Administrative Response to Office of the City Auditor - City Financial Condition Review

Recommendation

That the November 17, 2020, Financial and Corporate Services report FCS00164, be received for information.

Executive Summary

This report provides Administration's response to the findings in the Office of the City Auditor’s (OCA) 2020 City Financial Condition Review. The report concluded that the City’s financial condition is not as healthy as it was 20 years ago.

Administration is providing this response report to contextualize the financial trends outlined in the Auditor’s report and outline further plans to support Council’s decision-making. The insights provided from the Office of the City Auditor’s report and review have provided valuable opportunities to improve and validate the City’s financial practices.

Report

The Office of the City Auditor (OCA) completed its City Financial Condition audit by:
1. Reviewing City revenues;
2. Reviewing of City spending, including operating and capital;
3. Reviewing the City’s financial position, including debt;
4. Assessing the effectiveness of the City’s financial planning process in assessing risks to the City’s financial condition.

Administration accepts and appreciates the OCA’s conclusions about the City’s financial condition based on its review. Administration also appreciates the OCA comments about the effectiveness of the City’s financial planning process in assessing risks to the City’s financial position. In recent years, Administration has made a number of changes to its planning processes to ensure long-term financial viability. With the lens of the OCA observations, Administration will continue to implement practices that manage risk, consider inflation and population growth, and diversify funding sources.

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 economic 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 20-year review window, through the period of 1993-1999, the City contracted the size of municipal government, including:

- service cuts
- absolute reductions in full-time equivalents
- 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 full-time equivalents 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 shifted gears to slow growth in taxation and spending, while maintaining a capital program and continuing to invest in infrastructure renewal.

Long-Term Planning Process

The City has implemented conservative financial policies and practices, has a positive financial reserve position backstopped by the Ed Tel Endowment Fund, uses debt prudently, and maintains a AA credit rating. As reported in the January 27, 2020, Financial and Corporate Services report, CR_7757 Enhancing Financial Viability, the City of Edmonton has a resilient financial position.

The evolution and enhancement of financial policies and procedures is critical to ensuring the budgeting process remains relevant, and provides Council with tools to appropriately allocate resources across the organization. For example, at Council direction, Administration is adopting a Priority Based Budgeting process in a limited scope for the remainder of the cycle, and fully for the 2023-2026 operating and capital budgets.

To strengthen long-term financial planning, operating and capital budgets are developed on four-year cycles with semi-annual updates to ensure the Corporation can respond to emergent requests and needs. These processes have helped the City adapt to the COVID-19 pandemic and economic downturn.

Alongside the City's current financial policies and procedures, Administration has brought forward information about debt, franchise fees, user fees and assessment and taxation that have led to meaningful discussions with Council.

Through the recent adoption of ConnectEdmonton, City Council has committed to its long-term strategic vision for transformational change over 10 years. Administration bases its financial decisions and recommendations on ConnectEdmonton and the draft City Plan, and assess their impact using a spectrum of monitoring and reporting tools:

- Indicators: show how efforts are getting the city to ConnectEdmonton's strategic goals
- Stretch Targets: define aspirational community achievements for a future population of two million people
- Strategic Measures: monitor performance and communicate short and medium term progress to Edmontonians.

The City is evolving its business planning and budget practices to better achieve Council's strategic goals.

Revenue

As the Auditor's report notes, the City's reliance on property tax and government transfers has increased over the years. Less diverse revenue streams can increase dependence on transfers from other orders of government. 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.

In the past 10 years, property tax revenues have grown in their share of total operating revenues, from 51 percent in 2009 to 56 percent in 2019, while non-tax operating revenues have declined from 49 percent in 2009 to 44 percent in 2019. They are budgeted to drop further to 42 percent in 2022. In real terms or proportional to growth, non-tax revenues have seen relatively little change.

Through the white paper on User Fees and recently approved Fiscal Policy on Revenue Generation C624, the City addresses the important question of "who pays for what, in what amount and why?" Administration will apply the principles and policy statements toward the preparation of financial and budget information brought before Council.

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 20-year period under 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 under 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 impact on Edmonton's taxpayers.

Capital Spending and Use of Debt in Responding to the City's Growth Phase

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. While debt per capita grew over the period under the auditor's review, long-term borrowing helped the City's infrastructure keep pace in a period of significant growth.

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 huge tax increases to pay for assets. The City's financial debt was not growing, but its infrastructure deficit was becoming significant. 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, the City was unable to address these growing infrastructure needs.

Unlike the provincial and federal governments, the City can only borrow for capital spending. Borrowing allows large projects to proceed without having to accumulate enough in savings to pay for all costs up front. Saving to pay for significant infrastructure projects can mean that the taxpayers paying for the projects are not those who benefit. Several generations use infrastructure over the course of its life, and fairness would suggest that those costs should be paid by those who will use the infrastructure over time.

The other challenge that arises from saving for a cash purchase of significant infrastructure is negative carrying costs. Sometimes inflation can outpace a return on the investment of public funds over the life of the savings. In other words, the construction cost sometimes goes up faster than the investment income earned, making projects more costly. The City benefited from debt-financing in economic environments that saw rising inflation but decreasing interest rates.

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.

The City of Edmonton faces different inflationary pressures than residents do. The Consumer Price Index (CPI) is a measure of price changes experienced by Canadians, and is the most widely used measure of consumer inflation based on average spending for food, housing, clothing, utilities and transportation. Municipal governments, on the other hand, build roads and pools, buy trees and buses, and employ planners and firefighters. The CPI does not reflect the purchasing patterns of municipal governments, so the Municipal Price Index (MPI) was designed to estimate the inflation rate of the costs of municipal service provision. Between 2000 and 2019, the CPI in the Edmonton region grew by a factor of 1.51, whereas the MPI grew by a factor of 1.77. This indicates more inflationary pressure on the cost of municipal service provision in Edmonton than the CPI would measure.

Next Steps

Administration will continue to monitor the City's financial condition using the practices outlined above, and with the context of the OCA's insights. The Auditor's report emphasizes the importance of the enhancements already planned to support decision-making by Council. The implementation of a full Priority Based Budget process for the next budget cycle, as well as the Reimagine efforts, will help maintain a stable financial condition for the City during uncertain periods like the COVID-19 pandemic. It is important the municipality's financial procedures reflect the fiscal reality of the people it serves.

Corporate Outcomes and Performance Management

Corporate Outcome(s): The City of Edmonton has a resilient financial position			
Outcome(s)	**Measure(s)**	**Result(s)**	**Target(s)**
Ensure transparent, conservative and reasonable debt financing as a source of funding to support the City's long-term capital plans and strategies while maintaining long-term financial affordability, flexibility and sustainability.	● The City of Edmonton is subject to limits both for total debt and debt servicing by the *Municipal Government Act* and by the City's internal *Debt Management Fiscal Policy (C203C)*. ● The *Municipal Government Act* debt limit is two times the revenue of the City and the debt servicing limit is 35% of City revenues. For this calculation, revenues are net of capital government transfers and contributed tangible capital assets. ● The internal *Debt Management Fiscal Policy* (C203C) sets more conservative debt service limits at 22% (total debt) of City revenues and 15% (tax-supported debt) of Tax Levy Revenues.	● Based on the limits set under the *Municipal Government Act*, for December 31, 2020, the City is projecting to use 54.9% of its debt limit and 30.0% of its debt servicing limit. ● Based on the limits under the *Debt Management Fiscal Policy*, for December 31, 2020, the City is projecting to use 61.5% of its tax-supported debt servicing limit and 45.5% of its total debt servicing limit.	Total debt and debt servicing are below the limits set by the *Municipal Government Act* and by the internal *Debt Management Fiscal Policy (C203C).*

Others Reviewing this Report

- C. Owen, Deputy City Manager, Communications and Engagement
- J. Meliefste, Acting Deputy City Manager, Integrated Infrastructure Services