



June 22, 2009

Mr. Michael Wernick
Deputy Minister
Indian and Northern Affairs Canada
Ottawa ON K1A 0H4

Re: Letter to Parliamentary Budget Officer (PBO) dated June 19, 2009 (attached)

Dear Mr. Wernick:

Thank you for your letter dated June 19, 2009, in response to the report from the Office of Parliamentary Budget Officer (PBO) entitled *"The Funding Requirement for First Nations Schools in Canada"*¹. We do appreciate the opportunity to continue to engage in a dialogue with your department over the funding of First Nations schools to support parliamentarians in an enhanced dialogue and debate.

Firstly, we would like to note that PBO analysis is grounded on the principle that the engagement objectives, observations and conclusions are based on appropriate analysis and independent external peer review, whenever possible. Hence, to support the engagement objectives, observations and conclusions, PBO adopted the principles of data sufficiency, data relevance and data reliability. The Institute of Internal Auditors' practice advisories (PA 2301-1) define data sufficiency, data relevance and data reliability as follows:

- *"Data sufficiency is defined as sufficient information that is factual, adequate and convincing so that a prudent informed person would reach the same conclusion as the Internal Auditor"*
- *Data relevance is defined as information that supports engagement observations, conclusions and recommendations and is consistent with the engagement objectives*
- *Data reliability is defined as information that is competent and best attainable through the use of appropriate procedures."*

Any observations made by the department or the PBO must be seen through the lens of the above three principles that promote objectivity and rigor of analysis. As we indicated clearly in the report, PBO's analysis is based partially on data directly provided by Indian and Northern Affairs Canada (INAC). Therefore, given the significant data reliability issues coupled with other challenges noted in the PBO report, our analysis was subjected to a test of

¹ For the record, an embargoed copy was provided to you on May 21, 2009. The report was released by Mr. Charlie Angus, Member Parliament for Timmins-James Bay on May 25, 2009 and posted to the PBO website shortly thereafter.

reasonableness to eliminate any potential bias. Further, as you know the report itself has been peer-reviewed to assure parliamentarians that the work was undertaken without bias or subjectivity.

Second, the PBO report relied upon the data and practices of INAC in the context of its existing system of internal controls, as defined under the relevant statutes, Treasury Board policies and guidelines. In the context of the Government of Canada's accountability framework we have made reference to two key policy elements:

- a) the measures taken to organize the resources of the department to deliver departmental programs in compliance with government policies and procedures; and,
- b) the measures taken to maintain effective systems of internal control in the department.

Regarding the point (a), which deals with the measures taken by your department to deliver departmental programs consistent with government policies and procedures, we note that the Government's policy is to **replace transaction-level requirements** and rules **with basic principles of management accountability** and transparency." It is our view that a capital budgeting methodology and financial modeling approach are consistent with the policy and could also be useful to determine the funding requirements and effective resource allocation for First Nations school infrastructure.

With respect to point (b), regarding the determination of the funding requirements for First Nations schools, your department officials indicated to us throughout the engagement and which was confirmed again in your letter, that INAC's system of internal financial controls does not include capital budgeting.

Third, based on the content of the letter you provided, we would like to emphasize a few key points:

1. Perhaps most importantly, any new information contained in your letter of Friday, June 19, 2009 does not materially change the PBO's projected funding requirements. In fact, the new information provided in your letter would likely increase the funding requirement for First Nations schools.
2. The data used by the PBO in its report was provided by INAC. Limitations and discrepancies in the data were brought to the attention of INAC officials on a number of occasions over the period of the engagement. PBO corrections and adjustments to the data set were also brought to the attention of INAC officials (for example, the section "PBO's Test of Reasonableness for INAC's Asset Replacement Values (ARV)", section 8.3.2., page 42). No relevant objections were made by INAC officials throughout the three-month engagement process.
3. INAC, from what we understood, and is confirmed in your letter, does not have a capital budgeting methodology or an underlying financial model to determine the funding requirement for the portfolio of school assets.
4. In the absence of a robust capital budgeting methodology and an underlying financial model backed up by data with integrity, the department's examination of funding requirements and, hence allocations, are based to a large extent on subjective and non-financial criteria.

With regards to your letter, we are including specific responses as noted in the table below:

Statement in your response	PBO Comments
Page 1 - "The key challenge for Indian ... existing regional data ... that is comprehensive and accessible by ... "	The data provided by INAC to my officials is far from comprehensive; in fact it is inadequate at best and non-existent at worst. I would like to mention that the data in possession by INAC in its ICMS database does not meet the basic requirements of data sufficiency, relevancy, and reliability in terms of financial management.
Page 1 - "... and has invested approximately \$4.5 million this fiscal year ..."	The PBO would like to learn about the relevant improvements made in the system, the impact it has had on the quality of data collected, the frequency, reliability and the authoritativeness of the data as collected, and how all of the others compare with authoritative professional benchmarks for capital budgeting for real estate systems. Without these comparisons, any expenditure on internal subsystems may not meet its own objectives.
Page 1 - "... the Parliamentary Budget Office staff were encouraged to conduct regional interviews to verify the data."	<p>We would like to re-state that the data belongs to the INAC and is the responsibility of the department to ensure integrity of the data (please refer to sections on internal controls under the Federal Accountability Act noted earlier). We have neither the staff nor the resources to support any verification of the data as per your suggestion. Further, the PBO staff was informed by INAC officials that the department itself was not only unable to conduct regional interviews to verify the data themselves, but also that they may not be able to provide any other data if requested by the PBO.</p> <p>In section 8.3.2 of the PBO report on the same, the section entitled "PBO's Test of Reasonableness for INAC's Asset Replacement Values (ARV)" relates to the additional data as requested by the PBO to INAC officials for verification of the data. As you can note from Table 8 entitled "Random statistical sample of school projects depicting the divergence between Projected ARV and Actual ARV", which was given by INAC officials to my staff, many portions have been returned incomplete, due to the inability of the your staff to either furnish the</p>

	relevant data or to verify the data as reported.
Page 1- "While there are 462 schools on reserve, the report refers to 803 schools. In fact, the 803 figure includes housing for teachers and other types of school assets."	<p>The PBO staff has been provided with the INAC ICMS database with all the 803 schools as listed in the database. There was no distinction made by INAC officials regarding which of these 803 structures are really schools and which are not. However, it is worth reiterating that regardless of what type or structure of construction is used for the school infrastructure asset, it does not in any way change the funding requirement for schools infrastructure assets, given the fact that the funding for all of these 803 structures is sourced back to the CFMP.</p> <p>Long Term Capital Plan (LTCP) for school expenditure. Your point that the size of the schools differs from that as reported in the INAC ICMS database could not be confirmed by the INAC officials during our deliberations with them. The reason for this is because there is no standard benchmark used by your department for determining the "size" of the schools as reported in the INAC ICMS database, and the reporting approach is highly subjective. In fact, your department did not provide a definition of what would be included in the reporting of the "size" of a school asset.</p> <p>In addition to that, it is worth noting that INAC officials were themselves unable to quantify the standard used for the reporting of many characteristics of the school assets, including their sizes, build life, year of construction, etc. It is precisely for these reasons that the PBO notes these issues on page 14 in section 3.3 entitled "Challenges to Estimating the Fiscal Impact". Furthermore, the PBO recommends on page 15 in section 3.4 entitled "Considerations for Parliament" that "The department may wish to consider implementing asset management, with</p> <ul style="list-style-type: none"> • periodic asset review • timely, and independent engineering estimates to determine the actual replacement values of the First Nations school assets and • accurate asset reporting"

	<p>Further, the PBO report notes that, for the purposes of capital budgeting for school assets, the size of assets is irrelevant to the calculation. The most important criteria for determining the funding requirement is the build and design life, the existing physical condition of the assets, and accurate and reliable asset replacement values indexed to relevant local and national inflation indices. The PBO staff has covered this issue in great detail for the benefit of the INAC department in section 6 on pages 24-25 and section 7 on pages 26-34. An understanding of capital budgeting methodology and the underlying financial model is really what is at play.</p>
<p>Page 2- "The Integrated Capital Management System is also able to capture the results of our technical inspections, ..."</p>	<p>Unfortunately, as pointed out repeatedly throughout the engagement by PBO staff with INAC officials, the ICMS data as provided by INAC to the PBO is quite incomplete, and in many cases inconsistent and difficult to understand and to use. Further, the database contains no such "results of technical inspections" as you indicate. The ICMS database as provided by the INAC to my officials runs counterfactual to your claim that the ICMS system is able to capture the results of the technical inspections, given the fact that many of the inspections have not taken place, or are subjectively-based, or are incomplete, inconsistent, or not understandable. The INAC officials have also been unable to inform my staff as to what technical inspection standards (such as the Building Owners and Managers Association (BOMA) standards) are used in the INAC ICMS database.</p>
<p>Page 2- "In fact, 100 percent of school assets in Saskatchewan have been inspected through the Asset Condition Reporting System"</p>	<p>The state of the school assets as mentioned in the PBO report is exactly as stated in the ICMS database that INAC itself provided my staff with, it is not the independent assessment of the PBO staff. If we were to assume that the Asset Condition Reporting System, that you mention, is in fact a better source of data, we could conclude that the INAC officials have not represented the conditions of the schools to the PBO staff fairly. It is unfortunate that PBO was not provided access to this data.</p> <p>When we asked your department about the information on school structures on behalf of the requesting</p>

	<p>parliamentarian, we did not specify the source database, just that it be reliable and sufficient for the purposes of the modeling exercise.</p>
<p>Page 2- "The Saskatchewan regional office also conducts additional inspections between scheduled Asset Condition Reporting system inspections to monitor compliance on all schools and ensure that the technical recommendations of the Asset Condition Reporting system are acted upon."</p>	<p>We would be interested to know what technical standards are being applied to monitor the compliance of the schools. We would also like to know precisely the technical recommendations of the Asset Condition Reporting System, if any.</p> <p>Without any clarity on what the standards and the technical recommendations are, the discussion on this issue is purely subjective and not relevant to the modeling exercise.</p> <p>It is unfortunate that the PBO was not given this information.</p>
<p>Page 2- "However, the report fails to mention that a further 10 percent of schools are in "new" condition."</p>	<p>Please refer to the chart on page 39, entitled "Schools reported as "New" by region", in section 8.2 entitled "Physical condition of the assets in the portfolio". This chart clearly identifies that 86 school assets of the 803 school assets are reported as "New". In fact, it also breaks down the distribution of these schools into various regions to provide additional clarity</p> <p>Yet, I would like to re-emphasize the purely subjective nature of the classification and reporting scheme as employed by INAC for the reporting of the school condition. Going by your earlier statement in your response on page 2 that: "The Integrated Capital Management System is also able to capture the results of our technical inspections, which are conducted every three years on schools through our Asset Condition Reporting System". If this statement is true, then one would assume that all the school assets that are reported in the INAC ICMS database should have had their last inspection date no older than FY2006-07. However, even a cursory glance at the INAC ICMS database shows that 468 of the 803 school assets that are listed in the INAC ICMS database have not been inspected</p>

since FY2006-07. Furthermore there is no evidence of inspection for 179 of the remaining 335 school assets was provided to the PBO.

In addition, regarding the reporting of schools, the 86 schools that are reported as "New", the PBO would like to note that according to the ICMS database as provided by your staff, **ALL of the 86 school assets in question have been constructed only prior to FY2006-07. Given below are the statistical breakdowns of the years in which the school assets were constructed.**

Year of Construction	Number of schools that were constructed in that year that are reported as "New" in the ICMS database
1985	1
1986	1
1987	0
1988	0
1989	1
1990	1
1991	1
1992	1
1993	4
1994	9
1995	5
1996	9
1997	6
1998	3
1999	6
2000	3
2001	6
2002	8
2003	3
2004	7
2005	7
2006	4
2007	0
2008	0
2009	0
More	0

	<p>Some of the schools listed as “New” have been constructed in the 1980s and the 1990s, which brings into question the standard and definition of the term “New”, since it fails to give any useful information about the physical nature of the asset. Given these statistics, it is impossible to discern the real definition of the word “New”. We would like to note that this is an example of subjective use of terminology by INAC which does not appear to have a technical or professional basis.</p>
<p>Page 2- “Also, given the three year cycle of the Asset Condition Reporting System, many of the three percent of total schools identified as being in “poor” condition have since been identified as priorities for new construction.”</p>	<p>We would like to note that this information was not provided to my staff during their numerous interactions with your officials. We would like to emphasize however, that the decision to identify the schools for new construction has no bearing whatsoever on the funding requirement according to capital budgeting principles, as have been clearly outlined in section 7 on page 26 for the benefit of the your department.</p>
<p>Page 2- “For example, in February 2009, Minister Strahl announced the construction of a new school in Burnt Church, New Brunswick, under <i>Canada’s Economic Action Plan</i>. In May 2009, an opening ceremony was held for the Ermineskin elementary school in Alberta. Both of these schools had been listed as being in “<i>poor</i>” condition.</p>	<p>I would like to bring to your attention that the building of a new school on a site that already has an existing school asset does not constitute a new school asset – it is capital asset replacement. For the purposes of technical clarity, the definition of the word “New” applies to the building of a school asset on land on which no prior capital structure existed.</p> <p>However, we assume that the new announcement includes the proposed spending envelope – this should be added to the capital funding requirements as identified by the PBO’s methodology and financial model to determine the increased funding requirement.</p> <p>If conveyed to the PBO, we would be able to input these updated total costs of school replacement (called “Asset Replacement Values”) into the financial model as developed by my staff, and it is likely to increase the funding requirements by the department for First Nations school infrastructure.</p>
<p>Page 2- “The unduly</p>	<p>The condition rating categorization of the school assets</p>

<p>negative condition ratings are also due to the fact that the report confuses school related infrastructure (803) with schools (462). For example, many of the "poor" ratings in Alberta refer to individual portables."</p>	<p>were provided to my staff by INAC officials. This asset categorization provided by your officials has already been integrated into the PBO's financial model, and consequently, would not have any material bearing on the funding requirement.</p> <p>Furthermore, the rating for the particular school asset in consideration is used to determine the annual <i>recapitalization expenditure</i> required for the schools and not the <i>capital asset replacement</i>. Therefore, even if the assets such as workshops and or teacher's housing, which may have different condition ratings, are aggregated into the total school area, it would have no effect whatsoever on the funding requirement on the capital budgeting methodology. The PBO would like to reiterate that re-classification and re-categorization will NOT change the normative view of required expenditures for the funding requirement, which is based on the existing physical condition of the school infrastructure in question.</p> <p>In addition to that, the PBO would like to bring to the attention of the department to the tables 14a and 14b on page 49, in section 8.4, entitled "Total Cost Summation for First Nations School Funding Requirement", where the total annual recapitalization expenditure for school infrastructure across ALL FIRST NATIONS schools is shown to be in the range of \$57 million to \$78 million annually. Spread across 803 schools, this amounts to a minor expenditure of approximately \$100,000 per annum per school infrastructure asset. Thus even the re-categorization and repair of school infrastructure through recapitalization expenditure will have no SIGNIFICANT MATERIAL impact on the funding requirement according to robust capital budgeting principles.</p> <p>To clarify matters for your department, we would like to note that the department's existing ICMS database that uses subjective qualification into various ratings such as "good", "fair", "poor" do not appear to be based on objective standards. Accordingly, such terms are suspect in real world financial applications. In an optimal scenario, a manager of comparable real property assets would conduct independently verifiable third-party technical</p>
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	<p>assessments of all the school related assets across Canada, and then spread all the recapitalization expenditure into a strategic plan across multiple years. Such an assessment would restrict the use of subjective terminology that is not based on objective standards.</p>
<p>Page 2- "With respect to school construction trends ... In fact, between 1990 and 2000 the rate of new school construction averaged approximately 17 per year. Since 2006, the Government has completed 53 school projects including the construction of 16 new schools, the completion of 34 renovation projects, and three other major projects."</p>	<p>We would again note the fact that all the data referenced in the PBO report was sourced back to the ICMS database, which was provided to the PBO staff by INAC officials. No other external data was used for the purpose of this study. Consequently, your comment that between 1990 and 2000 the rate of new school construction averaged approximately 17 per year – conflicts with the data that your department provided the PBO with during the course of this study.</p>
<p>Page 2- "These renovation and new construction projects have accounted for over \$240 million in expenditure commitments since 2006."</p>	<p>We would like to note that this may be another example of department officials not providing appropriate data to my staff during the course of the study. However, when included in the calculations, this additional \$240 million expenditure commitment would further increase the funding requirement when input into the PBO's financial model developed for the same purpose. The PBO would be pleased to integrate this new funding commitment by the department to determine the revised and expanded annual funding requirement by the INAC department.</p>
<p>Page 3- "Currently, ... including 10 new schools and three major school renovation projects funded under <i>Canada's Economic Action Plan</i>."</p>	<p>The PBO would be prepared to integrate this new funding commitment by the department to determine the revised and likely expanded annual funding requirement by the INAC department.</p> <p>At the same time, we would like to note that construction of 10 new schools (not to be confused with capital asset replacement) is relatively small when compared to a total</p>

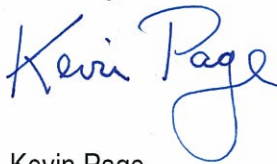
	<p>portfolio of 803 school structures. Therefore, the 10 proposed “new” schools, if funded to completion, are likely to pose little significant material impact on the funding requirement over the next five years, although it is quite likely that the funding requirement will increase, given the expansion in the capital asset outlay.</p>
<p>Page 3- “Indian and Northern Affairs Canada has in fact received an ongoing two percent annual increase on a bundle of basic services ...”</p>	<p>We would like to re-state that this information was not provided by your department to Parliament either in its annual DPR or RPPs, or to the PBO despite repeated requests. We are referring to policy documents that clearly outline the funding rule.</p> <p>However, it is very important for the PBO to make clear that a funding rule has no bearing whatsoever on the funding requirement for First Nations school infrastructure. The ability and willingness to spend on any specific capital has no bearing whatsoever on the needs or the “ask” of the said project. My staff dealt with the issue of a 2% cap merely for the thoroughness of the report. The report provided some background on this issue because it was raised in the broader context of issues facing INAC.</p>
<p>Page 3- “Your report recommends that ... Although this approach may appear to increase the clarity in identifying It would significantly reduce the Department’s flexibility to reallocate within a fiscal year ...”</p>	<p>For the perspective of parliamentarians scrutinizing the department’s estimates, limiting the department’s ability to reallocate and spend from the school infrastructure budget towards other programs would aid in the identification of funding appropriations for school infrastructure by reflecting them as a separate line item. From an asset and financial management perspective, long-term physical assets can benefit tremendously from clear reporting practices, a capital budgeting process and a funding model distinct from current expenses.</p> <p>Also, the ability to reallocate funds on a short-term basis challenges the realities of sophisticated long-term capital management. The current lack of a published comprehensive strategic plan on the part of the Department towards funding First Nations schools, available to parliamentarians, further constrains any serious parliamentary or public dialogue.</p>
<p>Page 3- “It should also be noted that ...</p>	<p>We would note the inconsistencies in the reporting by the Department in its annual Departmental Performance</p>

<p>the information is available from the Department's budgeting and reporting system, and has been provided"</p>	<p>Report (DPR) and Report on Plans & Priorities (RPPs) as noted in our report. We would further emphasize that the DPRs contain data that is often more than two years old, which is not helpful for making any capital budgeting and financial planning related decisions. Furthermore, increased reporting of funding does not impact the future funding requirements based on capital budgeting principles.</p>
<p>Page 3- "The report states that Indian and Northern Affairs Canada has no capital budgeting methodology to estimate the funding requirements for school infrastructure in future years. This is misleading, as Indian and Northern Affairs Canada has developed processes to: identify infrastructure needs on reserve; to cost those needs; and a priority ranking process to determine which projects to fund and in what sequence."</p>	<p>From a financial perspective, the PBO would like to clarify that a process is an <i>implementation</i> of a requirement as <i>determined</i> by a robust capital budgeting methodology to determine the <i>funding requirement</i> as determined from professional industry benchmarks.</p> <p>The implementation of processes, given lack of capital budgeting methodology and financial model, is generally inconsistent with the principles of internal controls or sound financial management. Such an ad-hoc approach risks compounding the challenge of determining future funding requirements.</p> <p>We note the Government's statement that it will "<i>review its procurement and financial management policies</i> to identify where they could be streamlined, and where the Government could replace transaction-level requirements and rules with basic principles of management accountability and transparency.² A capital budgeting approach to the management of school structures appears to be consistent with such a view.</p>
<p>Page 4- "First Nations seeking funding To meet the community's needs, as well as to determine the costs."</p>	<p>The willingness of the First Nations community to submit a plan for renovation of existing schools and construction of new schools does not change the benefits or obligations of the department to have its own robust capital budgeting methodology and financial model for determining the funding requirement. A capital budgeting methodology and financial model could well improve the internal system of controls for the management of such a program. Further, a capital budgeting methodology and a portfolio-wide real estate strategy by INAC for the First Nations</p>

² Annex A, Financial Administration Act, <http://www.pco-bcp.gc.ca/docs/information/Publications/ao-adc/2007/annex-eng.pdf>

	schools could significantly benefit the objective assessment of the funding requirement of the First Nations school infrastructure, or the plans submitted by First Nations communities.
Page 4- "... I would encourage you to amend the report to correct the factual inaccuracies contained therein. Departmental staff who worked with your team would be pleased to discuss these issues as soon as possible."	We welcome your suggestion that staff of INAC and the PBO work together to examine data issues. Should updated and improved data be provided to the PBO, we would be pleased to update the PBO estimate of the funding requirement for First Nations schools in Canada.

Sincerely,



Kevin Page
Parliamentary Budget Officer

c.c.: The Hon. Noël A. Kinsella, Speaker of the Senate
The Hon. Peter Milliken, Speaker of the House of Commons
The Hon. Chuck Strahl, Minister of Indian and Northern Affairs
Mr. Charlie Angus, Member of Parliament
William Young, Parliamentary Librarian