TORONTO

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2018 OPERATING BUDGET BRIEFING NOTE

City's Credit Rating Performance

Issue/Background:

Credit ratings affect the City's ability to borrow, as well as the cost of borrowing. A higher rating translates into a lower cost of borrowing, as well as a wider market for investors to invest in City debt.

The City receives a credit rating on its long-term debt annually by three credit agencies, namely: Dominion Bond Rating Service, Moody's Investor Services and Standard & Poor's. While each credit rating agency has its own criteria for rating a municipality's debt, critical rating factors generally include:

- the strength of the local economy
- fiscal management and performance (fiscal sustainability & tax policies)
- financial management (debt & liquidity)
- relations with other orders of government

Of particular concern to Budget Committee is the impact that rising debt and associated debt service might have on the City's credit rating.

Key Points:

The City's credit rating among the three credit rating agencies has not changed since 2001. DBRS and Standard & Poor's both rate the City of Toronto at AA (Stable) while Moody's Investor Services rates the City of Toronto at AA+ (Stable) – one notch below AAA.

City of Toronto's Credit Rating History	1997 and Prior	1998-2001	2002-2017
Dominion Bond Rating Service	AAA	AA (High)	AA (Stable)
Standard and Poor's	AA+/ AAA	AA+	AA (Stable)
Moody's Investors Services	Aa2	Aa2	Aa1 (Stable) (Equivalent to AA+)

A summary of the key points raised by each credit rating agency follows:

Rating Agency	Comments
Standard & Poor's	• City has managed budgetary pressures well, improving its operating balance while maintaining very high levels of reserves and liquid assets • The City faces significant capital requirements and a continuing challenge to increase own-source revenues in line with expenditures • The stable outlook reflects expectations that Toronto's continued economic expansion will support revenue growth, and that its ongoing efforts to contain costs will keep unfunded capital from escalating further.
Moody's Investor Services	• The City is expected to maintain a low debt burden and solid liquidity profile over the next 18-24 months despite an increase in capital spending which will put pressure on debt and reserve levels • The City has unique taxation powers, which allow it to access additional revenue sources besides property taxes and user charges • The City has been able to reduce reliance on non-recurring measures to balance its operating budget, although a high backlog of deferred capital spending and reliance on MLTT Tax will remain significant challenges
DBRS	• The City's AA stable rating is supported by: 1) large and dynamic economy as the leading commercial centre in Canada 2) low current debt burden 3) considerable base of liquidity and reserves to manage unforeseen events • Constraining the ratings are the longer-term challenges associated with renewing aging infrastructure and the need for major investment in transit • Reliance on MLTT, exposing a modest but rising share of the operating budget to dynamics of the local housing market

As noted in the above comments, the City of Toronto is still considered to have a relatively low debt burden, although the Credit Rating Agencies note that rising capital requirements will lead to higher borrowing levels in future years.

City's Debt Ratio Policy and Strategies to Maximize Capital Investment

One key reason for the City's relatively low burden is the City's self-imposed debt ceiling that limits the debt service costs (annual principal and interest payments) to no more than 15% of property tax revenues on average over the ten-year capital plan. The 2018 approach, similar to the one in 2017, of keeping the average 10-year debt ratio below 15% represented a relaxation of the City's debt ratio policy of limiting debt service charges to 15% of the property tax revenues in a budget year. The City is well below the provincial legislative debt service ratio requirement of 25% of own-source revenues (City's Debt Service/Own-Source Revenue is 8.1%).

Two strategies were employed in 2018 to prioritize any available funding to critical unmet needs, such as State of Good Repair including energy retrofits, AODA compliance, Transformation, modernization and innovation projects with financial benefits and high-need social infrastructure capital projects:

- Realignment of annual cash flow estimates were examined to more realistically match the cash flow of project timelines and stage-gating for major capital projects was implemented which released some debt room for critical unmet needs in the first 5 years, especially 2018, of the Capital Plan's timeframe

- The incremental commitments in Provincial Gas Tax, $1.096B over the 10 years, under the Dedicated Gas Tax Funds for Public Transportation Program provided additional funding for Transit projects also increased debt room for critical unmet needs

The strategy of growing capital from current (CFC) contributions by 10% annually is another reason for the City's relatively low debt burden. The City employs debt as a last resort and when all other sources of funding have been maximized. The City's "pay-as-you-go" funding strategy or Capital-from-Current ("CFC") funding uses an allocation of tax funding that is transferred from the Current Operating Fund to the Capital Fund in order to finance capital projects and reduce reliance on debt issuance.

Debt Metrics used by Credit Rating Agencies

Credit rating agencies look at a variety of debt metrics. As illustrated below, the City of Toronto's debt levels are comparable or lower than other major Canadian municipalities, including those municipalities currently assessed a AAA rating.

	Toronto	**Montreal**	**Ottawa**	**Peel Region**	**Vancouver**	**York Region**
Credit Opinion Date:	**July 2017**	**July 2017**	**Oct. 2017**	**Aug. 2017**	**Aug. 2017**	**Aug. 2017**
Debt Service/Capita	256	442	209	93	61	221
Debt Service/Total Revenue	5.4%	15.1%	5.3%	3.8%	3.3%	12.2%
Interest as a % of Operating Revenues	2.8%	8.1%	2.9%	3.2%	2.7%	6.6%
Net Debt/Operating Revenue	47.9%	94.9%	64.5%	79.7%	51.9%	145.2%
Credit Rating - Moody's	Aa1	Aa2	Aaa	Aaa	Aaa	Aaa
Equivalent Credit Rating	(AA+)	AA	AAA	AAA	AAA	AAA

Sources: *Moody's Investors Service except Debt Service/Capita*

Debt Service/Capita is based on 2016 Financial Information Returns for Ontario muncipalities and Annual Report information for other muncipalities

The credit rating agencies have advised City staff that the ratings consider not only current debt levels, but also the forecast. While they have indicated that there is no specific threshold of rising debt levels that would necessarily result in a credit rating downgrade, a significant change in debt service policy that escalates debt services growth could result in a change in the City's credit rating outlook to negative from the current level of stable. A credit rating downgrade could subsequently occur if no action is taken to improve the situation and other credit rating factors also deteriorate.

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