Region of Peel
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REPORT
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Regional Council

For Information

REPORT TITLE:	**Overview and Impact of Heightened Inflation on Regional Services**
FROM:	Gary Kent, CPA, CGA, ICD.D, Chief Financial Officer and Commissioner of Corporate Services

OBJECTIVE

To provide an overview of the impact of heightened inflation on Regional Service Delivery and proposed strategies to mitigate the risk from inflation.

REPORT HIGHLIGHTS

- The Region of Peel has been experiencing heightened inflation for the past year largely due to impacts from COVID-19 and resulting supply chain issues which have been worsened with the outbreak of war in the Ukraine.
- For Q1 2022, the year over year Consumer Price Index was 6.8 per cent and the non-residential Construction Price Index was 17.3 per cent.
- Supply constraints, tightening labour markets and price increases for specific commodities such as gasoline, fuel oil, asphalt, steel and other base metals are driving inflation.
- Peel is currently experiencing significant impacts to its procurement of goods and services for operations such as chemicals for the treatment of wastewater and fuel for its fleet. Major capital expenditures such as growth-related construction projects, housing development and ambulances are also seeing significant price increases.
- Inflation and interest rates have historically tended to move in the same direction so while prices are increasing, Peel's incremental investments are expected to generate higher rates of return which help offset some inflationary pressure.
- However, the Region's debt management program will be negatively impacted, as future debt transactions will be completed at a higher interest rate.
- For the procurement process, managing existing contracts under the terms they were signed has become increasingly challenging with the heightened inflation and supply chain issues. A June 23, 2022, companion report from the Chief Financial Officer and Commissioner of Corporate Services titled "Procurement Approach to Managing Impacts of Inflation on Regional Contracts" provides additional information and recommendations from a procurement perspective.
- Looking forward, inflation is expected to remain heightened for the next two years, with a return to more "normal" inflation rates expected in 2024. However, inflation remains very volatile and can change significantly over the next 6 months.
- Staff will continue to monitor inflation and are currently developing strategies to mitigate the risk and impacts of inflation on Peel's service delivery and overall financial health.

DISCUSSION

1. Background

Peel is impacted by changes in the macroeconomic environment and in 2021, the macroeconomic environment continued to support growth. Interest rates remained at historic lows and government supports to businesses and individuals remained in place. Although uncertainty remains unusually high, growth is expected to continue in 2022. The significant vaccination rates, the further easing of COVID measures, and the continuation of growth enhancing policy environment, are expected to support economic growth of about 3.3 per cent in 2022.

As the 2021 economic recovery progressed, expectations were for prices to recover to pre-pandemic levels. However, several factors, including improved economic prospects, supply chain challenges, and demand/supply imbalances in some markets, contributed to higher-than-expected price increases for commodities including some that are key inputs to construction. In response, building construction costs increased. The Non-residential Construction Price Index (NRCPI) for the Toronto Metropolitan Area (CMA) which captures the changes building construction costs in the Toronto CMA, registered sustained acceleration in the year-over-year change since Q1 2021 to reach a record 17.3 per cent in Q1 2022.

Geopolitical tensions heightened in early 2022, due to the outbreak of war in Ukraine, triggering higher prices in energy and commodity markets, including those for major construction inputs. Average prices for products such as asphalt, steel, and lumber & wood which are key components of municipal capital projects, increased. Land costs have also increased and labour shortage in some industries have started to put upward pressure on wage rates.

For most commodities, prices are expected to be significantly higher in 2022 than in 2021, and to remain high in the medium term. The NRCPI is forecast to register double digit annual increases in 2022 (19.7 per cent), 2023 (15.9 per cent) and 2024 (13.3 per cent). Consumer price changes have also accelerated due to higher commodity prices and are expected to remain elevated throughout 2022 and into 2023.

Higher price of most construction inputs will have significant impacts at all economic levels, including in Peel, with repercussions for resource costs related to Regional capital projects. In addition, inflation has accelerated significantly. The year-over-year increase in the price of consumer goods as measured by the Consumer Price Index (CPI), showed sustained increases throughout 2021 and into 2022 to reach 6.8 per cent in April 2022, the highest rate in almost 40 years. This report examines the implications of the higher prices for the Region of Peel.

2. Findings

As mentioned earlier in the report, for Q1 2022, the year over year Consumer Price Index was 6.8 per cent and the non-residential Construction Price Index was 17.3 per cent. These increases even outpaced the high indices that had been previously forecasted for this period and will have important implications for the Region of Peel’s service delivery and overall financial health.

Overview and Impact of Heightened Inflation on Regional Services

a) Impact on Budget

Peel's 2022 Budget was developed using assumptions based on available information at the time in 2021. For the operating budget, an inflation adjustment of 1.75 per cent was used and for the capital budget and capital plan, a construction price index of 2.6 per cent was used. In addition to the general inflation rates used, specific rates of inflation were used for commodities that could significantly impact the budget such as concrete, steel, asphalt, wood, fuel and electricity. The current inflation rates are significantly exceeding those assumed in the budget and will result in the following:

i) Higher Capital Costs for some Regional Projects

One of the most significant impacts of higher commodity prices on the Region will be on the cost of capital projects. The prices of major inputs such as steel, lumber and wood, asphalt, and energy have increased significantly since 2020. The World Bank expects commodity prices to remain elevated in 2022 and may be more elevated than expected over the medium term. This suggests higher costs for the Region's capital program over the same time horizon. Peel currently has in excess of $4 billion in capital works in progress with major construction projects for roads, new housing development and water/wastewater infrastructure which are all experiencing elevated prices.

ii) Higher Operating Expenses

Rising inflation will influence higher costs for many goods and services purchased by the Region. These higher prices are already impacting services such as the wastewater program where significant chemical price increases are putting negative pressure on its projected year end results. Gasoline prices are also significantly impacting services with large fleets such as Paramedics, Police Services and TransHelp. In addition, the higher inflation rate will increase the challenge of hiring and staffing retention in an already tight labour market and put additional pressure on compensation.

b) Increased Pressure on Financial Sustainability of the Growth Program

It is anticipated that future tendered prices for capital projects will increase at a pace that is greater than the Development Charge (DC) rate increase (indexed based on NRCPI). Assuming all other things remain the same, this would further widen the gap between the DC revenues and expenditures and in turn, would increase pressure on financial flexibility and debt affordability.

Regional staff are examining construction industry data to assess trends in material and labour costs, the results of which are showing an estimated 20-30 per cent increase in construction costs. The requests from developers for reimbursement of capital projects with cost estimates much higher than what was forecasted (in both the budget and the background study), coupled with risks/pressures associated with DC By-law appeal, would require corporate level holistic prudent and strategic review.

c) More Challenging Procurement

Regional contract costs are also likely to increase in upcoming periods as vendors adjust costs to compensate for higher wage and material costs as well as supply chain issues.

In addition, vendors under existing contracts are requesting adjustments to contracts or may walk away.

To determine to what degree Peel is already experiencing the impact of the current heightened inflation environment, staff undertook a review of Peel's procurement activity over the past six months. The review indicated that Peel is already experiencing significant impacts to its procurement of goods and services for operations and especially on capital related expenditures. A June 23, 2022, companion report from the Chief Financial Officer and Commissioner of Corporate Services titled "Procurement Approach to Managing Impacts of Inflation on Regional Contracts" provides additional details on the impacts of the heightened inflation on procurement and proposes strategies to mitigate its impact.

d) Higher Investment Returns and Higher Debt Cost

Inflation and interest rates have historically tended to move in the same direction because interest rates, specifically the Bank of Canada's policy rate, is the primary tool used by Canada's central bank to manage inflation. The objective of the Bank of Canada's monetary policy is to preserve the value of money by keeping inflation low, stable and predictable.

Given the severity of the current inflationary environment, the Bank of Canada is forced to materially raise its policy rate to slow the pace of inflation back to its target range (i.e., two per cent to three per cent). These actions by the Bank of Canada, among other factors have materially impacted the interest rate environment in Canada and have had various impacts to the Region's investment and debt management programs.

i) Higher Investment Returns

The Region's investment portfolio is primarily comprised of fixed income securities which have seen declines in market values, given that market values of fixed income securities fluctuate as the interest rates change. Incremental investments within the Region's investment management program, are being transacted at a higher rate of return, which is a benefit to the Region's investment portfolio. Given the Region's prudent and conservative investment management program, the Region has not and is not expected to see losses on the principal values that have been invested, assuming bonds are held to maturity.

ii) Higher Debt Cost

As the interest rate has shifted higher, the Region's debt management program will be negatively impacted, as future debt transactions will be completed at a higher interest rate, increasing the Region's interest expense; however, there is potentially some offset, as sinking fund provision payments are able to be invested at higher rates, reducing required annual provision payments on new debt, all else equal.

e) Other Impacts

In addition to the aforementioned areas, there are some other notable areas that will be impacted by the heightened inflation.

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i) **Elevated Affordability Challenges for Vulnerable Peel Residents**
For Peel residents, higher commodity prices and elevated inflation risks suggest ongoing affordability challenges for many residents. As the price of construction inputs rise, the price of housing is also expected to increase further and worsen housing unaffordability for many residents. This elevates the risk for higher demand for affordable housing while adding to the stock of affordable housing will become more expensive and will likely put increased pressure on the Income Support program within Human Services as costs continue to escalate.

ii) **Revenue from Recyclables Likely to Rise**
The Region is likely to benefit from higher price for recyclables in the short term. The general shift towards recycling should sustain prices over the medium-to-long-term, possibly extending the benefits over the same period.

3. Proposed Direction

Interest rates have started to increase and are expected to rise further in 2022. The outlook for CPI inflation in Canada is expected to average just below six per cent for the second half of 2022 and decline to 2.5 per cent in 2023 and eventually to two per cent some time in 2024. The timing of the decrease in inflation is expected to coincide with the easing of supply chain issues currently being experienced.

A review of the Bank of Canada Monetary Policy and other material suggests that inflation is expected to remain heightened for the next two years, with a return to more "normal" inflation rates expected in 2024.

To mitigate the risks and impacts of heightened inflation on Peel's service delivery and overall financial health, staff are currently developing strategies considering the budget, current and future operations, the capital program and the possible use the reserves.

To manage the challenges to procurement, a separate companion report from the Chief Financial Officer and Commissioner of Corporate Services titled "Procurement Approach to Managing Impacts of Inflation on Regional Contracts" will be presented to Council on June 23, 2022.

RISK CONSIDERATIONS

The outlook remains very uncertain as the COVID-19 pandemic situation continues to change. Currently pandemic restrictions are easing but as seen over the past two years, the virus continues to evolve and may still impact Peel in the future in ways that we can't foresee.

In addition, the market continues to react to the outbreak of war in the Ukraine. If the war comes to an end quicker then supply chain disruptions and commodity prices may be reduced. However, a prolonged war will likely have longer term impacts on the economy and inflation.

CONCLUSION

The Region of Peel has been experiencing heightened inflation for the past year largely due to impacts from COVID-19 and resulting supply chain issues which have been worsened with the outbreak of war in the Ukraine. This heightened inflation is expected to continue over the next two years. Staff are developing strategies to mitigate the impact of inflation on its operations and overall financial health.

Authored By: Norman Lum, Director, Business and Financial Planning

G. Kent.

Gary Kent, CPA, CGA, ICD.D, Chief Financial Officer and Commissioner of Corporate Services