

Methodology

*Rating Canadian
Municipal Governments*

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Insight beyond the rating.

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Overview

DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on forward-looking measurements that assess a debt issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest or dividend) in accordance with the terms of an obligation. Ratings are not buy, hold or sell recommendations and they do not address the market price of a security.

DBRS rating methodologies consider a broad array of quantitative and qualitative factors that are both industry- and entity-specific. In the case of Canadian municipal governments, or municipalities, DBRS groups the risk factors into four broad categories listed below in order of importance:

- I. Economic profile
- II. Fiscal management
- III. Debt and liquidity
- IV. Relations with senior governments

These risk categories form the basic framework for all municipal ratings, with each underlying risk factor assessed by DBRS in a uniform fashion across debt issuers in order to ensure consistency among ratings.

DBRS rating methodologies are underpinned by a stable rating philosophy. Consequently, DBRS takes a longer-term "through the cycle" view of the issuer, which means that in order to minimize rating changes due primarily to temporary cyclical economic changes, DBRS generally strives to factor the expected impact of a normal economic cycle into its ratings. Rating revisions will occur when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future. An equally important aspect of DBRS's analysis is its broad industry coverage, which it undertakes in order to better appreciate the major differences and subtle nuances within a particular industry and to develop a solid understanding of the issuer relative to its peers.

Critical in the determination of a rating is the application of the analyst's experience and expertise in forming an initial rating opinion and recommendation for the rating committee, as well as the role of the DBRS rating committee as the final decision-maker. DBRS rating committees comprise experienced and knowledgeable DBRS personnel and strive to provide objective and independent rating decisions that are based upon all relevant information and factors, incorporate both global and local considerations, consistently apply DBRS approved methodologies and reflect the opinion of DBRS.

The following is a detailed discussion of the various factors considered by DBRS when assessing the creditworthiness of Canadian municipal governments.

I. Economic Profile

The economic base of a municipality constitutes a key consideration in the credit assessment of its government, as it is the primary determinant of the capacity of a government to raise the revenues necessary to fulfil its service responsibilities and carry its debt. In its analysis of this risk category, DBRS focuses on the diversification, wealth and propensity for growth of the economy, as well as on its demographic composition and any impediments that could foster volatility or impair growth going forward. Outlined below are the primary factors used by DBRS to evaluate the contribution of the economy to the rating of a municipal government.

ECONOMIC DIVERSIFICATION

The composition of a municipal economy provides valuable insight into its volatility, dynamism and growth potential, as well as its propensity to create jobs, generate wealth and attract residents. A large, well-diversified economy with a strong emphasis on value-added industries will generally tend to fare better and experience more consistently robust growth over the longer term than a commodity-based economy. In its analysis of the economic structure, DBRS focuses on: (a) GDP and/or employment breakdown by major industry and major employer; (b) prospects of key industries and employers with competitive advantages; (c) track record of employment creation; and (d) adequacy of major infrastructure (e.g., roads, land availability, electricity generation). Structural distortions within the economy, such as burdensome tax or regulatory systems, are also considered in the analysis. In the case of a small suburban commuter municipality highly reliant on a neighbouring urban centre for employment, DBRS may incorporate in its analysis consideration for some of the larger city's economic fundamentals, provided the municipality being rated is strongly integrated into its larger neighbour and is likely to retain this relationship over time thanks, for example, to its close proximity, competitive taxes and/or considerable land availability.

DEMOGRAPHICS & SOCIAL STRUCTURE

Demographic and social trends can influence political stability and have a significant impact on a government's fiscal position by affecting the labour force, income distribution and the demand for municipal services. For example, cities with a rapidly growing population will often enjoy an expanding tax base, but may also face greater popular pressure to expand public services like transit and build appropriate infrastructure such as roads and water plants. In contrast, mature cities will generally face less capital growth pressure, but their aging population may translate into out-migration, declining property values and a shrinking tax base. Demographic and social indicators assessed by DBRS include: (a) average age of the population; (b) migration trends; (c) education attainment; (d) welfare caseloads; and (e) income and wealth distribution.

HISTORICAL GROWTH & PROSPECTS

A sound record of sustained economic growth is prime evidence of a municipality's ability to generate wealth for its population and fiscal resources for its government. DBRS looks at the level and trend of key summary indicators and seeks to understand the growth potential of the municipality in relation to that of the province and other municipalities across the country. Key variables analyzed include: (a) taxable assessment; (b) housing starts; (c) per-capita income; (d) employment growth; and (e) public and private sector investments.

Key Economic Statistics

Gross domestic product (GDP) growth trend	Taxable assessment
Employment & labour force growth trend	Housing starts
Unemployment rate	Private sector investment
Employment by major sector and employer	Population growth & migration trends
Personal income per capita	Age distribution & dependence ratio

II. Fiscal Management

The review of the fiscal management framework is aimed at assessing the government's fiscal sustainability and prospects, looking at revenue generation, program responsibilities and fiscal discipline, as well as the coherence and appropriateness of the strategies, policies and processes governing the planning and allocation of public funds. Particular attention is paid to the quality of the fiscal management framework in place, the service responsibilities entrusted by the provincial government to its municipalities, the adequacy of revenues to cover core programs and interest charges, and the level of fiscal flexibility afforded by the system, that is, the degree to which expenditures can be contained or revenues increased in order to protect fiscal soundness. DBRS also analyzes the fiscal track record of the government, which provides an indication of the government's commitment to fiscal soundness.

PLANNING AND EXPENDITURE CONTROL

DBRS reviews the effectiveness of the management team and budgetary process, including the transparency, timeliness and comprehensiveness of the government's planning, reporting and monitoring systems, as well as the proficiency of fiscal authorities at setting achievable fiscal targets and containing in-year expenditure pressures. Additional considerations include the allocation of responsibilities and controls within the government organization, adherence to budget policies (e.g., balanced budget legislation), and the coherence and consistency of fiscal policies, with frequent changes in strategic goals generally perceived as weakness in the management framework.

In assessing the quality of the fiscal planning framework, DBRS compares recent years' fiscal results against original budget estimates, putting emphasis on the frequency and extent of major budget deviations. DBRS also reviews accounting consolidation practices in order to understand the composition of the reporting entity and verify whether all tax-supported activities are appropriately captured.

EXPENDITURES

For this part of the analysis, DBRS distinguishes between three major types of expenditures: service programs, capital investments and debt servicing, with particular emphasis placed on identifying major trends, actual and potential areas of pressures and sources of rigidities.

Through its analysis of program expenditures, DBRS seeks to understand the government's primary service responsibilities, and the relationship between key expenditure items and factors such as demographics and economic conditions in order to identify potential sources of fiscal volatility and cost pressure. Analysts review major program responsibilities established by the provincial government, focusing on the coherence and sustainability of each program, and expected cost implications in relation to third-party revenue sources, if any, such as senior government grants.

Relative to their provincial and federal counterparts, Canadian municipalities are responsible for a disproportionately large proportion of public infrastructure, including municipal roads, water and sewer facilities and transit assets. As a result, capital investments account for a considerable portion of municipal budgets and constitute the primary driver of debt. Historically, capital spending has been more cyclical than ongoing program expenditures, as capital funding from senior governments has fluctuated with their fiscal results and as municipalities in times of financial hardship have often opted to reduce capital spending to better their budget balance. This practice led to significant underinvestment at both the provincial and municipal levels in the 1980s and 1990s and to the accumulation of significant deferred maintenance deficits in most large Canadian municipalities, despite a marked ramp-up in capital investments observed in recent years. As a result, DBRS analysts seek to get a clear understanding of current and future capital requirements faced by the government, focusing on the state of good repair of major public infrastructure and on the estimated future costs of addressing growth-related needs. Financing methods and accounting rules for capital



spending are also reviewed in order to fully appreciate the debt implications of projected capital needs and verify whether accrued costs are reported consistently across municipalities.

Of all three expenditure categories, debt servicing is definitely the most rigid and can constitute a substantial portion of a government's budget. As a result, the stability and trend of government interest and debt payments are an especially important consideration. In analyzing debt servicing requirements, DBRS pays attention to the government's debt structure and management strategy, incorporating findings from the analysis of the debt and liquidity profile, which is described later on in this methodology.

REVENUES

Revenue analysis covers the major components of a government's revenue base, focusing on diversification, volatility and ability to grow key sources when needed, as well as the extent of the tax effort imposed on residents and corporations. Key revenue sources for municipal governments include residential, commercial and industrial property taxation, user fees for services like water and waste management, and senior government grants and earnings from government enterprises. Since Canadian municipalities do not tax income, they generally benefit from a more stable revenue base than provincial governments, although at the expense of more limited revenue growth prospects.

Special emphasis is put on the resilience of major revenue sources, over-reliance on provincial government transfers, and on the competitiveness of the city's tax rates relative to neighbouring jurisdictions. Constraints in revenue-generating powers, such as legislated caps on certain property tax rates, and structural defects in the government's tax system are also analysed closely since, for example, an inefficient tax system may create distortions in the economy by influencing business decision-making and discouraging investments.

FISCAL BALANCE

Fiscal results are viewed by DBRS as a reliable indicator of management proficiency and commitment to fiscal soundness. Analysts look at the operating balance (operating revenues minus program expenditures and interest charges) as the primary indicator of fiscal flexibility, while the net fiscal balance (inclusive of capital expenditures) better reflects overall fiscal sustainability and the potential financing requirements in a given year. DBRS notes that in most provinces, municipalities are required under legislation to balance their operating budget, although large capital investments may at times translate into post-capex deficits and upward pressure on debt and tax rates. Analysts examine historical as well as prospective results, focusing on the cyclical and sensitivity of the budget and financing requirements to adverse developments. While repeated sizeable net shortfalls are perceived negatively by DBRS, the impact of such shortfalls will generally be discounted if they are the result of catch-up capital investments or non-recurring events, as opposed to a structural imbalance about which a government is showing little initiative.

Key Fiscal Management Statistics

Surplus or Deficit	Capital spending per capita
Expenditure volatility & trend	Interest charges / Total expenditures
Actual expenditures / Budgeted expenditures	Revenue diversity & stability
Expenditures per capita	Key tax rates and user fees
Expenditure change / Revenue change	Tax arrears as a % of current levy

III. Debt and Liquidity

The sustainability of a government's debt burden is a central consideration in the determination of the rating. DBRS carefully examines current and projected levels of indebtedness and considers the full range of factors that could affect the debt burden and related servicing requirements.

DEBT

The primary focus is on tax-supported debt, which includes financial obligations for which taxpayers are directly accountable. This concept captures tax-supported debt directly issued by the government as well as the financial obligations of any other related tax-supported organization that is within municipal jurisdiction (e.g., transit authorities). Debt is measured by DBRS net of sinking funds and other quality assets set aside explicitly for debt retirement purposes. The resulting debt figure is compared with the capacity to carry debt of the government as represented by its taxable assessment. It is also analyzed relative to total tax revenues, on a per capita basis. Although not included in the calculation of tax-supported debt, other financial commitments such as capital lease obligations and unfunded pension liabilities are also considered in the analysis of debt affordability.

Self-supporting debt, which is issued by or for the purpose of commercial or potentially commercial government enterprises and serviced by distinct user fees (e.g., electric utilities or water services), is analyzed separately by DBRS for its affordability. Such debt is generally allocated a much smaller weighting in the credit review provided the services clearly have a commercial value and are mostly (if not entirely) funded by user fees, and the burden is not excessive for the organization and is highly unlikely to require government support.

DEBT SERVICING

Interest charges are also an important consideration in the analysis and are measured as a percentage of fiscal revenues in order to assess the affordability of outstanding debt. A look into the debt structure and the government's debt management strategy also helps assess the potential volatility of the servicing requirements. More particularly, analysts examine the maturity structure of the debt stock and its sensitivity to changes in inflation, interest and exchange rates. In keeping with the forward-looking nature of DBRS ratings, analysts will generally seek to develop a three- to five-year outlook for debt and debt servicing requirements.

LIQUIDITY

Due to their fairly predictable expenditure base and steady stream of revenue, some municipal governments tend to minimize their cash balances. Large municipalities, in particular, often benefit from superior access to capital markets due to high investor receptivity, which considerably reduces refinancing risk and further reduces the need for back-up liquidity. Nonetheless, municipalities will often have sizeable reserve funds in place which, although generally earmarked for specific capital projects, could be temporarily reallocated to other purposes in the event of severe liquidity stress. DBRS analyzes cash balances and reserves in relation to projected fiscal results, scheduled debt repayments and availability of external liquidity sources such as bank facilities. Liquid assets will generally only be netted against debt if the funds are unrestricted and earmarked for debt retirement.

Key Debt and Liquidity Statistics

Tax-supported debt per capita

Debt structure – maturity, currency, interest rate

Debt servicing / Revenue

Tax-supported debt / Taxable assessment

Annual borrowing needs / Total debt

Cash balances, reserve funds as % of spending

IV. Intergovernmental Relationships

In determining the creditworthiness of a Canadian municipality, DBRS focuses on the fundamentals of the municipality, as described above. However, the credit profile of the provincial government may also have a material influence on the municipality's rating, since municipalities share their taxpayer base with their provincial counterpart and receive substantial provincial funding for capital projects and the delivery of certain programs. As a result, a fiscally and financially healthier provincial government will often have more resources to share with its municipalities and will do so in a more consistent fashion, while minimizing pressure on the taxpayer base.

Furthermore, service responsibilities, revenue-generating powers and all other determining features of the operating framework of municipalities are defined by the provincial government. As a result, the responsiveness of a provincial government to the realities faced by municipal governments, as well as the various constraints or flexibilities provided through the legislated framework, may have significant implications for the credit profile of municipalities, highlighting the importance of carefully analyzing the dynamic between municipalities and their provincial government.

Conflicting tax or social policy objectives between levels of government may also introduce challenges in fiscal management, as municipalities share their tax base and, in certain jurisdictions, responsibility for certain programs with their senior counterpart. DBRS analysts pay particular attention to the sustainability and consistency of key provincial policies aimed at its municipalities. Tensions between the two levels of governments as well as the municipality's dependence on provincial funding and the structure of key transfer programs are also analyzed carefully.

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