COUNCIL REPORT

Edmonton

ADMINISTRATION RESPONSE - CITY FINANCIAL CONDITION UPDATE

RECOMMENDATION

That the October 21, 2022, Financial and Corporate Services report FCS01499, be received for information.

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**	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 • C629 Financial Stabilization Reserve		
Related Council Discussions	• 2008COF061, City Council, July 23, 2008 • FCS00164, Audit Committee, November 17, 2020 • FCS00822, City Council, December 6, 2021 • FCS01169, City Council, June 7, 2022 • FCS01168, City Council, June 7, 2022 • FCS01494, City Council, October 17, 2022 • OCA01511, Audit Committee, October 21, 2022 • FCS01393, City Council, October 31, 2022 • FCS01394, City Council, November 14, 2022		

Executive Summary

- This report provides Administration's response to the findings in the Office of the City Auditor's (OCA) City Financial Condition Update report OCA01511. The auditor's report updates the nine financial indicators first reported in the Office of the City Auditors' (OCA) November 2020 City Financial Condition Review, which was presented to Audit Committee on November 17, 2020 (Office of the City Auditor report OCA00145).
- This response report contextualizes the financial trends outlined in the Auditor's report. The information from the OCA's report and review has provided valuable insights related to the City's financial practices, condition and trends. Understanding the financial sustainability and viability of the corporation helps inform fiscally responsible decision-making. Understanding financial trends is an important part of budgeting.
- The OCA City Financial Condition Update report calculates financial indicators using figures from the City's consolidated annual financial statements. The financial statements reflect the revenues, expenses, assets, liabilities and accumulated surplus of the consolidated City of Edmonton reporting entity, which comprises all organizations and enterprises accountable for the administration of their financial affairs and resources to the City, and which are controlled by the City. In addition to the tax-supported departments, these organizations, enterprises and utilities are consolidated and include the following: Edmonton Public Library, Explore Edmonton, Fort Edmonton Management Company, Edmonton Combative Sports, Non-Profit Housing, Waste Services Utility, Land Enterprise, Blatchford Redevelopment, Blatchford Renewable Energy Utility, Ed Tel Endowment Fund, and Innovate Edmonton. As a result, certain ratios, such as property taxes as a percentage of total revenues, will differ from those presented in the main operating budget document, which only reflect tax-supported operations.
- Administration accepts the OCA's observations regarding the City's financial condition.

REPORT

The Office of the City Auditor (OCA) updated its City Financial Condition audit by adding 2020 and 2021 financial data to financial indicator ratios assessed in the original audit report. At that time, it was difficult to predict the financial impact of the COVID-19 pandemic on the City. Revenues were uncertain as funding from other orders of government was not known. Expenses could not be predicted due to the potential need to significantly reduce City services and spending.

The financial indicators assessed in the report were:

Revenue	Property tax reliance
	Government grant/transfer reliance
Operating Spending	Operating spending growth relative to inflation and population growth
Capital Spending	Change in value of capital assets
	Capital asset condition

Debt	Debt per capita Debt service relative to total operating spending
Financial Position	Uncommitted reserves Financial assets to liabilities ratio

Historical Financial Context

Fiscal policy is set by Council largely through budgets and financial policies that underpin decisions on taxation, spending and borrowing. Economic conditions such as growth rates, unemployment, household income growth, and business revenues, etc. are major influencing factors for fiscal policy.

The City has experienced distinct fiscal policy phases over the last 25 years. Although it pre-dates the auditor's review window, through the period of 1993-1999, the size of the City's municipal government contracted, including:

- service cuts
- absolute reductions in full-time equivalents (FTEs)
- limited capital growth
- limited renewal investment with deteriorating asset condition

From 2000 to 2004, the City underwent a phase of moderate growth, which saw base budget increases to counteract inflationary pressures with some service growth and an increase in the total number of FTEs to keep pace with population growth. With a limited capital program, however, asset condition continued to deteriorate.

From 2005 to 2016, the City underwent a significant growth phase that was responsive to a rapidly growing city and economy. This phase saw added and expanded services, significant capital investment and the implementation of a comprehensive infrastructure renewal program.

Since 2016, in response to the economic contraction and slow recovery, and more recently the effect of the COVID-19 pandemic on Edmonton's economy, the City has slowed growth in taxation and spending, while maintaining a capital program and continuing to invest in infrastructure renewal.

Specifically in 2020 and 2021, the update period of review in the auditor report, the City managed the financial impacts of COVID-19 through expense management strategies and use of funding from other orders of government. Ongoing revenue impacts to user fees and other revenue sources will be addressed through the 2023-2026 budget.

Revenue

Property Tax Reliance

As the Auditor's report notes, the City's reliance on property tax has increased throughout the years: even more so in 2020 and 2021. From 2000 to 2021, property tax revenues have grown in their share of total consolidated revenues, from 35 per cent in 2000 to 45 per cent in 2021. On the other hand, non-property tax revenues have decreased as a portion of consolidated revenues, over the same time period, from 65 per cent to 55 per cent. Taxes are the primary method of funding City services.

As the City has grown, the cost of providing existing services and the demand for new services has also grown, resulting in an increase in property taxes. The City also made a decision to address its infrastructure deficit through tax-supported borrowing to fund renewal and the implementation of a dedicated neighborhood renewal levy in 2009. The City has a limited suite of revenue tools, and while the property tax model provides stability and predictability, the City must consider tolerance for tax increases.

Through the User Fees discussion paper and City's Fiscal Policy on Revenue Generation C624 (October 16, 2020, Financial and Corporate Services report CR_8018), the City addresses the important question of "who pays for what, in what amount and why?" The City recognizes that service and infrastructure costs must be shared in some way amongst the tax base and benefiting parties, and aims to equitably distribute these costs according to the accrual of benefits throughout the community. This policy and principle will be considered for Administration's recommendations to Council for discussion of the 2023-2026 operating budget.

Government Grants/Transfer Reliance

The City uses government grants to fund a significant portion of its capital program. The City's reliance on government grants to fund capital and operations has generally increased from 2000 to 2021. In 2000, government grants comprised 11 per cent of total consolidated revenues, and over the last five years (2017-2021) government grants were approximately 18 per cent of total consolidated revenues. Government transfers vary widely from year to year, as revenue is recorded as eligible expenditures on capital projects are incurred. In general, the City's reliance on government grants has trended upwards to build the infrastructure and provide services for a growing municipality, meaning the City now relies more on a funding source outside its control. If there is a reduction in transfer payments, property tax increases would likely be needed to replace the lost revenue, or the City would need to slow down or reduce its capital growth and renewal program.

The Municipal Sustainability Initiative (MSI) program, launched in 2007, is currently the primary provincial funding source for Alberta municipalities' core capital infrastructure needs. The Local Government Fiscal Framework (LGFF) will be replacing MSI starting in 2024, and on average will provide approximately $35 million less annually compared to historical funding levels received through MSI. Provincial Budget 2020 reflected funding for the City in the magnitude of $185 million in the first year of the LGFF. Subsequent provincial budgets reduced this commitment, which will now see the City's estimated annual funding decrease to approximately $150 million in 2024-25. The impacts of this are highlighted in the 2023-2026 capital budget as funding for capital renewal is limited, and there is almost no funding for growth projects, outside of those projects required for safety and mandate reasons.

Continued advocacy to other orders of government for grant funding to support the City's capital program is critical. For the 2023-2026 Capital Budget, Council will also consider alternative funding strategies for its capital renewal program, including dedicated renewal levies, reallocation of Neighborhood Renewal funding, and policy decisions, such as right-sizing of the City's growing inventory of buildings and facilities.

Operating Spending

Municipal budgets, and in particular operating spending, change in response to the economy, the needs and expectations of its residents, and the goals of the municipality's council. The pattern of City of Edmonton's operating expenditures have changed over the 22-year period reflected in the OCA's review.

From 1999 to 2004, expenditure increases were primarily to counter inflationary pressures so the City could maintain existing service levels. During this period, the City operated using stabilized fiscal policies aimed at delivering core services, maintaining existing service levels over time, limiting new service growth, a limited capital program, and low-to-moderate tax growth.

As the economic fortunes of Edmonton and Alberta rose during the growth phase from 2005 to 2016, Council priorities shifted to respond to evolving resident expectations for new and enhanced services, a greater emphasis on city-building, and developing modern infrastructure and facilities (with their associated operating costs). This phase was also characterized by investments in renewing and maintaining the City's existing infrastructure. Beginning in 2009, the City also implemented dedicated annual tax levy increases for its Neighbourhood Renewal Program to address a long waiting list.

From 2016 onward, the City shifted toward moderate growth in response to slower economic growth, using reductions to the base budget to fund service growth and impacts of capital. The 2019-2022 budget stabilized fiscal policy in a moderate economic growth period. Since the start of the current four-year cycle, budgets have been further reduced to limit the financial impact on Edmonton's taxpayers.

City operating expenses generally grow with population and inflation. Growth greater than population and inflation can be attributed to:

- Demand for new services as a result of increasing demand within a growing City including new facilities, roads, and bridges and enhancements to the transit system like LRT, and
- the cost to address the City's infrastructure deficit through focused capital asset renewal balanced with capital asset growth that required the use of debt to expand the City's capital program resulting in an increase in debt servicing.

Operating spending declined in 2020 and 2021 relative to 2019 due to the COVID-19 pandemic, as the City responded to changing public health guidance that resulted in the closure of facilities and a reduction of certain City services, combined with various expense management strategies necessary to manage the pandemic's financial impacts.

Capital Spending and Use of Debt

Until the early 2000s, the City's strict adherence to a pay-as-you-go financial strategy for capital made it impossible to provide the infrastructure required to support growth without significant tax increases to pay for assets. The City's financial debt was not growing, but its infrastructure deficit was. At that time, the City estimated the gap between the value of infrastructure that could be funded with identified capital resources and the value of the infrastructure required to support growth to be in excess of $4 billion. With a “no tax-supported debt” strategy, within the growth phase (2005-2016) it was difficult for the City to enhance infrastructure and services in a manner that kept pace with the needs and expectations of a fast-growing community. The City’s higher levels of capital spending, particularly since 2007, have led to increased use of debt, allowing City to complete capital projects it would otherwise not have been able to afford on a pay-as-you-go basis. Debt financing during the growth phase enabled the City to receive funding from other orders of government that required matching municipal dollars for significant growth projects.

As the City continues to grow and expand its capital assets, the net book value of assets also grows. The City continues to expand its capital assets to meet the growing needs of its residents. The ongoing addition of new assets and the renewal of existing ones has resulted in an increase in the value of the City’s capital assets. The value of the City’s capital assets have consistently increased, as additions were greater than disposals and depreciation.

While debt per capita grew over the period reflected in the OCA review (2000 to 2022), long-term borrowing helped the City’s infrastructure keep pace in a period of significant growth. The increased debt and related increase in debt servicing results in an increase in taxes, and also means that debt servicing comprises a larger portion of the operating spending. In 2000, debt servicing was 11.7 per cent of operating spending; in 2021 it was 13.6 per cent. 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. Council should balance this intergenerational equity, acknowledging that too much use of debt now can constrain budget and tax resources in the future, especially considering that debt financing costs are currently on the rise.

In 2019, the City’s lone credit rating agency, S&P (Standard and Poor’s), 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 City needs to use debt to advance critical, new infrastructure, and renew existing infrastructure, but should be strategic to ensure debt remains affordable and does not negatively impact the financial sustainability and health of the City. The City currently has one of the higher debt per capita ratios amongst comparable Canadian cities; and the City’s credit rating has been downgraded due to its debt burden, which is being monitored by its credit agency.

Administration carefully adheres to the City’s Debt Management Fiscal Policy (C203C) and the *Municipal Government Act Debt Limit Regulation.* Council’s current Debt Management Fiscal Policy establishes financial guidelines and appropriate controls for the issuance and use of new debt and to ensure a favourable financial position while supporting the City’s ability to meet current and future infrastructure challenges. Administration is bringing forward a revised Debt Management Fiscal Policy (October 17, 2022, Financial and Corporate Services report FCS01494), prior to budget deliberations, for Council discussion and voting after an advertised public hearing. Further details about the City's debt are available in that report.

Financial Stabilization Reserve Balance Relative to Operating Spending

The Financial Stabilization Reserve (FSR) was established in 1997 to provide flexibility in addressing financial risks associated with revenue instability and emergent financial issues, and to ensure the orderly provision of services to residents. The unappropriated balance of the FSR is uncommitted and provides the City with flexibility to address significant emergent financial issues. City policy establishes that the FSR must have a minimum balance of five per cent, with a target balance of 8.3 per cent, of current general government expenses (excluding non-cash amortization). Any annual general government surplus would be applied to the reserve in the subsequent year; any annual tax-supported deficit would draw on the reserve.

City Policy C629 - Financial Stabilization Reserve, requires that a risk based review of the unappropriated FSR be completed every three years to ensure the sufficiency of the minimum and target percentages. Administration conducted a risk-based review of the unappropriated FSR balance in 2021 and confirmed that the respective minimum and target balances of five per cent and 8.3 per cent of current general government expenses (excluding non-cash amortization) were appropriate. The year end balance of the reserve varies based on the tax-supported year-end position and Council's decisions to use the reserve for emergent needs. The past few years have seen the FSR balance stable at just above the minimum balance of five per cent of tax-supported expenditures. A large portion of the 2020 tax-supported surplus was set aside within the appropriated FSR to manage the financial impacts of COVID-19 in 2021, resulting in a lower unappropriated FSR balance at the end of 2021.

Maintaining a healthy reserve balance to address emergent financial needs is critical to ensure the financial health and sustainability of the City. Continued use of the FSR for only emergent purposes is prudent financial management.

The City carefully manages its reserve balances and completes a full reserves review every three years, the most recent of which was completed in 2021. Results of this review were provided in the December 6, 2021, Financial and Corporate Services report, FCS00822, 2021 Reserves Review. Amounts in reserves are typically set aside for specific purposes, including third party or regulatory requirements, to manage revenue and/or expenditure fluctuations (stabilization reserves), or, in the case of the FSR, to manage overall City risks.

Financial Assets to Liabilities Ratio

This indicator measures the City's financial resources available relative to its financial obligations. Its financial resources include items such as cash, receivables, and investments. Its financial obligations include items such as accounts payable, deferred revenue, and debt.

A ratio greater than one indicates that the City has financial resources available to finance future operations. The City's ratio of net financial assets has been consistently greater than one, but has decreased since 2000: in 2000, the ratio was 2.93; by 2021, the ratio was 1.51. The decline of this ratio means that the City has fewer financial resources to pay for future operations. This decrease in the ratio is consistent with the City's higher levels of capital spending (increase in non-financial tangible capital assets) and greater use of debt (increase in liabilities). The City's financial assets to liabilities ratio over the past five years has remained greater than one, and has stabilized ranging from 1.50 to 1.57, which reflects the City's ability to pay for its obligations.

Municipal Comparisons

As stated by the OCA in their review of municipal comparators, it is difficult to draw conclusions from municipal comparisons based on a number of factors, including but not limited to:

- Legislative and structural differences
- Difference in service levels
- Models of service delivery

The City of Edmonton is in the mid-range for the majority of the comparators:

- S&P credit rating,
- population growth,
- operating spending,
- total FTEs per 1,000 population,
- capital spending, and
- municipal tax-levy as a percentage of household income.

The exception to this is long-term debt per capita, where the City of Edmonton is shown as the highest among comparator municipalities in the OCA review, at $3,353 per capita as of December 31, 2021. As mentioned within the Capital Spending and Use of Debt section of this report, while debt per capita grew over the period reflected in the OCA review (2000 to 2022), long-term borrowing helped the City's infrastructure keep pace in a period of significant growth.

Next Steps

Administration will continue to monitor the City's financial condition using sound financial practices and policies, some of which are outlined in this report, and with the context of the OCA's insights. It is important the municipality's financial planning and procedures reflect the fiscal reality of the people it serves.

Council should consider the insights raised through the financial condition update as one tool to help aid decision-making during the 2023-2026 budget deliberations.

COMMUNITY INSIGHT

Administration is undertaking a number of research and engagement activities to support the development of the 2023-2026 budgets and provide Council with analysis on the perspectives of Edmontonians when it comes to priorities for City spending, as well as tolerance for increasing/adjusting City revenue streams.

GBA+

GBA+ was not completed for this response as GBA+ considerations were not in scope of the audit. A strong financial condition allows the City to deliver projects and services that each have individual implications for GBA+.