintenance requirements of these assets.

Overall Assessment of Projections

Throughout this report we have focused on areas where the projections could be improved but we would like to reiterate our opening comments that these projections appear to be prepared with an appropriate degree of effort and due diligence. None of the items we have identified cause concern over the overall integrity of the projections and we feel they are suitable for the Board’s decision making purposes.

Evaluation of Specific Assumptions in the Projections

In this section we evaluate specific assumptions used in the projections that we would like to point out for the Board's consideration and that may cause the projections to deviate from actual results if amalgamation were to occur.

Reduction of Allowance for Doubtful Accounts

At the beginning of each year, towns and municipalities record a tax receivable for all property taxes owed to them for the fiscal year. In most cases there are some property taxes that remain unpaid by the end of the year. To ensure the town's or municipality's financial results do not show tax revenues or tax receivables that are too high, potential bad debts are estimated and recorded as an allowance for doubtful accounts.

This allowance for doubtful accounts is usually based on historical results for uncollected tax revenues. For example, if the municipality has historically been unable to collect 5% of tax receivables over one year old, they would set up an allowance for doubtful accounts equal to 5% of all tax receivables over one year old.

The Municipality of the County of Pictou has chosen an accounting policy, per its audited financial statements in Exhibit P-5, to set up an allowance for doubtful accounts equal to 100% of property taxes outstanding at the end of each fiscal year. As of the March 31, 2014 audited financial statements, this allowance for doubtful accounts amounted to more than $2.5 million.

As it is relatively unusual to set up an allowance for doubtful accounts equal to 100% of outstanding taxes receivable, the Applicants have decided to reverse $1 million of this allowance in the NM projections. What this means is the NM projections have a one-time, non-cash increase of $1 million to its surplus that is over and above what has been recorded in the status quo projections. This increase is strictly from a change in accounting policy and has no positive cash flow impact for an amalgamated municipality.

Further to this, there has been no indication for how the $1 million adjustment was calculated so the actual adjustment that could happen in the proposed NM may differ.

Amalgamation Costs

The letter of intent has listed $700,000 in funding to cover pre-amalgamation expenses incurred by the Applicants. However, comments made in Exhibit P-29 list this funding at $750,000, of which $200,000 has been included in the NM projections. As this funding is to cover pre-amalgamation costs and the letter of intent states it will be fully requisitioned by October 31, 2016, it is unclear if the Province would pay this amount to the post-amalgamation entity. If that is the case the NM projections have overstated this funding.

Accuracy of Infrastructure Costs

In previous amalgamation applications there were external consultants retained to evaluate the infrastructure requirements of the new municipality to bring its infrastructure up to meet Provincial regulations. In the case of this application, the majority of infrastructure needs appear to be established by in-house engineers employed by the Applicants.

While the fact that in-house engineers did a comprehensive review on infrastructure needs is comforting, an independent external expert may point out additional infrastructure needs that would be required of the Applicants.

As far as the cost estimates used in the projections, the Applicants have listed the basis for their estimates, including the level of reliance that can be placed on them by providing a Class A though Class D classification. While the Class A estimates are considered fairly accurate, these figures could be significantly different from the costs when these projects go to tender. If any of them are significantly different the projections will differ.

Accuracy of Inflationary Adjustments

Statistics Canada Nova Scotia shows that historical all-items inflationary increases have been fairly volatile ranging from annual increases of 0.4% to 3.8%. The projections have used consumer price index increases of 0.3% in year one and 2.0% in years two through five. While the inflationary increases used in the projections may be reasonable, if actual inflation differs there could be a significant impact on the projections.

Police and Fire Costs

Fire and police department costs have only been factored into the projections as a combination of the status quo costs plus an annual inflationary increase. Per section 7.1 of Exhibit P.29, the Applicants have agreed to defer the harmonization of fire and police services until after an amalgamation order is received from the Board. As such, the actual costs of police and fire services may differ from those incorporated into the NM projections.

Water Treatment Plant Funding

The water utility that services the applicants is considered a separate entity from the applicants, and as such the revenues and expenditures of the water utility have been correctly excluded from the projections. However, since the letter of intent includes funding for the water utility in the event of an amalgamation, this is a distinct financial advantage for amalgamation that is not represented in the projections.

Reduction of Combined Costs

With the amalgamation of the Applicants there may be additional redundancies that could be eliminated that have not been identified in the projections. Some of the redundancies included in the projections include a decrease in human resource costs, but there may be additional cost savings available if amalgamation were to occur.

An example of this would likely be for audit services. The NM projections have added the cost of audit services for all four Applicants to calculate the cost of audit services in the NM. Although audit fees may be high in the first year or two after the proposed amalgamation, future assurance services would likely be lower than the combined costs of the status quo.

Disposal of Tangible Capital Assets

There has been little discussion of whether there is an ability to sell assets on amalgamation. As the assets of the Applicants will be combined if amalgamation occurs, it may be found that some of those assets are redundant or unnecessary. An example of this may be the town halls of the applicants. The projections do not include the proceeds on sale that would be realized by the sale of these redundant assets nor does it include a reduction in costs to operate and maintain those assets.

Per section 4.1 of the letter of intent with the Province, the proceeds of any tangible capital assets sold during the first five years of an amalgamated municipality will be held in a special reserve, which can only be used for the purposes associated with the municipal unit that formerly owned the asset. This indicates that any proceeds on the sale of tangible capital assets will be reinvested as infrastructure upgrades.

Financial Viability of Proposed Options

Reliance on Projections

We have evaluated the financial projections prepared as part of this voluntary amalgamation application and our conclusion is that they have been prepared on a reasonable basis. While we do point out a number of considerations for the Board, overall we feel the Applicants have put an appropriate amount of effort and due diligence in their preparation and the projections can be used by the Board for decision making purposes.

Amalgamation or Status Quo

While we feel that none of the Applicants are in immediate financial distress and should be viable in the short term, there are significant financial benefits to amalgamation with few disadvantages. These include the economies of scale of a combined municipality through the reduction of councillors, staff and other resources, funding available through the letter of intent, and an increase in infrastructure expenditures.