Council Report

Report Number:	**CORP2021-002**
Meeting Date:	February 23, 2021
Title:	**Municipal Credit Rating**
Description:	To illustrate the advantages and disadvantages of obtaining a credit rating
Author and Title:	Sandra Shorkey, Supervisor-Treasury

Recommendation(s):

That Report CORP2021-002, **Municipal Credit Rating**, be received;

Department Head: ______________________________

Financial/Legal/HR/Other:______________________________

Chief Administrative Officer:______________________________

Background:

At the Council Meeting of October 1st, 2019 the following resolution was approved.

8.3.10 CW2019-192

CR2019-576
Moved By Councillor Ashmore
Seconded By Councillor O'Reilly

That the memorandum from Councillor Ashmore regarding **Alternative Financing for Capital and Operating Pressures**, be received;

That staff be directed to study alternative sources of funding for Kawartha Lakes' capital and operating needs;

That staff explore the creation of Kawartha Lakes "Savings Bonds" and/or "Equity Shares" as a method of increasing our Capital funding; and

That staff report back to Council by the end of Q1, 2021 with alternatives and additions to the current sources of funding for capital and operating budgets.

Carried

This report follows that direction.

Rationale:

Municipalities have many options to finance capital and operating budgets. The City utilizes Federal and Provincial Grants, donations of money and assets, partnerships with community groups, investment income, Development Charge Reserves, user fees, Council created reserves and Property Taxes. Sources of financing, other than those above, usually originate from new legislation from the Federal or Provincial Government. Upper levels of government typically prescribe a very conservative approach to utilization of different forms of revenue. This is evidenced by their very conservative investment policy which is risk averse unless you utilize a particular company to invest in stocks and bonds on the open market. These restrictions are intended to ensure that municipalities manage taxpayer money in safe ventures that protect the investment.

With the reduction of Federal and Provincial Grants in recent years Council has increased the amount of debenture funding in financing capital projects. Debt is an effective way to finance capital projects as it spreads the expense across the life cycle of the asset. It also smooths out the burden to the taxpayer by avoiding a large tax levy pressure in the year the capital asset is approved. To date, the City has utilized debentures through either the bank or Infrastructure Ontario to secure debt financing.

Debt in a municipality is governed by the Ministry of Municipal Affairs and Housing (MMAH) area of the Provincial Government. The City is prescribed an Annual Repayment Limit (ARL) which is reviewed annually. An ARL is the maximum principle and interest payments on debt that a municipality can incur on an annual basis. It does not prescribe the amount of debt the municipality can have outstanding at the end of the year but rather the maximum amount of payments that a municipality can make on debt in a year. It is calculated based on acquiring the municipality's total revenue for the year and eliminating Federal and Provincial grants and other municipal contributions. The municipality's "own source revenue" is then established and 25% of this number is calculated as the City's Annual Repayment Limit. Based on figures in the 2019 Financial Information Return (annual filing with the MMAH) the City's Annual Repayment Limit is approximately $40 million. In 2019 our total debt payments (principle and interest) were $15.5 million thereby leaving the City the ability to increase debt payments by $24.5 million and still be in compliance with provincial legislation.

The ARL encompasses all debt payments including those taken out through a Canadian bank, Infrastructure Ontario or utilizing a credit rating to secure debt. Debentures obtained through Canadian bank loans and Infrastructure Ontario are similar to an individual obtaining a mortgage or loan. In order to secure alternative sources of financing such as bonds or equity shares, the City would be required to obtain a credit rating. This is an annual third party assessment of the City's creditworthiness as a borrower.

In considering options that a municipality has to raise debt financing for capital projects, Finance Staff investigated the positive and negative components of utilizing the bank, Infrastructure Ontario and issuing our own debt.

The following illustrates the attributes of each option that include interest rates, additional fees, staff burden and timeline:

	Bank Debenture	Infrastructure Ontario Debenture	Municipal Issuance
Interest Rate	• highest rate of these options	• lower than Bank	• dependent on credit rating
Timeliness	• 4-6 weeks	• 6-8 weeks	• 6-8 weeks excluding credit rating process
Additional Fees	• None	• Minor < $2,000	• Significant and ongoing
Staff Burden	• minimal	• minor	• significant due to the need to maintain credit rating
Best Use	• Immediate funding required	• Debt issuance less than $100K	• Debt issuance greater than $100K

As the municipality already utilizes bank and Infrastructure debentures the balance of this report will primarily focus on municipal issued debt and the process for obtaining a credit rating.

A municipal credit rating refers to an opinion by a credit rating agency that indicates the capacity and willingness of a borrower to pay principal and interest on a debt, financial obligation or other financial instrument in a timely manner. It is a current assessment of the creditworthiness of a borrower with the respect to a specified obligation. Common credit rating agencies include Moody's and Standards & Poor's, and both have rated Canadian municipalities for years. A credit rating is typically obtained in order for the municipality to obtain a more competitive rate then they could get by borrowing from the bank. A credit rating does not bring a municipality a higher debt limit. It is simply another tool in financing capital projects as it is still considered debt in terms of a municipality's Annual Debt Repayment Limit. (ARL)

The City has been reviewing and considering a credit rating since amalgamation in 2001. The process of obtaining a credit rating is extensive and requires significant staff resources and has both a one time, and annual cost. Credit rating agencies when determining a baseline credit assessment in rating the municipality will review and evaluate the following:

> Economic Fundamentals: performance, strength, structure and volatility to remain stable. Factors would include predictable property taxes and user fees and maintain a strong fiscal profile that provides buffer against adverse provincial funding changes.

Institutional Framework: legislative background, financial flexibility. Factors would include proven strong fiscal results that are supported by strong governance and management characteristics. Stable relationship with higher levels of government in the division of roles and responsibilities between the province and municipality is clearly articulated.

Financial Management: political and management strength, financial operating results.

Budget Performance: level and volatility of expected cash flows, budgetary trends, budget flexibility, initial budget performance assessment and qualitative adjustments.

Liquidity: determining an initial liquidity assessment based on a debt service coverage ratio, access to external funding.

Debt Burden; reflects a forward looking view of debt and interest burden relative to available resources.

The more positive attributes a municipality can demonstrate, the higher the credit rating achievable. Local governments have a number of similarities and differences that can influence the outcome of the rating process. These attributes include the stability of revenues such as taxing powers, services provided, a stable political system, local economies and provincial funding provided. Attached is a list of Moody's Municipal clients and the credit rating they have received. (See Appendix A)

Consideration in moving towards the City obtaining a credit rating would have to include the time, effort and cost of the Finance and Development Services staff to provide the critical data to enable the credit rating agency to determine the rating and the outlook of the City. Upon completion of the initial rating process and obtaining an assigned rating, municipalities would then enlist the services of a broker with the bank to issue debentures. The broker will use the municipal credit rating and assign an interest rate to establish what the investor will pay. The lower the rating, the higher the interest rate will be for investors to accept the risk. For example, a municipality with a AAA rating will attract lower rates than an A rated municipality. Once the rate has been established the broker will list the Municipal Bonds on the open capital market at the interest rate determined by taking in all the factors discussed above.

The potential for lower interest rates however have to be considered against the costs of obtaining and maintaining the rating, as well as the additional issuance fees. These additional costs will apply when a debt is issued and are typically based on a percentage of the value of the debt with a minimum fee associated with each debt issued.

The current fees quoted are:

Credit Rating Agency	Initial Fee	Annual Surveillance Fee*
Moody’s	$32,000	$32,000
Standards and Poor	$36,000	$23,000

**annual surveillance fees may be subject to annual escalation*

In addition, Standards and Poor’s has an additional minimum fee of $80,000 each time a Municipality issues debt. Any annual debt issuance less than or equal to $120 million will warrant paying the minimum fee. The City’s average annual debenture is approximately $18.5 million. For clarity, if the City sought a credit rating through Standards and Poor there would be an initial fee of $36,000; an annual fee of $23,000; and an additional fee of $80,000 with each issuance of debt.

In discussions with rated municipalities it is found that the larger municipalities find it advantageous to issue debt directly on the open market primarily because of the dollar value of the debt being issued. One AAA rated municipality is currently preparing to issue a debenture of $275,000,000 to support their capital needs. For larger municipalities that have a large financial growth expectancy a credit rating is useful in obtaining a better rate. It does however, come with extra costs including broker and legal fees not only in the issuance itself but in certification and consultants. A larger municipality also typically has a team of analysts dedicated to these endeavours. In addition, these municipalities have substantially higher levels of cash flow and reserves and are therefore only required to finance with debentures for large scale projects. It’s important to note that these larger municipalities still utilize banks and Infrastructure Ontario for debentures that aren’t significant enough to justify the amount of issuance costs.

In comparing with the City of Peterborough, who has been AA rated with Standards & Poor’s, the decision was made with their last debenture to forgo issuing their own debt and take advantage of the interest rates offered through Infrastructure Ontario. They found the cost to issue as a rated municipality would be more than that of borrowing with Infrastructure Ontario. The last time the City of Peterborough issued directly through the Capital Markets, utilizing their credit rating, was in 2018. The total interest rate on that debenture issue was 3.27%. Comparably, in 2018 the City of Kawartha Lakes utilized Infrastructure Ontario to obtain debt with an interest rate of 3.38% for a ten-year term.

For illustrative purposes, below is a comparison of the Peterborough experience of utilizing their credit rating and the City of Kawartha Lakes using Infrastructure Ontario, assuming Kawartha Lakes' average annual debt requirement of $18.5 million

Debenture Example	Standard and Poor AA Rated Municipality	Infrastructure Ontario
Debt Issuance	$18,500,000	$18,500,000
Interest Rate	3.27%	3.38%
Interest Cost	$3,176,402	$3,283,253
Annual Fee	$23,000	
Issuance Fee	$80,000	
Legal Fee (assumption)	$2,000	$2,000
Total Cost of Debt Issuance	$3,281,402	$3,285,253

The illustration above highlights that the benefits of a lower interest rate are quickly diminished by the fees associated with a credit rating. It is important to note that the costs above don't include the staff resources required to maintain a preferred credit rating. With those costs added in, borrowing from Infrastructure Ontario is significantly more cost effective.

The creation of Infrastructure Ontario was in part to support smaller municipalities to obtain affordable borrowing costs as the additional fees to obtain and keep a credit rating are very expensive. Other rated municipalities have indicated that it has been their experience that the lower the debenture value the more challenging it is for brokers to sell to investors, and thus the lower the interest rate on these vehicles are.

Conversations with our investment representative has also identified that they have had fewer municipal bonds available to them. They indicated that based on the City's average annual debt requirement of $18.5 million, it is not cost effective to issue bonds on the open market. They recommended that the City consider a credit rating and bond issuance once the on-going debt issuance exceeds $25,000,000 annually.

Given the extensive costs of both obtaining and then maintaining a credit rating staff are not recommending a credit rating at this time. The amount of time spent administering the requirements of the credit rating would be a task that could not be managed within the current staff complement. If growth in the City starts to increase considerably and our debenture needs increase, then a credit rating could be considered. At this point the costs far exceed the benefits when consideration is given to the City's debenture needs, staff time and the current availability of low interest rates with Infrastructure Ontario.

Other Alternatives Considered:

Council could direct staff to obtain an indicative credit rating. With an indicative credit rating a municipality would be assessed at a particular point of time. This would be an unpublished and private credit rating that could be used to determine the rating for possible debt issuance. The fee that Moody's credit rating agency charges for this assessment is the same as the initial fee of $32,000 that can be credited towards the initial fee if the City decides to go forward with obtaining a credit rating within a reasonable time of receiving an indicative rate.

It is important to note that this could also not be managed with the current staff complement and additional temporary resources would be required to support this decision.

If Council wished to proceed with an indicative credit rating then the following resolution could be considered:

That Council direct staff to obtain an indicative credit rating and report back on the results.

Alignment to Strategic Priorities

This report aligns with the strategic priority of good government with the effective use of financial resources.

Financial/Operation Impacts:

The financial and operation impacts have been noted throughout this report. The issuance of municipal debt is an appropriate tool when the financial benefits outweigh the associated direct and indirect costs.

Staff require Council approval to issue debt, regardless of the means. Staff will continue to monitor and assess the City's debt issuance and will report to Council when it is appropriate to consider issuing municipal debt on the open market.

Consultations:

Moody's Credit Rating Agency
Standards and Poor's Global
Royal Bank of Canada
RBC Dominion Securities
Infrastructure Ontario
City of Peterborough
The Regional Municipality of Durham
Treasurer

Attachments:

Appendix A – Municipality Credit Ratings

Moody Municipal Clients.docx

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