Council Report

Report Number:	**CORP2025-005**
Meeting Date:	February 18, 2025
Title:	**Municipal Credit Rating**
Description:	To illustrate the advantages and disadvantages of obtaining credit rating
Author and Title:	Sandra Shorkey, Financial Services Supervisor-Treasury

Recommendation(s):

That Report CORP2025-005, **Municipal Credit Rating**, be received;

That Staff be directed to continue to utilize Infrastructure Ontario for debentures; and

That Staff be directed to not pursue a credit rating at this time.

Department Head: ______________________________

Financial/Legal/HR/Other: ______________________________

Chief Administrative Officer: ______________________________

Background:

At the request of Council, Staff have been directed to explore the option to fund capital projects through the open market by obtaining a municipal credit rating.

The decision for the City of Kawartha Lakes (CKL) to obtain a credit rating to issue CKL debentures has been analyzed previously in Council and with the Senior Management Team. Reports TREAS-2013-008 and CORP2021-002 recommended not pursuing a credit rating due to the costs of obtaining the rating, as well as, maintaining it annually. Council supported Staff's recommendations on both reports.

This report addresses the recent Council direction to analyze again.

Rationale:

Municipalities have various sources for financing capital budgets. CKL leverages federal and provincial grants, donations, partnerships with community groups, investment income, development charge reserves, user fees, Council-created reserves, property taxes and debenture financing. Financing sources outside of these typically arise from new federal or provincial legislation.

Debt financing distributes the capital cost over some or all of the assets' useful lives, easing the immediate tax burden. To date, CKL has secured debt financing through bank loans, Infrastructure Ontario (IO) debentures, the Federation of Canadian Municipalities and the Canada Mortgage and Housing Corporation.

A municipal credit rating is an opinion by a credit rating agency on whether debt service payments will be made fully and on time. Common credit rating agencies are Moody's and Standards and Poor, which have a history of rating Canadian municipalities. A credit rating is normally obtained as a requirement for the municipality to approach the marketplace to issue debentures on the open market for the best price possible. A credit rating is used by municipalities to secure potentially lower interest rates than those available from banks. The use of issuing debt from credit rating and borrowing from IO has the same effect on the Annual Repayment Limit (ARL).

Since 2003, with the provincial creation of IO (formerly known as Ontario Strategic Infrastructure Financing Authority), there have been additional options for the municipal sector to borrow to support capital needs. The mandate of IO is to provide low-cost and long-term financing to renew critical public infrastructure. IO provides low interest loans to municipalities with minimal transaction cost and offers access to the capital market for smaller municipalities. The IO interest rate offered to municipalities are competitive with bank lending rates. It is comparable to rates obtained in the open market by those municipalities that currently hold a credit rating.

IO was established partly to enable smaller municipalities to access affordable borrowing without the high expenses associated with credit rating. Other municipalities with credit ratings have reported challenges with issuing lower-value debentures, as brokers often struggle to market these to investors, which can also result in less favorable interest rates. It is common to see credit rated municipalities utilize IO for their debenture needs due to the low interest rates available.

Rating agencies evaluate several key factors when assessing a municipality's creditworthiness:

1. ***Economic Fundamentals:*** Stability and performance of economic factors like property taxes and user fees that support a strong fiscal profile.
2. ***Institutional Framework***: Legislative background, financial flexibility, and governance strength, including a stable relationship with provincial authorities.
3. ***Financial Management***: Strength of management, financial results, and resilience.
4. ***Budget Performance***: Expected cash flows, budget trends, flexibility, and qualitative assessments.
5. ***Liquidity****:* Debt service coverage and access to external funding sources.
6. ***Debt Burden***: Projections of debt relative to resources.

In considering a municipal credit rating, it is essential to weigh the time, effort, and cost to prepare the required data. Staff would be involved with fiscal management in general and debt and liquidity considerations. Staff would also be polled on growth, current and projected building permit activity, planning rules and regulations in force and plans for industrial and commercial expansion. Appendix A provides a methodology for rating with Standards & Poor.

Once the rating process is complete and a rating is assigned, the municipality must work with a broker at the bank to issue debentures. The broker will assign an interest rate to the debenture based on the municipality’s credit rating and what the investor will pay. The lower the rating, the higher the interest rate will be for investors to accept the risk. In addition to the interest expense, brokerage fees and lawyer fees are applicable on these transactions.

Higher ratings such as AAA lead to lower interest rates for investors, potentially reducing the City’s financing costs. Appendix B provides a list of Moody’s Municipal clients and the credit rating they received.

The current fees quoted are illustrated below in Table 1:

Table 1

Credit Rating Agency	Initial Fee	Annual Surveillance Fee*
Moody's	$35,000	$35,000
Standards and Poor	$37,000	$23,000

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

CKL obtained debenture interest rates from IO during the same period as the City of Toronto issued a $300 M debenture (utilizing their credit rating). Since CKL would not go out for such a considerable sum, Table 1 provides a comparison of the debenture costs based on the City of Toronto interest rate, but at a lower dollar value. Staff were not able to obtain the costs incurred by the City of Toronto specifically so Staff utilized an estimate on what normal costs would be for an AA rated municipality issuing debt on the open market. (City of Toronto's credit rating is a AA). These estimates were obtained by an independent broker. This table 2 compares CKL'S cost of borrowing from IO with that of borrowing from the market, assuming a AA credit rating for CKL.

Under this scenario, as shown by Table 2, CKL would incur approximately $156,000 more in financing costs by utilizing the market instead of IO for a 10-year $20M debenture. Staff are unable to determine what credit rating CKL might achieve but based on Toronto's rate it appears that the rates achieved through Infrastructure Ontario are comparable.

Table 2 - Comparison between Open Market estimated based on City of Toronto and IO debenture

	City of Toronto Bylaw July 763-2024 Based on Credit Rating	**Open Market (RBC) AA Rated Municipality**	**Infrastructure Ontario**
Debt issuance	$300 M	$20 M	$20 M
Term	10 years	10 years	10 years
Interest rate	4.25%	4.25%	4.38%
Interest cost over term	$127,500,000	$4,466,342	$4,602,960
Annual surveillance fee lifecycle ($23,000 annual fee times 10 year term)	Not public	$230,000	nil
Initial Fee	Not public	$35,000	nil
External broker and legal fees	Not public	$30,000	$2,000
Total finance cost of debt servicing		$4,761,342	$4,604,960
Cost over Infrastructure Ontario		$156,382	

The analysis above illustrates that while a credit rating could potentially lower interest rates, the benefits are potentially outweighed by the maintenance costs associated with the rating. These costs include not only the fees to obtain a credit rating, but also the staff resources to maintain a favorable rating over time. Factoring in these additional expenses, borrowing from IO remains a cost-effective option for CKL.

Discussions with investment representatives have confirmed that municipal bonds are less available in the current market, currently. They advised that, given the City's typical annual debt needs of approximately $20 million, pursuing bond issuance on the open market is not financially prudent at this time. Instead, they recommend only considering a credit rating if the City's debt issuance exceeds $50 million annually.

Due to the costs and administrative functions of obtaining and maintaining a credit rating, staff do not recommend pursuing this option currently. The associated requirements would entail additional staffing capacity. However, should CKL experience significant growth and a corresponding increase in debenture issuance values, a credit rating could be reconsidered. Staff will continue to monitor the debenture levels and perform the analysis as the values increase.

Other Alternatives Considered:

Council could direct staff to obtain an indicative credit rating. This is completed by a credit rating agency and will indicate the Municipality's credit rating at a point in time. CKL would be unable to use the indicative rating to go to the open market. This assessment provides a snapshot of CKL's creditworthiness at a point in time, without being published or made public. An indicative rating could help gauge CKL's potential rating for future debt issuance. The fee for an indicative rating agency such as Moody's is the initial fee of $35,000, which could be credited toward a formal credit rating should Council decide to proceed within a reasonable time. With a formal rating, additional costs would be the Annual Surveillance Fee as shown in Table 1 above.

It is essential to note that this initiative would require staffing resources.

If Council selects to proceed with obtaining an indicative credit rating. Council could pass a resolution to that effect.

Staff are not recommending this alternative. The rating will not allow CKL to obtain a competitive rate as compared to IO. The City will continue to optimize borrowing across sources.

Alignment to Strategic Priorities

This report supports the strategic priority of good governance through the effective use of financial resources.

Financial/Operation Impacts:

The financial and operational impacts of obtaining and using a credit rating are discussed throughout this report.

As always, staff require Council approval to issue debt, regardless of the chosen approach. Staff will continue to monitor CKL's debt requirements and will bring forward recommendations should conditions become favourable for open-market debt issuance.

Consultations:

Director, RBC Debt Capital Markets
Senior Accountant (Contract)
Moody's Credit Rating Agency
Standards and Poor Credit Rating Agency
Infrastructure Ontario
Manager of Corporate Assets

Attachments:

Appendix A – Standards & Poor Methodology for Rating Local and Regional Governments

Appendix A.pdf

Appendix B – List of Municipalities with Credit ratings

Appendix B.docx

Department Head email: sbeukeboom@kawarthalakes.ca

Department Head: Sara Beukeboom

Department File: Corporate Services