COUNCIL REPORT

Edmonton

DEBT MANAGEMENT FISCAL POLICY UPDATE

RECOMMENDATION

That the October 17, 2022, Financial and Corporate Services report FCS1494, be referred to the November 14/15, 2022, City Council meeting, for the purpose of City Council holding a Statutory Public Hearing on the revised Debt Management Fiscal Policy C203D as outlined in Attachment 1.

Requested Council Action		Information only	
ConnectEdmonton's Guiding Principle		**ConnectEdmonton Strategic Goals**	
CONNECTED This unifies our work to achieve our strategic goals.		**N/A**	
City Plan Values	N/A		
City Plan Big City Move(s)	N/A	**Relationship to Council's Strategic Priorities**	Economic Growth Conditions for service success
Corporate Business Plan	Managing the corporation		
Council Policy, Program or Project Relationships	• C203C Debt Management Fiscal Policy • C624 User Fees and Fiscal Policy on Revenue Generation • Capital Budget		
Related Council Discussions	• 2008COF061, City Council, July 23, 2008 • FCS01169, City Council, June 7, 2022 • FCS01168, City Council, June 7, 2022		

Executive Summary

- The City uses debt to finance a significant portion of its capital budget and build infrastructure for a growing City.

DEBT MANAGEMENT FISCAL POLICY UPDATE

- The City of Edmonton is currently subject to limits both for total debt and debt servicing set by the *Municipal Government Act* (MGA).
- In 2008, the Council adopted the City's current debt policy, City Policy - C203C Debt Management Fiscal Policy taking a more conservative approach than what is mandated by the *MGA Debt Limit Regulation* by further constraining the limit for total debt servicing and tax-supported debt servicing.
- The *City of Edmonton Charter, 2018 Regulation* was formally approved by the Alberta Cabinet in April 2018. The charter regulation permits the City of Edmonton to establish its own debt and debt servicing limits, so long as the City obtains an external credit rating and establishes its own debt limit policy and debt servicing policy. The charter regulations also specify that, before establishing a debt limit policy and debt servicing policy, City Council must hold an advertised public hearing.
- Administration reviewed and proposes updates to the Debt Management Fiscal Policy to establish a new internal debt limit and revised internal debt servicing limits. The proposed updated City Policy C203D - Debt Management Fiscal Policy is included as Attachment 1.

REPORT

Background

Historical Context

The City of Edmonton managed tax-supported debt in the 1970's by setting a limit on the amount of new debt that could be issued each year. New debt was generally issued for 25-year terms. Tremendous growth pressure at the end of the 1970's to support a resource boom cycle led to a relaxation of the total debt limit, resulting in a threefold increase in annual borrowing and Edmonton's tax-supported debt being higher than most other major Canadian cities.

The recession and high interest rates of the early 1980's prompted a revised debt management strategy in the 1990's. New tax-supported debt issues were limited to $25 million per year, with a five-year repayment term. This revised strategy also prohibited new tax-supported borrowing after 1990. Subsequent to 1990, a pay-as-you-go approach was adopted for tax-supported capital projects as a response to the debt challenges of the 1980's.

In 2002, pay-as-you-go as a strict financial strategy was abandoned as it became impossible to provide the infrastructure required to support a growing city without large increases in taxation to pay for costly assets on a cash basis. The City's financial debt was not growing but its infrastructure deficit was becoming significant. At that time, the City estimated a gap between available infrastructure funding and the cost of infrastructure required to support a growing city to be in excess of $4 billion.

Tax-supported debt was reintroduced with a revised debt management fiscal policy (DMFP) in 2002. At that time, a $250 million borrowing guideline was established with $50 million per year allocated over five years for debt-financed projects. As growth pressure continued to accelerate, a revised Debt Management Fiscal Policy C203C was approved in 2008 that is still in effect in 2022 (Attachment 2). A table comparing Policy C203C to the new recommended Policy C203D is included in Attachment 3.

DEBT MANAGEMENT FISCAL POLICY UPDATE

Why the City Uses Debt

There are several reasons that the City uses debt to optimize its capital infrastructure program. The City borrows to advance large projects without having to accumulate enough in savings to pay for all of the cost at one time. The accumulation of savings to pay for significant infrastructure projects can mean that the taxpayers paying for the projects are not those that benefit from them. This concept is referred to as generational equity. Users of a capital project will likely change over its useful life, and applying a principle of fairness would suggest that costs should be paid by everyone who will use the infrastructure over time. Therefore, well-managed and prudent debt financing over a longer-term can be considered more equitable than using funds collected and accumulated over time from current and prior residents who may not get to benefit from future improvements.

Under a pay-as-you-go approach it can be difficult to accumulate and hold funds over long periods of time necessary to accumulate sufficient funding to advance capital growth as public expectation is that taxes that are paid are put to use in the short-term. Just as it is difficult to tax the public and not spend the funds for extended periods of time it is also difficult to require significant one time tax increases to fund required capital expenditures.

The City's large capital program does not use resources at a consistent rate. Even though the City currently engages in long-term planning for capital infrastructure, generating a 10-year Capital Investment Outlook every four years and approving a four-year capital budget, the need for capital expenditures is not consistent annually, particularly for new infrastructure. Even with a consistent and significant annual contribution of taxes and grants to fund infrastructure, it would not be possible to move forward with significant capital growth projects like LRT without using debt. The City could not stop funding all other capital requirements in any given year to advance a single large project. Debt financing allows the City to smooth out significant peaks in required expenditure.

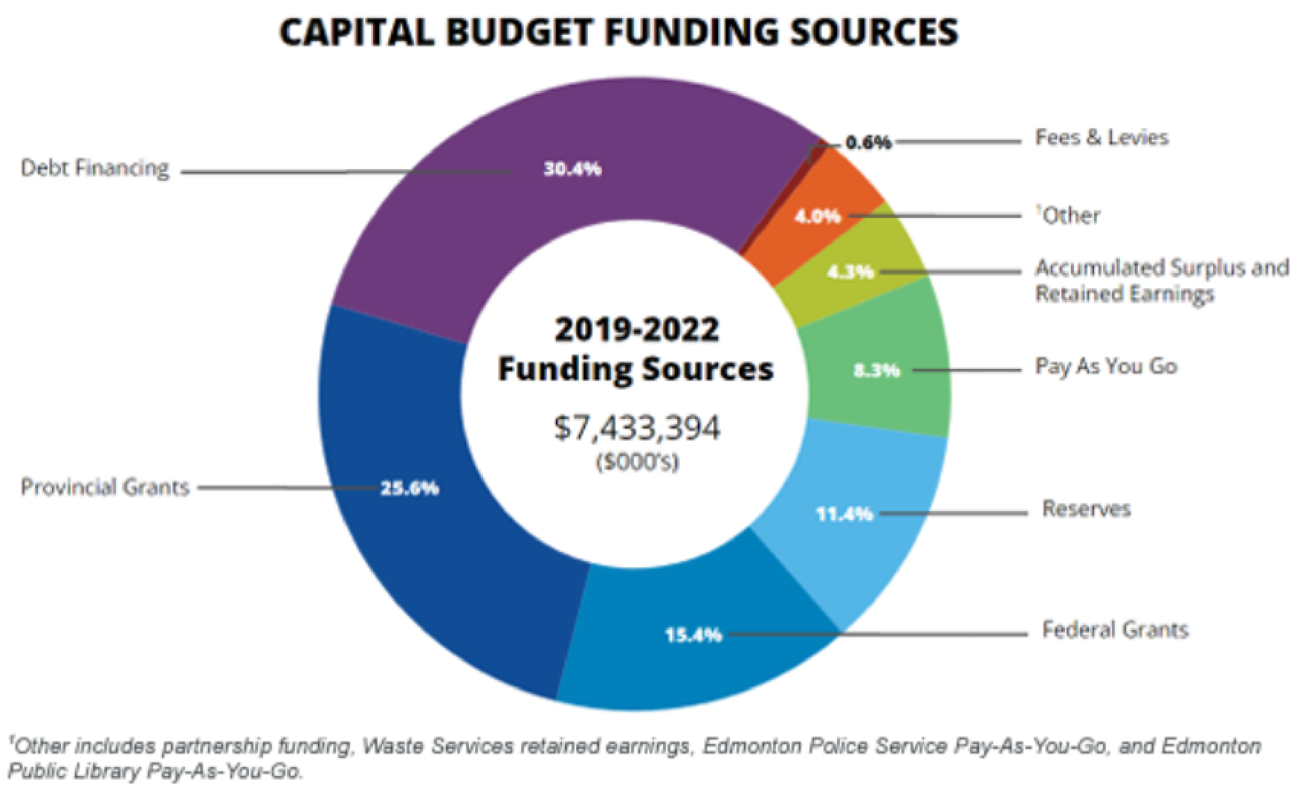
Maintaining the infrastructure the City already has is also important. The City of Edmonton is responsible for stewarding a wide range of assets on behalf of Edmontonians with a replacement value of $31.2 billion and growing each year. Based on a recent analysis shared in the Capital Investment Outlook 2023-2032, over the next 10 years, the City expects a $4.7 billion gap between ideal investment levels and forecasted revenues. Assets must be renewed and upgraded throughout their lifecycle to ensure they are safe and deliver on defined service levels while meeting resident expectations. Appropriate stewardship requires that cost-effective decisions are made in terms of when and how to maintain, repair, renew, and replace the vast network of assets that serves the diverse needs of a steadily growing metropolitan population. The challenge of uneven capital expenditures applies to renewal and rehabilitation, as well as to new infrastructure. The need to borrow for capital renewal projects does not happen often, but is an option that should be available in order to smooth out significant peaks in required expenditure. Without the ability to borrow for large scale renewal, funds would need to be saved for long periods of time to undertake projects with significantly higher than average capital renewal cost. Previously, the City has borrowed to fund major renewal projects such as the Walterdale Bridge rehabilitation, Stadium LRT Station upgrade and Stanley A. Milner Library.

The other challenge that arises from saving money for cash purchase of large infrastructure relates to the possible negative carrying costs. With varying economic conditions and the impacts of inflation, it is not always possible to earn a return on the investment of public funds required to offset the inflationary impacts on the cost of infrastructure. In other words, the cost of construction sometimes increases faster than earnings on investments, which means that waiting to construct certain infrastructure can be more expensive in the long-term.

Debt financing also helps the City to optimize its capital funding, as some grant programs from other orders of government require matching funds. Without the use of debt, the City could potentially be unable to access hundreds of millions of dollars of grant funding.

What the City Uses Debt For

Unlike other orders of government, most municipalities do not borrow for operating expenditures, and only borrow to help pay for City infrastructure. In contrast, federal and provincial debt often accumulates to cover annual operating deficits. The City's 2019-2022 capital budget is funded through various funding sources, with debt used to finance just over 30 per cent of the capital budget.



Reflects the capital budget and funding sources as approved in the Fall 2021 Supplemental Capital Budget Adjustment.

Details of outstanding debt as of June 30, 2022 based on currently approved capital projects using debt financing are included in Attachment 4. Some of the larger projects with outstanding debt include:

- Valley Line Southeast LRT - $674 million
- Rogers Place - $441 million
- Yellowhead Trail Freeway Conversion - $250 million
- Waste Management - $222 million
- Capital Line South LRT from Health Science Station to Century Park - $221 million
- Multi-Purpose Recreation Centres (Meadows, Clareview, North Central) - $208 million
- Valley Line West LRT - $202 million

Attachment 5 provides a summary of debt financing by asset type from 2003 to 2021. The analysis shows that the City has used debt to mostly finance LRT, facility and road infrastructure during this period, as well as drainage infrastructure when the drainage utility was managed by the City, prior to its transfer to EPCOR in 2017.

Types of Debt

Borrowing is a method of financing capital projects. It is not a funding source itself. When debt is used to finance a project, the funds to pay for that debt need to be identified. The first consideration in determining if debt is a reasonable way to finance a project is to understand what funds will be used to pay for the principal and interest payments.

The City has two primary categories of debt based on the source of funding used to pay for it: tax-supported and self-liquidating.

For debt categorized as tax-supported, the funding source for servicing the debt is general property tax. The category of tax supported debt is then broken down further based on whether the primary source of funding for making the payments on the debt is general property taxes or some other source such as grants from other orders of government, user fees, lease payments or Community Revitalization Levy revenues. This sub-category is referred to as self-supporting tax-guaranteed debt. Self-supporting tax-guaranteed debt is included as tax-supported debt in calculating how much debt room is consumed because the City would be required to fund the debt payments using property tax revenues if for some reason there was a shortfall in the debt-servicing revenue source used to service the debt (for example if a grant was cancelled).

The second category of debt is self-liquidating debt, which is predominantly debt incurred on behalf of the City's Waste Services Utility, local improvements[1], and Blatchford Renewable Energy Utility. The primary difference is that the funding source for self-liquidating debt comes from a source other than general property taxes, but is a source the City controls and is therefore guaranteed. In the case of utility debt, it is paid for out of utility rate revenue; City Council is the authority that approves the utilities' rates.

As at June 30, 2022 around 85 per cent of the City's total outstanding debt is tax-supported. This is forecast to grow to 89 per cent by the end of the 2023 - 2026 Budget Cycle, based on currently approved debt projects. The remaining 11 to 15 per cent is self-liquidating debt.

[1] Local improvements are projects that are of greater benefit to an area of the City than to the whole City, and are paid for by the property owners who are the recipients of that benefit. Even though the debt associated with local improvements is paid for through a property tax, it is not a general tax. Therefore, local improvement debt is considered to be self-liquidating debt.

DEBT MANAGEMENT FISCAL POLICY UPDATE

Current Framework

From the period 1993 through to 2020 borrowing was generally in the form of amortizing debentures administered by the Alberta Capital Finance Authority (ACFA). In 2019 the Province introduced legislation to dissolve the ACFA and by mid-2020 the City began borrowing directly from Treasury Board and Finance.

<u>MGA Debt Limits</u>

The City of Edmonton is subject to limits both for total debt and debt servicing (the principal and interest payments on debt) set by the *Municipal Government Act* (MGA). Section 271 of the MGA allows the Minister of Municipal Affairs to make regulations respecting how a debt limit for a municipality is determined. The MGA *Debt Limit Regulation* specifies that the total debt limit is two times the revenue of the municipality, and in respect of the City's debt servicing, is 0.35 times the revenue of the municipality.[2] These proportional debt and debt servicing limits mean that as revenues grow, the debt and debt servicing limits increase.

The ACFA had its own credit policy that required any municipality with no credit rating, or with a credit rating less than "A" with debt levels above 75 per cent of the MGA limit, to greater credit scrutiny prior to loans being granted. This meant that for debt servicing, the ACFA would subject municipalities to greater scrutiny if their debt servicing was greater than 26 per cent of eligible revenues (75 per cent of the MGA debt servicing limit - 35 per cent of revenues).

<u>Current DMFP Debt Limits</u>

In developing its existing City Policy C203C - Debt Management Fiscal Policy (approved July 23, 2008), the City took a more conservative approach than what is mandated by the MGA by constraining the limit for total debt servicing for both tax-supported debt and self-liquidating debt to 22 per cent of City revenues. The policy further constrained tax-supported debt servicing, which includes self-supported tax guaranteed debt, to 15 per cent of Tax Levy revenue. These limits were established when the current policy was developed in 2008.

Given that the City's approach to debt just prior to the policy being developed was extremely risk-averse, limiting total debt to $250 million dollars at $50 million per year from 2002 to 2007, the City acknowledged the need to provide greater flexibility for the use of debt while at the same time maintaining a fiscally conservative approach to debt. When the current policy was drafted in 2008, it achieved this by setting the debt servicing limit at 85 per cent of the trigger percentage set by ACFA for the need for a municipality to undergo a credit review. Administration took a more conservative approach, and recommended setting the percentage for total debt servicing at 85 per cent of ACFA's 26 per cent credit review trigger. This resulted in the 22 per cent total debt servicing limit in the City's current policy. The approach was taken at the time to ensure that debt remained affordable and sustainable.

The split between tax-supported and self-liquidating debt servicing was based on projections at the time about required capital investments for City utilities and local improvements, and ensuring adequate debt servicing room was available for self-liquidating debt. This resulted in the policy

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[2] The revenue for purposes of this calculation is the consolidated revenue of the City, less capital government transfers and developer contributed tangible capital assets and excludes revenue from EPCOR.

placing constraints on debt servicing of 15 per cent of tax levy revenue for tax-supported debt to ensure that the limit of 22 per cent of City revenues for total debt servicing would not be reached.

Effective September 1, 2017, the City transferred all drainage services to EPCOR Water Services Inc. (EWSI). At the time of drafting the 2008 DMFP, the projected self-liquidating debt room to meet future capital needs of City utilities and local improvements is what determined the 15 per cent tax-supported debt servicing limit. A significant portion of self-liquidating debt was issued for drainage infrastructure. Without the need for the City to borrow for drainage any longer, with exception of local improvements for underground EPCOR drainage and water infrastructure, the City's debt servicing limits, as currently defined, may now be less relevant.

Edmonton City Charter

The *City of Edmonton Charter, 2018 Regulation* (the Charter) was formally approved by the Alberta Cabinet in April 2018. The Charter contains policy tools that provide the City with increased authority or flexibility in areas such as administrative governance, assessment and taxation, city planning and environment.

The Charter permits the City of Edmonton to set its own debt limit and debt servicing limit, so long as the City obtains an external credit rating and establishes its own debt limit policy and debt servicing policy. The Charter also specifies that, before establishing a debt limit policy and debt servicing policy, City Council must hold a Statutory Public Hearing.

Municipal Comparisons

Administration completed a review of the debt and debt servicing limits of other municipalities across Canada. A summary of the findings are included in Attachment 6. The cities included in the review were Calgary, Vancouver, Toronto, Montreal, Ottawa, St. John's, and Winnipeg.

Edmonton has the third highest debt per capita compared to the selected cities. If the debt servicing limits used by other municipalities were applied to Edmonton, in most cases the City would have less debt servicing room compared to existing DMFP debt servicing limits. In addition to having one of the highest debt per capita and one of the more flexible debt policies in terms of debt servicing limits, the City also has one of the lower credit ratings ("AA") amongst the municipalities assessed in the review. In the most recent S&P (Standard and Poor's) credit rating for Edmonton, S&P indicated that it expects the City to be conservative in its use of debt in the next budget cycle, and that Edmonton would put itself at risk of a downgrade if there were further sustained increases to the direct debt burden (debt as a percentage of revenues).

In establishing debt servicing limits, the City should be cognizant of its existing debt burden, affordability of debt, and the financial health of the City.

Factors in Establishing Debt Servicing Limits

While debt is an essential financial tool for municipalities to advance their long-term capital plans, it is not a funding source itself; borrowing is a method of financing capital projects. When debt is used to finance a project, the funds to pay for that debt need to be identified. The first consideration in determining if debt is a reasonable way to finance a project is to identify what funds will be used to pay for the principal and interest payments. In its second consideration, the City must determine how much it can reasonably afford to dedicate to making debt payments.

Consideration should be given to the affordability of debt, the financial sustainability and health of the City, as well as long-term capital planning. Debt is an ongoing component of the City's capital financing structure and is integrated into the City's long-term plans and strategies.

Tax Tolerance

It is important that the City does not just borrow up to the MGA regulated debt and debt service limits, without gauging what is appropriate or optimal for Edmonton and affordable for the City. Just like a homeowner might not want to spend as much on mortgage payments as the bank is willing to allow them, the City has to consider what other uses it has for funds that could be used to pay for debt. The potential allocation of 35 per cent of Edmonton's tax levy revenue to debt servicing would be significant for an organization that has large operating expenditures associated with day-to-day programs and services that Edmontonians rely on and expect. The operating impacts of servicing new debt need to take into consideration both budgetary constraints and tax tolerance limits (a measure of affordability).

Tax tolerance is guided by the desired services and service levels, including asset infrastructure growth and renewal that impact the lives of Edmontonians. Edmontonians and Council make choices on the level of services provided and the types of capital assets that are built and maintained, balancing quality of life and financial considerations.

Debt servicing impacts are generally a significant contributing factor to the net operating requirements that drive tax increases. The tolerance that taxpayers have for tax increases varies: when the economy is prospering and business revenues and household income growth is high, there is tendency for tax tolerance to increase; conversely, when economic times are challenging, tolerance for tax increases typically declines.

While borrowing should always consider the broader context of other budget constraints, during times of low tax tolerance this consideration is particularly significant. Affording all the various inflationary and growth pressures under a low tax increase can be challenging, particularly if debt impacts are significant. If budgetary impacts of debt servicing are large under periods of fiscal constraint, it might mean that the City will have to make budget reductions in other areas, or adjust operational spending for programs and services.

In the 2023-2032 Operating Investment Outlook that was presented to City Council on June 7, 2022 (Financial and Corporate Services report FCS01168), it was estimated that debt servicing impact over 2023-2026 budget cycle would require an estimated one to two per cent tax levy increase per year based on currently approved debt financed projects.

Interest Rates

One factor often raised as a consideration in whether or not to borrow is the level of interest rates. While interest rates should be considered, low interest rates should not be the only consideration in determining whether or not to borrow. A City's level of borrowing should consider affordability and what amount is reasonable to spend on debt payments. Based on current interest rates, borrowing $100 million in tax-supported debt at current rates for a 25-year borrowing (5.05 per cent), would result in $7.1 million in annual tax-supported debt servicing, equivalent to a 0.4 per cent tax increase.

Once a reasonable amount to spend on debt payments is determined, interest rates affect the amount of debt that could be incurred. In times of low interest rates, debt is leveraged to provide greater value than when interest rates are high. For example, for a homeowner who can afford to pay a $2,000 a month mortgage payment, if the interest rate on the mortgage is three per cent, the homeowner could borrow approximately $360,000 over 20 years. If the interest rate was six per cent, the homeowner could borrow approximately $280,000 over 20 years.[3]

The impact of higher interest rates is the same for the City as for a homeowner. The higher the interest rates, the less debt the City can afford to take on for a given amount of debt servicing. Careful consideration should be given to current interest rates and the proportion of operating expenditures allocated towards debt servicing payments prior to approval of new debt.

By borrowing through the provincial Treasury Board (previously Alberta Capital Financial Authority) the City is able to secure a fixed interest rate over the term of the borrowing for a capital project. This helps eliminate the volatility associated with fluctuating interest rates and provides a level of predictability from a budgeting perspective. The City does not borrow in advance; rather, borrowing is done in an effort to match debt proceeds as closely as possible with capital project expenditures. This avoids paying interest on debt that is not being effectively utilized. Furthermore, Administration does not borrow based on interest rate speculations.

In December 2021, the provincial government announced new loan pricing for local authorities that included an increase of approximately 0.5 per cent to 0.75 per cent over rates the City received in the past. The Bank of Canada has also increased its policy interest rate target four times since March 2022 to address high inflation. These rate increases are pushing provincial loan pricing rates for local authorities higher at a relatively rapid pace. This will impact the City's operating budget by requiring additional tax-levy to fund future debt servicing on projects currently under construction for which borrowing has not yet been initiated and for new projects financed with tax-supported debt. Further increases to the City of Edmonton's debt will not only be more costly, they could also impact its credit rating by further increasing the City's debt burden, especially if debt financing is relied on heavily in the 2023-2026 Capital Budget. For context, for a $100 million of borrowing over 25 years, every one per cent increase in interest rate results in an estimated annual increase in debt servicing of $0.7 million (total cost of borrowing increases by $17.5 million over the 25 year life of the loan).

<u>Maintaining Credit Ratings</u>

Credit rating agencies typically assess the financial sustainability of the City by calculating key ratios relevant to debt management. These key ratios are the balance after capital accounts, which is total operating and capital revenues less operating and capital expenditures, and direct debt percentage, which is outstanding debt as a percentage of operating revenues. Credit rating agencies also consider other critical risk factors in their rating of municipalities, such as financial management, economic variables, budgetary performance, and debt and liquidity management.

Significant increases in debt or debt servicing levels have the potential to negatively impact the City's credit rating. A downgrade to the City's credit rating can have both reputational and financial

[3] This assumes the interest rate stays the same for the entire twenty years of the mortgage.

impacts. Administration does not recommend increasing the City's debt level to a point that would trigger a credit rating downgrade. When establishing debt and debt servicing limits, it is critical to develop them in consideration of the thresholds where credit ratings may be downgraded. Risks for a credit rating downgrade include:

- **Reputational Risk** - A downgrade to the City's credit rating would indicate to lenders and the public that the City' financial health is trending downwards.
- **Cost of Borrowing** - A downgrade to the City's credit rating could result in higher borrowing costs if the City is deemed higher risk.
- **Ability to Borrow** - A downgrade to the City's credit rating could subject the City to greater credit scrutiny with its lenders.

In 2019, the City's lone credit rating agency, S&P, downgraded the City's credit rating from AA+ to AA. At that time, S&P noted that the downgrade "reflects Edmonton's significant capital spending plans and corresponding growth in debt over the next several years." In 2022, S&P, affirmed its AA rating for the City of Edmonton. The stable outlook reflected S&P's expectation that "the city's execution of the capital plan will not result in a significantly higher reliance on debt or internal resources relative to [their] current expectations."

The existing and proposed Debt Management Fiscal Policy aligns with the Government Finance Officers Association's (GFOA) best practice requirement, which recommends that local governments adopt comprehensive written debt management policies, including procedures related to issuance and administration of debt, and set specific limits of acceptable ranges for each type of debt.

Alternative Debt Servicing Limit Measures

As shown through the jurisdictional scan in Attachment 6, all other big cities in Canada with self-imposed debt servicing limits set limits at some per cent of revenues or expenditures. Alternative measures are discussed in Attachment 7, including percentage of Edmonton gross domestic product, consumer inflation, and percentage of aggregate household income.

Generally, the alternative measures are not reflective of the City's ability to pay for debt for various reasons. Although some alternative measures may to some degree correlate with the City's ability to afford debt payments, these correlations are imperfect. Leading practice across other municipalities indicates that using revenues and/or expenses as the basis for determining the ability of a municipality to pay for debt is most appropriate. Intuitively speaking, revenues reflect how much funding is available to pay for all City expenses, including debt servicing. Furthermore, setting debt servicing as a percentage of expenses limits debt servicing to a portion of the operating budget that is reasonable based on Council's goals and objectives.

As a result, Administration suggests establishing a debt servicing limit as a percentage of revenues or expenditures. The approach recommended by Administration is discussed further under the proposed debt servicing limits.

Proposed Debt Servicing Limits

From a financial sustainability and affordability perspective, maintaining a strong credit rating is a reflection of the City's ability to manage its debt burden, and allocate a reasonable portion of the operating budget towards debt servicing payments.

Administration is proposing debt servicing limits for total debt servicing, which includes tax-supported debt servicing and self-liquidating debt servicing, and separate limits exclusively for tax-supported debt servicing. The proposed policy also incorporates more restrictions on borrowing as debt servicing increases, allowing the City to continue to advance key priorities, while using debt in a prudent manner.

<u>Tax-Supported Debt Servicing</u>

Tax-supported debt servicing is funded through property taxes and new borrowings result in tax-levy increases to service that debt. Tax-supported debt and debt servicing needs to remain affordable for the average citizen, and tax tolerance needs to be considered when establishing these limits.

Because the City's existing per-capita debt levels and tax-supported debt servicing limits are among the highest among comparable Canadian cities, Administration recommends a debt servicing limit that allows for tax-supported debt servicing as a percentage of tax-supported net expenditure similar to currently forecasted peak levels, based on approved borrowing to date. From both an affordability and financial sustainability perspective, this allows tax-supported debt servicing to grow at a level consistent with overall tax-supported expenditures, and avoids tax-supported debt servicing outpacing other tax-supported expenditures.

As of December 31, 2021, tax-supported debt servicing was 10.5 per cent of tax-supported net expenditures as reflected in the City's 2021 consolidated financial statements, and is expected to peak at just over 16 to 17 per cent of tax-supported net expenditures in 2026-2027 based on currently approved borrowing.

Administration proposes establishing the tax-supported limit at 18 per cent of tax-supported net expenditures, which would allow for minor increases in current tax-supported debt servicing levels compared to overall tax-supported net expenditures, while still holding tax-supported debt at a reasonable level of tax-supported expenditures.

There is no clear best practice when determining the percentage of revenues and expenses to use to establish tax-supported debt servicing limits. Review of limits used by other municipalities showed a range from 7.5 per cent to 17.5 per cent of property tax revenues or expenditures for a limit. Furthermore, expenditures and revenues were defined differently across the municipalities. Ultimately, each city selects a limit that meets its goals and objectives and is based on its specific circumstances and needs.

Establishing a tax-supported debt servicing limit based on percentage of expenditures was chosen for two main reasons. First, this is consistent with how the City discusses its tax-supported operating budget; often categories of expenses are shown as a percentage of the overall expense budget. Setting debt servicing as a percentage of expenses limits debt servicing to a portion of the operating budget that is reasonable based on Council's goals and objectives. Second, it uncouples the limit calculation from tax levy revenues that are used to fund tax-supported debt. A perceived shortcoming of the City's existing calculation is that by issuing more tax-supported debt, increases to the tax levy are commonly required, which then increases the tax-supported debt limit.

Tax-supported borrowing, including self-supported tax-guaranteed debt, up to and equal to the 18 per cent tax-supported debt servicing limit can be used for large infrastructure projects with long-term benefits to the community at large that are aligned with corporate priorities and approved strategic plans, growth projects, major rehabilitation of existing assets as a short-term strategy to eliminate a significant backlog and address urgent renewal needs, and for emergency capital purposes (as defined within the policy). The policy defines an emergency as a situation that could not have reasonably been anticipated, and is urgent, critical and of a temporary nature that pertains only to the City's capital assets.

Tax-supported borrowing in this range is unconstrained, flexible, can be used without limitation, and allows for 100 per cent tax-supported debt financed projects.

Tax-supported borrowing, including self-supported tax-guaranteed debt, that results in tax-supported debt servicing exceeding the proposed 18 per cent limit would be restricted to projects where debt is used by the City to match funding for projects that have a minimum of one-third funding from external sources (government grants, external funding, etc.), or for emergency capital purposes.

Tax-supported borrowing in this range is restricted to ensure affordability, and does not permit 100 per cent tax-supported debt financed projects, unless for emergency capital purposes.

<u>Total Debt Servicing</u>
Total debt servicing includes tax-supported, self-supported tax-guaranteed, and self-liquidating debt servicing (funded through non-tax revenues). There are two proposed limits:

- The first limit is set at 21 per cent of City revenues, and
- The upper limit is set at 26 per cent of City revenues.

The first limit of 21 per cent of City revenues is based on maintaining a strong credit rating of at least AA (the City's current credit rating). As part of the credit rating process for the City of Edmonton, S&P Global Ratings evaluates the City's direct debt level, which is the ratio of total debt over revenues. Based on a review of the details of previous credit rating reports for the City, Administration believes that close to 240 per cent direct debt, calculated as total outstanding debt divided by total operating revenues, S&P would likely consider downgrading the City's debt rating. At this level of debt burden a larger portion of the City's budget would be allocated towards debt servicing, which would likely begin to negatively impact the City's financial health. The 240 per cent direct debt threshold corresponds to a total debt service level of 21 per cent of City revenues.

Total debt servicing between zero and 21 per cent of City revenues is allowed for large infrastructure projects with long-term benefits to the community at large that are aligned with corporate priorities and approved strategic plans, growth projects, major rehabilitation of existing assets as a short-term strategy to eliminate a significant backlog and address urgent renewal needs, and for emergency capital purposes (as defined within the policy). Tax-supported borrowing within this range must follow the tax-supported debt service limits and related constraints where applicable.

The upper limit of 26 per cent of City revenues is based on 75 per cent of the MGA debt servicing limit of 35 per cent of City revenues, which equates to 26 per cent of those same revenues. The province has its own credit policy that requires any municipality with no credit rating, or with a credit rating less than “A” with debt levels above 75 per cent of the MGA limit, to greater credit scrutiny prior to loans being granted. Although the City currently has a credit rating, and is not currently at risk of a credit rating of less than “A”, by reaching this limit the City would have met one of the considerations that would result in the province applying more security to borrowing.

Once total debt servicing exceeds 21 per cent of City revenues, borrowing is restricted for emergency purposes only up to 26 per cent of City revenues. Borrowing in this range allows for one-hundred per cent tax-supported debt financed projects as the borrowing is only permitted for emergency purposes.

Administration’s proposed debt servicing limits are summarized in the table below:

<table>
<tr><th>Debt Servicing Limit</th><th>Description</th><th>Rationale for Limit</th></tr>
<tr><td colspan="3">Tax-Supported Debt Servicing Limits</td></tr>
<tr><td>Less than 18% of tax-supported net expenditures

(Unconstrained)</td><td>Tax-supported borrowing in this range, including self-supported tax-guaranteed debt, is <u>unconstrained</u> and can be used for the following types of capital projects:
Large infrastructure projects with long-term benefits
Projects with benefits to the community at large
Growth related projects
Projects aligned with corporate priorities and approved strategic plans
Major rehabilitation of existing assets as a short-term strategy to eliminate a significant backlog and address urgent renewal needs
Borrowing for emergency capital purposes*
Projects financed through self-supported tax- guaranteed debt
Allows for 100% tax-supported debt financed projects</td><td>As of December 31, 2021, tax-supported debt servicing is 10.5% of the tax-supported net expenditures.
The City currently has a credit rating of AA, and based on the last credit rating report is at the risk of a downgrade if debt levels continue to rise.
Based on this, Administration proposes maintaining a tax-supported debt servicing level as a percentage of tax-supported net expenditures equivalent to current levels.
The proposed tax-supported debt limit in this category is 18% of tax-supported net expenditures.</td></tr>
<tr><td>Equal to or greater than 18% of tax-supported net expenditures

(Constrained - tax supported borrowing only)</td><td>Tax-supported borrowing in this range, including self-supported tax-guaranteed debt, is <u>constrained</u> and can be used for the following types of capital projects:
Projects that have a minimum of one-third funding from external sources**, or
Borrowing for emergency capital purposes*, or
Unless for emergency purposes or for projects financed through self-supported tax- guaranteed debt, tax-supported</td><td>This category only allows for tax-supported debt borrowing in order to leverage other external capital funding sources, or tax-supported borrowing required for emergency purposes, or capital projects financed through self-supported tax-guaranteed debt.</td></tr>
</table>

	borrowing in this range prohibits 100% tax-supported debt financed projects. If the project is financed through tax-supported debt, at minimum the project must have one-third funding from an external source.	
Total Debt Servicing Limits		

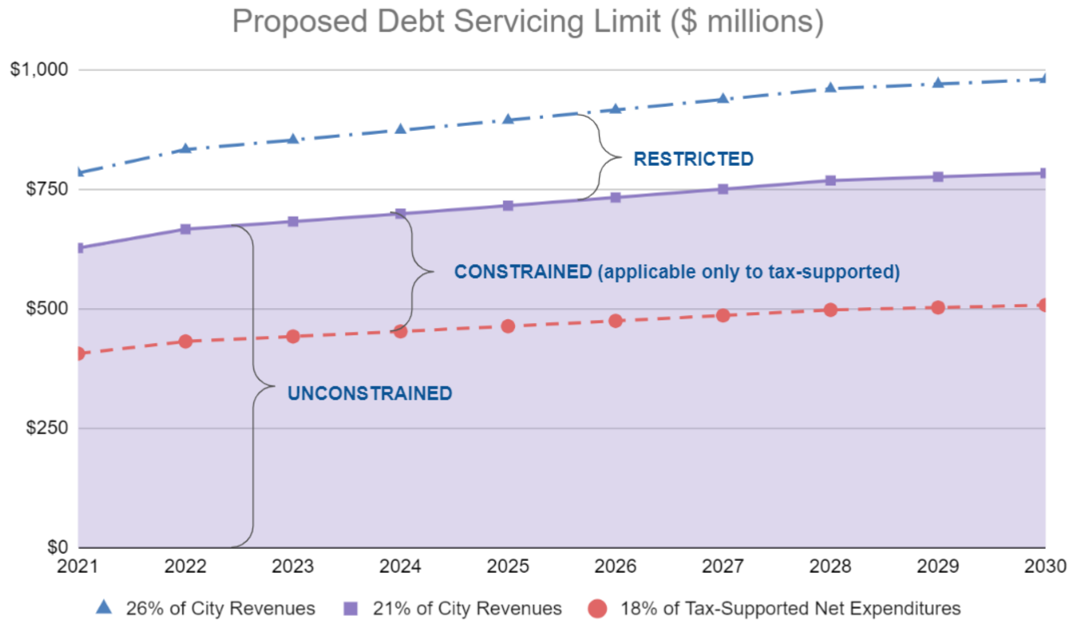
Less than 21% of City revenues	• Total debt servicing includes all tax-supported, self-supported tax-guaranteed and self-liquidating debt servicing.
	• Borrowing in this range is <u>unconstrained</u>, with exception of constrained tax-supported borrowing, and can be used for the following types of capital projects:
	  ○ Large infrastructure projects with long-term benefits
	  ○ Projects with benefits to the community at large
	  ○ Growth related projects
	  ○ Projects aligned with corporate priorities and approved strategic plans
	  ○ Major rehabilitation of existing assets as a short-term strategy to eliminate a significant backlog and address urgent renewal needs
	  ○ Borrowing for emergency purposes*
	
	Tax-supported borrowing within this range must follow the tax-supported debt service limits and related constraints where applicable.
		• Based on credit rating agency practices, debt servicing beyond the equivalent of 21% of City revenues, may trigger a credit rating downgrade, reflecting a degradation of the City's financial sustainability. The 21% of City revenues limit is based on S&P's 240% direct debt threshold, where exceeding this is likely to trigger a credit rating downgrade.
		• The impacts of borrowing beyond the 21% of City revenues limit can be significant for the City's financial condition and debt servicing amounts would impact other operations of the City (i.e. impacts affordability and sustainability of services negatively).

Equal to or greater than 21% of Cityrevenues and up to 26% of City revenues (Restricted)	• Borrowing in this range is restricted and is only permitted for emergency purposes. ***Allows for 100% tax-supported debt financed projects for emergency purposes.***	• The 26% of City revenues limit is calculated as 75% of the 35% MGA debt servicing limit. • Any borrowing where the City exceeds the 26% of City revenues threshold will be scrutinized by the province, and may have a higher interest rate. Debt servicing amounts in this range would negatively impact the City's credit rating. • The impacts of borrowing beyond the 21% of City revenues limit can be significant for the City's financial condition and debt servicing amounts would impact other operations of the City (i.e. impacts affordability and sustainability of services negatively). • Borrowing in this category should only be completed for emergency purposes.

** For the purposes of this policy, an emergency is a situation that could not have reasonably been anticipated, and is urgent, critical and of a temporary nature that pertains only to the City's capital assets that:*
(a) imminently and seriously endangers the lives, health, safety or welfare of people, or
(b) requires prompt action to limit damage to City property, or
(c) compromises the integrity of infrastructure service delivery

***For purposes of this policy, external funding sources include:*
(a) Grants from other orders of government
(b) Partner contributions
(c) Any other funding source that is not a City own-source revenue

The chart below illustrates the three debt servicing limits.



<u>Proposed Debt Limit</u>

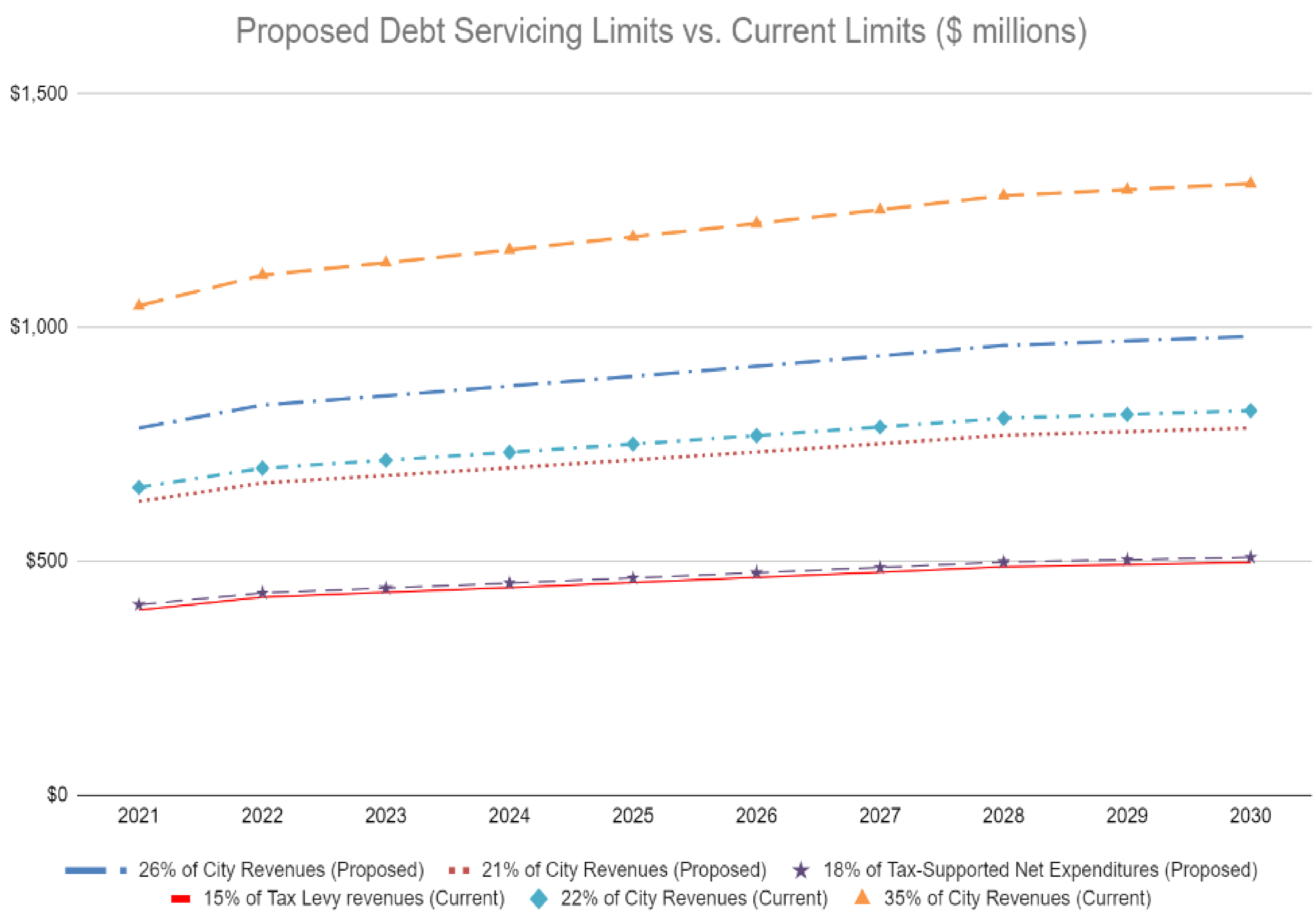
The existing DMFP only provides debt servicing limits and does not provide debt limits, deferring to the MGA debt limit of two times consolidated revenues.

The MGA debt limit (two times consolidated revenues) and debt servicing limit (35 per cent of consolidated revenues) were based on interest rates at the time the limits were established. As interest rates fluctuated, the correlation between the debt and debt servicing limits weakened and the interrelationship between the limits became less purposeful. For example, under the current MGA limits the City is projected to be approximately at 70 per cent of the MGA debt limit by the end of 2025, but only at roughly 40 per cent of the MGA debt servicing limit by 2025. Inherently, the percentage of the limits reached by municipalities should be fairly close to each other and provide the same narrative on use of debt for the municipality.

In accordance with the *City of Edmonton Charter, 2018 Regulation*, the City needs to have an established debt limit. As a result, Administration proposes that a debt limit be based on the maximum proposed debt servicing limit of 26 per cent of City revenues. Establishing this type of fluid debt limit allows it to correspond to the specifically defined debt servicing limit and eliminates the tension between establishing a debt limit under certain interest rate conditions that will certainly change over the long-term. For example, using the proposed debt servicing limit of 26 per cent of City revenues, theoretically the City would be able to take on more debt and still maintain debt servicing at or below 26 per cent of revenues if interest rates decrease. From an affordability and financial sustainability perspective the City is not impacted and should not be limited based on a debt limit calculated on interest rates at a point in time that may no longer be relevant.

Proposed Limits Compared To Existing Debt Servicing Limits

The following chart compares the proposed debt servicing limits, the current MGA debt servicing limit, the DMFP debt servicing and tax-supported debt servicing limits.



In general, the proposed debt servicing limits provide a similar amount of unconstrained borrowing room as the current debt servicing limits in the DMFP, but allows City Council to consider further tax-supported borrowing when matching funding is available from external sources, or for emergency purposes, or for capital projects financed through self-supported tax-guaranteed debt.

The following conclusions can be drawn from the comparison:

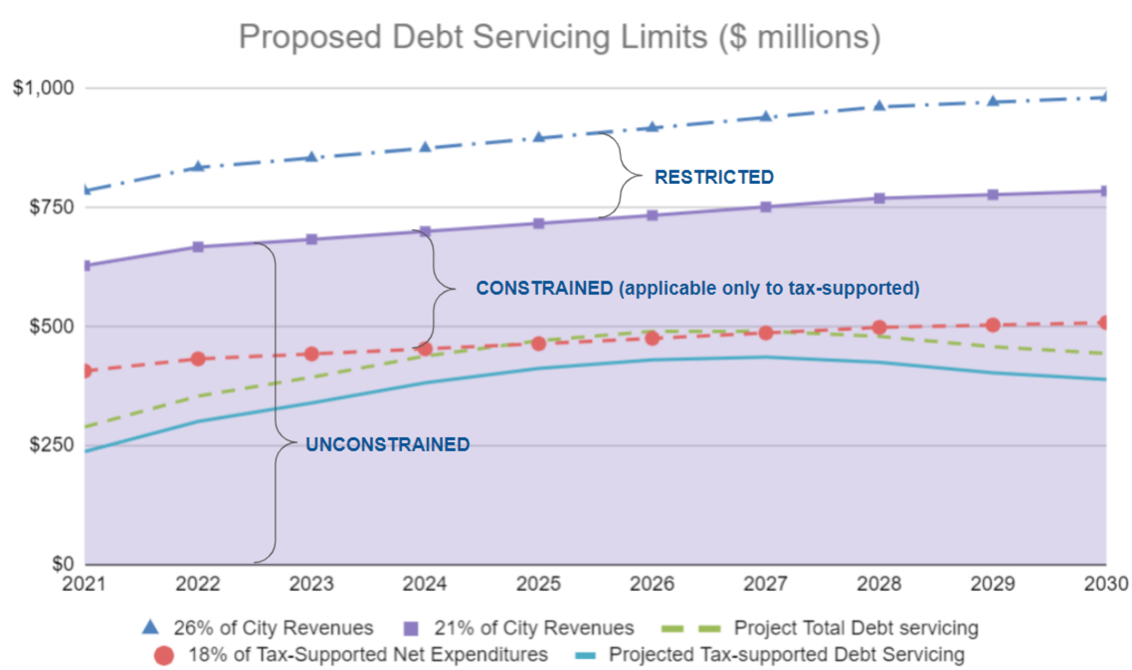
- The highest proposed total debt servicing limit of 26 per cent of City revenues is more restrictive than the MGA total debt servicing limit of 35 per cent of City revenues. The proposed limit still provides a significant amount of borrowing room, and is reasonable based on the risk of credit rating downgrades and greater scrutiny from the province on borrowing.
- The highest proposed total debt servicing limit of 26 per cent of City revenues provides greater ability to borrow for emergency purposes compared to the current DMFP total debt servicing

limit of 22 per cent of City revenues. The additional borrowing capacity is restricted to emergency purposes.

- The proposed total debt servicing limit of 21 per cent of City revenues is fairly consistent with the current DMFP total debt servicing limit of 22 per cent of City revenues, and is established based on a maximum level of debt servicing before the City may be subject to a credit rating downgrade.
- The proposed tax-supported debt servicing limit of 18 per cent of net tax-supported expenditures provides for a similar level of tax-supported debt when compared to the 15 per cent of tax-supported revenue limit in the current DMFP.
- Increased tax-supported borrowing capacity is provided for by allowing tax-supported debt servicing to exceed 18 per cent of net tax-supported expenditures up to a level where total debt servicing (including tax-supported debt servicing) reaches a maximum of 21 per cent of City revenues. However, this borrowing is only allowed for projects that require matching City funding and have a minimum of one-third funding from external sources (government grants, external funding etc.), or for emergency purposes, or for capital projects financed through self-supported tax-guaranteed debt.

Impact Of Proposed Limits On Current Debt Forecast

The table below provides information on forecasted debt servicing compared to the proposed limits, showing the City nearing the tax-supported limit near the end of the 2023-2026 budget cycle. The projected debt only includes currently approved debt financed projects.



Similar to the limits in the existing DMFP, the proposed debt servicing limits would allow limited room remaining for new tax-supported debt projects in the 2023-2026 capital budget cycle that are

100 per cent financed through tax-supported debt (unconstrained). Current estimates show that approximately $650 million in tax-supported debt borrowing room remains for 100 per cent tax-supported debt financed projects.

A larger amount of borrowing room is available for tax-supported debt projects that have a minimum of one-third funding from external sources, or those that are for emergency purposes, or for capital projects financed through self-supported tax-guaranteed debt (constrained - tax-supported only). Based on current estimates $3.5B in debt room is available for capital projects in this range.

And lastly, up to $6.2 billion in debt room is available for emergency purposes (restricted).

See the table below for a breakdown of the estimated remaining borrowing room based on current interest rates.

	($ millions)
Borrowing Room to 18% Tax-supported debt servicing limit	650
Borrowing room to 21%t total debt servicing limit	3,500
Borrowing room to 26% total debt servicing limit	6,200

Note that the $6,200 in the table is total available borrowing room and includes the $3,500 and $650 in the other categories. These estimates would change as rates change.

Application of Debt and Debt Servicing Limits

Calculation of Debt and Debt Servicing Limits

The limits proposed in the policy are based on forecasted revenues and expenditures using growth assumptions derived from historical growth patterns in revenues and expenses. Currently, revenues and expenses are assumed to grow at 2.4 per cent for the period 2022 to 2028, and then one percent thereafter. The assumptions will be revisited and updated on a periodic basis to reflect the most current information available and can result in an increase or decrease in limits.

Monitoring and Reporting Debt and Debt Servicing

As a part of regular quarterly financial update reporting and as a part of the budget process, forecasted debt and debt servicing will be reported and monitored against the limits defined in the policy. Forecasted debt and debt servicing amounts include financing for capital projects approved by Council through the capital budget process and do not include forecasted or anticipated financing for new capital projects.

Through this reporting process, Administration will inform Council when borrowing is nearing the limits, or when approval of a proposed debt financed project will result in a defined limit being exceeded.

Approaching Limit

The intention of establishing limits is to ensure the debt remains affordable and does not harm the financial health of the City. In certain cases, debt room could be available when a capital project is first being considered for debt financing, however approval of the project with debt financing would exceed the stated limit (for example causing the calculation to move from the unconstrained category to constrained category). In this particular situation, under this policy the intent is that projects can be advanced but projects approved subsequent to a limit being exceeded must follow the constraints indicated in the policy.

For greater clarity, once defined policy limits have been reached all subsequent borrowings must follow the defined constraints or restrictions outlined. If Council would like to advance a project with debt financing, that exceeds the limit and does not follow the defined constraints then Council must approve an exception to the policy following an advertised statutory public hearing.

Prioritization and Decision Making

As debt servicing approaches the limits, Council will need to prioritize which capital projects they would like to advance with debt financing to make the best use of the available debt room. Decisions on use of debt should not be made on a first-come basis or in an isolated manner, but should be considered alongside all capital projects that would be considered eligible for debt financing during budget discussions.

Once a decision has been made on the use of debt to finance a project, the related debt servicing is factored into the total debt servicing for the City, which is tracked in relation to the limits. Shifting debt servicing amounts for specific projects to other ranges of borrowing (constrained and restricted) within the policy to create debt room in the unconstrained borrowing range that in turn would be used to debt finance additional projects is not permitted. This is best explained using an example:

> Capital Project A is tax-supported debt financed for 50 per cent of its cost, with the remaining 50 per cent funded through external grants. Assuming the City has not already breached the 18 per cent of tax-supported expenditures limit (unconstrained borrowing), the related debt servicing would result in use of a portion of the 18 per cent limit. Now, assume the next year the City has reached its 18 per cent tax-supported debt limit, and Council is considering financing 100 per cent of Capital Project B with tax-supported debt. This would not be permitted as the 18 per cent limit has already been reached. Capital Project A could not be recategorized into the tax-supported constrained borrowing range, where tax-supported debt is permitted beyond the 18 per cent limit for purposes of matching external grants, in order to create room within the 18 per cent tax-supported debt limit to finance Capital Project B.

Clean Energy Improvement Program

The Clean Energy Improvement Program (CEIP) is a Property Assessed Clean Energy (PACE) style program that helps people make energy efficient upgrades to their properties without having to fund the projects up front. The cost of the upgrade is recovered through the property owner's property taxes. The amount can be paid off at any time, and any outstanding repayments remain with the property; if the property is sold, the new owners take on the repayments. Eligible projects focus on energy efficiency or on-site renewable energy such as solar power, upgraded insulation and high-efficiency heating.

Under CEIP, the City borrows on behalf of the property owner to pay for the up-front capital improvement. The property owner then pays the City through its property taxes to service that debt. Any CEIP borrowing is effectively a flow-through for the City, thus any municipal debt related to financing CEIP are excluded from debt limit calculations. This is consistent with MGA, which excludes any borrowing made by a municipality to pay for costs associated with clean energy improvements from the MGA debt limit or debt service limit of the municipality.

Legal Implications

Pursuant to the *City of Edmonton Charter, 2018 Regulation,* AR 39/2018, Council must obtain an external credit rating and then establish a debt limit and debt servicing policy. Before establishing a debt limit and debt servicing policy, Council must hold a public hearing in accordance with section 230 after giving notice of it in accordance with section 606 of *Municipal Government Act*. Furthermore, it aligns with other pertinent sections of MGA, namely those related to “Borrowing” and “Loans and Guarantees”, including any subsequent amendments.

COMMUNITY INSIGHT

Prior to City Council approving an updated City Policy C203D - Debt Management Fiscal Policy, a Statutory Public Hearing must be held.

GBA+

The Debt Management Fiscal Policy impacts the City’s practices related to borrowing to finance capital projects, and as such GBA+ was not completed specifically for the policy. Projects approved through the capital budget process will each have individual implications for GBA+.

ATTACHMENTS

1. Revised Debt Management Fiscal Policy C203D
2. Current Debt Management Fiscal Policy C203C
3. Policy C203C and C203D Comparison
4. Outstanding Debt by Project - June 30, 2022
5. Debt Financing by Asset Type 2003 - 2021
6. Municipal Comparison
7. Alternative Debt Servicing Limit Measure Considerations