



Methodology

*Rating Canadian Municipal  
Governments*

SEPTEMBER 2011



*Insight beyond the rating.*

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DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



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# Rating Canadian Municipal Governments

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## Introduction to DBRS Methodologies

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- In general terms, 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 an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general operating and financial risk factors applicable to most sectors as well as sector-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness that would be more critical for a peer issuer and may also differ depending on the sector being considered. Conversely, there are cases where one weakness is so critical that it overrides the fact that the issuer may be strong in most other areas.
- DBRS rating methodology is underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Consequently, DBRS takes a longer-term "through the cycle" view of an issuer and, as such, rating changes are not based solely on normal economic cycles.
- Rating revisions do occur, however, 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 analysis is its broad sector coverage, which it undertakes in order to understand the major differences and subtle nuances within a particular industry and to form an appropriate rating of an 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 DBRS rating committee and the role of the rating committee as the final decision maker.
- DBRS rating committees, which comprise experienced and knowledgeable DBRS personnel, strive to provide objective and independent rating decisions that are based on all relevant information and factors, incorporate both global and local considerations, apply DBRS-approved methodologies and constitute the opinion of DBRS.

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## Rating Canadian Municipalities – Overview

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- This methodology applies to Canadian municipalities covered by DBRS. Large local governments, in particular, have a number of similarities and differences that can have a significant influence on the outcome of the rating process. Similarities include a stable revenue base owing to well-defined though relatively limited taxing powers, a wide array of responsibilities for the provision of relatively customary public services, fairly stable political systems and local economies, and a generally meaningful reliance on provincial governments, which share their tax base and have a considerable influence over the funding and operating environments of municipalities.
- However, the level of economic diversification and overall financial strength can vary substantially among Canadian municipalities, which partly explains the wide range of ratings in the sector. These are just a few of the important attributes assessed during the rating process. Overall, large Canadian municipalities rank solidly in the investment-grade category.

## Issuer-Specific Operating Risk Factors

- DBRS's ratings incorporate a considerable number of general and issuer-specific rating drivers. By focusing on the key drivers, which vary on a sector-by-sector basis, we believe that DBRS methodologies capture essential strengths and challenges of each industry in an accurate fashion, providing transparency for outside readers.
- The table below presents the key factors defining municipal government ratings, along with a brief overview of the characteristics of each factor expected for the various rating categories relevant to municipal ratings. Although these factors are important considerations in the determination of a municipality's rating, they only represent a portion of the considerations factored into the assessment process as explained throughout this methodology.
- Therefore, a municipality does not have to consistently fit within a rating category for each factor in order to achieve a given rating. A weak factor can be offset by strength in other critical or non-critical indicators, although material weakness in one of those considerations may eventually become an impediment to achieving a higher rating.

### Critical Rating Factors

| Rating Category                   | AAA  | AA  | A   | BBB  |
|-----------------------------------|--|---|---|--|
| Fundamental Strength <sup>1</sup> | Exceptional  | Exceptional   | Superior  | Adequate   |
| <b>Economic Structure</b>         | <ul style="list-style-type: none"> <li>• Population and taxable assessment growth has been consistently above the provincial average over the last five to ten years.</li> <li>• The economy comprises a broad mix of industries, with no undue reliance on any single sector, which helps reduce volatility and cyclicity in GDP growth.</li> <li>• Income and taxable assessment per capita stand out relative to peers.</li> <li>• The labour force is highly skilled and unemployment is below average.</li> </ul> | <ul style="list-style-type: none"> <li>• Population and taxable assessment growth are sound and fairly consistent year over year.</li> <li>• The economy boasts a relatively diversified mix of industries but may be influenced by a few large industries, resulting in average volatility overall.</li> <li>• The economy is dynamic and constantly evolving, but certain sectors may require reform to secure long-term growth prospects.</li> <li>• Income and taxable assessment per capita are consistent with other large peers.</li> <li>• The labour force is skilled and unemployment is low and stable.</li> </ul> | <ul style="list-style-type: none"> <li>• Population and/or taxable assessment growth has been steadily below average or inconsistent in recent years.</li> <li>• The economy may be relatively small or reliant on seasonal industries, with a limited number of key industries accounting for a substantial portion of economic activity, resulting in above-average volatility.</li> <li>• Income and taxable assessment per capita may be below average.</li> <li>• The job market is dynamic, although the unemployment rate may be above average.</li> </ul> | <ul style="list-style-type: none"> <li>• Population is small and/or has been steadily declining in recent years.</li> <li>• The economy is relatively small and far from major urban centres, with one seasonal or challenged industry accounting for a substantial portion of economic activity.</li> <li>• Income and taxable assessment per capita are markedly below the provincial average, highlighting low wealth levels.</li> <li>• The job market is characterized by a high unemployment rate that may be above the provincial average.</li> </ul> |

1. The fundamental strength is relative to DBRS's other rating categories and is consistent with those identified in other DBRS rating methodologies.



## Critical Rating Factors

| Rating Category                   | AAA  | AA  | A   | BBB   |
|-----------------------------------|--|---|---|---|
| Fundamental Strength <sup>1</sup> | Exceptional  | Exceptional   | Superior  | Adequate  |
| <b>Fiscal Management</b>          | <ul style="list-style-type: none"> <li>Budgets are consistently balanced using very conservative assumptions and incorporating meaningful contingencies to help manage unforeseen events.</li> <li>Very tight expenditure management, with a strong track record of surpluses as measured by DBRS.</li> <li>Demonstrated ability to address unexpected adverse budget deviations to protect fiscal balance.</li> <li>Property taxes and user fees are low, providing ample room to raise taxes if necessary.</li> <li>Transparency and timeliness in reporting are exemplary.</li> </ul> | <ul style="list-style-type: none"> <li>Fiscal sustainability is emphasized by the government, but reliance on one-time funding or sizable tax increases may be exhibited at times to balance the budget.</li> <li>Budget contingencies vary year to year, although assumptions are generally prudent.</li> <li>Results, as measured by DBRS, maintain a balanced position year over year.</li> <li>Expenditure management is prudent, with limited in-year slippage.</li> <li>Property taxes and user fees are in line with peers, providing moderate flexibility to raise taxes.</li> <li>Transparency is good and financial reporting is timely.</li> </ul> | <ul style="list-style-type: none"> <li>The fiscal management framework is well developed, but some key planning documents or reports may lack details.</li> <li>Budget pressures tend to linger but are viewed as sustainable, although reliance on one-time funding and/or sizable tax increases to balance the budget is high.</li> <li>Fiscal results may exhibit greater volatility due to lower ability to manage in-year budgetary pressures.</li> <li>Budget assumptions are deemed conservative, although the use of contingencies may be limited.</li> <li>Reduced ability and/or willingness to manage downturns through meaningful expenditure restraint or revenue-raising initiatives.</li> <li>Property tax and user fee burdens may already be somewhat high, limiting the ability to further raise taxes and fees if needed.</li> </ul> | <ul style="list-style-type: none"> <li>The fiscal management framework lacks structure and transparency, with only limited planning documents.</li> <li>Budget pressures tend to linger and are viewed as potentially unsustainable, resulting in steady reliance on one-time funding and/or sizable tax increases to balance the budget.</li> <li>Reduced ability and/or willingness to manage downturns through meaningful expenditure restraint or revenue-raising initiatives.</li> <li>Tax and user-fee burdens are high and delinquencies are building up.</li> </ul> |

1. The fundamental strength is relative to DBRS's other rating categories and is consistent with those identified in other DBRS rating methodologies.

## Critical Rating Factors

| Rating Category                                  | AAA   | AA   | A   | BBB  |
|--|---|--|---|--|
| Fundamental Strength <sup>1</sup>                | Exceptional   | Exceptional  | Superior  | Adequate   |
| <b>Financial Management – Debt and Liquidity</b> | <ul style="list-style-type: none"> <li>Debt is low and capital requirements for the foreseeable future are manageable and are not expected to pressure debt materially.</li> <li>Debt and liquidity management practices are exemplary and very conservative.</li> <li>The debt structure is very prudent, with low refinancing risk, a smooth maturity profile and minimal unhedged exposure to interest rate reset risk and foreign currency fluctuations.</li> <li>The borrowing platform is well established and recognized.</li> <li>Liquidity is substantial and in excess of short-term debt outstanding.</li> <li>Unfunded pension liabilities, if any, are low and being addressed.</li> </ul> | <ul style="list-style-type: none"> <li>Debt is moderately low.</li> <li>Although capital requirements may be sizable, they are not expected to put excessive pressure on debt.</li> <li>Debt and liquidity management practices are sophisticated and conservative.</li> <li>The debt structure is prudent but may at times entail sizable refinancing needs, an uneven maturity profile or material exposure to interest rate reset risk.</li> <li>The borrowing platform is well established and recognized.</li> <li>Liquidity is significant relative to short-term debt and refinancing needs.</li> <li>Unfunded pension liabilities may be sizable but are being addressed.</li> </ul> | <ul style="list-style-type: none"> <li>Debt is sizable and although management may have been successful at containing upward pressure in recent years, significant capital requirements have the potential to lead to significant increases going forward.</li> <li>Interest costs consume a material portion of the budget.</li> <li>Debt and liquidity management practices are conservative but may lack formality or sophistication relative to those of frequent borrowers.</li> <li>The debt structure is prudent but may at times entail sizable refinancing due to an uneven maturity profile or material exposure to interest rate reset risk.</li> <li>The borrowing platform is not well established, although the track record of execution of annual borrowing programs may be good.</li> <li>Liquidity is limited.</li> <li>Unfunded pension liabilities may be considerable and steadily growing.</li> </ul> | <ul style="list-style-type: none"> <li>Debt is sizable and steadily growing owing to large capital needs.</li> <li>Interest costs may already consume a material portion of the budget.</li> <li>Debt and liquidity management practices are lacking structure and sophistication relative to those of frequent borrowers.</li> <li>The debt structure is prudent but may at times entail sizable refinancing due to an uneven maturity profile or material exposure to interest rate reset risk.</li> <li>There is no established borrowing platform since the municipality infrequently accesses the debt market.</li> <li>Liquidity is negligible.</li> <li>Unfunded pension liabilities may be considerable and steadily growing.</li> </ul> |

1. The fundamental strength is relative to DBRS's other rating categories and is consistent with those identified in other DBRS rating methodologies.



## Critical Rating Factors

| Rating Category                         | AAA   | AA  | A   | BBB  |
|---|---|---|---|--|
| Fundamental Strength <sup>1</sup>       | Exceptional   | Exceptional   | Superior  | Adequate   |
| <b>Relations with Senior Government</b> | <ul style="list-style-type: none"> <li>The legislative framework defining municipal responsibilities and revenue-generating powers is supportive and fosters financial sustainability.</li> <li>Adequate provincial monitoring is provided.</li> <li>Sizable and reliable funding support may be provided the by provincial government, especially for capital investments.</li> <li>Cooperative relationship with senior government and track record of supportive tax and program policy objectives.</li> <li>Limited interference in areas of municipal responsibility.</li> </ul> | <ul style="list-style-type: none"> <li>The legislative framework defining municipal responsibilities and revenue-generating powers is supportive and fosters financial sustainability.</li> <li>Adequate provincial monitoring is provided.</li> <li>Senior government funding support is meaningful but may display volatility depending on the economic and fiscal environment.</li> <li>Reasonable level of cooperation with senior government, although policy objectives may diverge in some areas.</li> </ul> | <ul style="list-style-type: none"> <li>The legislative framework defining municipal responsibilities and revenue-generating powers is rigid and may lack the guidelines necessary to foster financial sustainability.</li> <li>Provincial monitoring is limited.</li> <li>Less cooperative relationship with senior government.</li> <li>History of downloading of responsibilities or interruption of funding programs by the provincial government during downturns.</li> </ul> | <ul style="list-style-type: none"> <li>The legislative framework defining municipal responsibilities and revenue-generating powers is inadequate and lacks the guidelines necessary to foster financial sustainability.</li> <li>Provincial monitoring is absent.</li> <li>Less cooperative relationship with senior government.</li> <li>History of downloading of responsibilities or interruption of funding programs by the provincial government during downturns.</li> </ul> |

1. The fundamental strength is relative to DBRS's other rating categories and is consistent with those identified in other DBRS rating methodologies.

- A well-defined basket of responsibilities, developed and diverse economic and taxable assessment bases and relatively supportive provincial governments characterize Canada's largest municipal governments and lend support to their credit ratings. Nonetheless, economic disparities and varying fiscal management styles and capital needs are only a few of the considerations that lead to differing credit quality among major Canadian cities.
- DBRS endeavours to rate each issuer through the cycle and does not penalize an issuer at economic troughs nor reward it at economic peaks unless such changes are structural and are expected to materially alter future financial metrics and/or qualitative rating considerations. Below is a summary of the key considerations and drivers of DBRS ratings that characterize Canadian municipal governments.

## PRIMARY FACTORS

### *Economic Structure*

- Similar to provinces, the economy 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 revenue necessary to fulfill its service responsibilities and carry its debt. Both the composition and the location of a municipal economy provide valuable insight into the volatility, dynamism and growth potential of a municipality and its propensity to create jobs and generate wealth. A diversified economy located close to other large and dynamic urban centres and well integrated into the provincial transportation network will generally tend to fare better and experience more consistent population and taxable assessment growth over the longer term than a more isolated commodity-based economy.

- In its analysis of the economic structure, DBRS focuses on (1) gross domestic product (GDP) and employment breakdown by major industry and major employer; (2) prospects of key industries and employers with competitive advantages; (3) track record of employment creation; and (4) adequacy of major infrastructure (e.g., roads, transit, 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 of 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.

### *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 at 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 (i.e., the degree to which expenditures can be contained or revenues increased in order to protect fiscal soundness).
- DBRS also analyzes the volatility of fiscal results and the government's fiscal track record, which provides an indication of the government's commitment to fiscal soundness.
- DBRS reviews the effectiveness of the budgetary process, including the timeliness and comprehensiveness of the government's planning, reporting and monitoring systems, as well as the ability of fiscal authorities to control 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 social and fiscal policies, with frequent changes in strategic goals generally perceived as weakness in the policy framework.
- In assessing the quality of the fiscal planning framework, DBRS compares recent years' fiscal results with original budget estimates, putting emphasis on the frequency and extent of major budget deviations.

### *Financial Management – 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 capital investments and borrowing needs and considers the full range of factors that could affect the debt burden and related servicing requirements.
- The primary focus is on tax-supported debt, which includes financial obligations for which taxpayers are directly accountable. 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.
- A look into a government's financial management strategy, including the level of sophistication of its borrowing practices and overall debt structure, helps assess the potential volatility of debt-servicing requirements. In particular, analysts examine the composition and maturity structure of the debt stock and its sensitivity to changes in inflation, interest rates and exchange rates. DBRS aims to develop an outlook for debt and debt-servicing requirements to assess overall affordability.
- As a result of their fairly predictable expenditure base and steady stream of revenue, some municipal governments tend to minimize their cash balances. Large municipalities, in particular, also often benefit from superior access to capital markets because of high investor receptivity, which considerably reduces refinancing risk and further reduces the need for backup liquidity.
- Nonetheless, municipalities will often have sizable reserve funds in place, which, although generally earmarked for specific capital projects, could be temporarily allocated to other purposes in the event of severe liquidity stress. DBRS analyzes cash balances and reserves in relation to expenditures, 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.

### *Relations with Senior Government*

- While the creditworthiness of a Canadian municipality is primarily driven by the fundamentals of that municipality, the credit profile of the provincial government may also have a material influence on the rating since municipalities share their taxpayer base with their provincial counterparts 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.
- 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 also have significant implications for the credit profile of municipalities, highlighting the importance of carefully analyzing the dynamic between municipalities and their respective provincial governments.
- 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 counterparts. DBRS analysts pay particular attention to the sustainability and consistency of key provincial policies aimed at municipalities.

## **ADDITIONAL FACTORS**

### *Tax Competitiveness*

- The structure and level of taxation can have a bearing on a municipality's ability to attract and retain residents and businesses, which can in turn have implications for longer-term growth prospects or the government's ability to implement tax increases in the future, if necessary.
- DBRS looks at a municipality's tax competitiveness, particularly in relation to neighbouring jurisdictions, and at the composition and level of key user fees and any barriers the framework may pose to future growth.

### *Demographics and Social Structure*

- Demographic and social trends have a significant impact on a government's fiscal position by affecting the labour force, income distribution and demand for municipal services.
- For example, cities with a rapidly growing population will often enjoy an expanding taxable assessment base, but they may also face greater public pressure to expand public services, such as transit, and 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.

### *Ownership of Valuable Municipal Corporations*

- DBRS also incorporates into its analysis material benefits generated by the ownership of self-supporting corporations fulfilling commercial mandates. Electric utilities are the most common type of valuable corporations owned by major Canadian municipalities. These entities often generate steady dividend streams that contribute positively to fiscal results and could be monetized, if needed, to significantly reduce debt. However, ownership of poorly performing corporations can represent a drain on municipal resources and potentially add to tax-supported debt obligations.

### *Transparency*

- An examination of budgeting practices and financial reporting provides an indication of how transparent a municipal government is and the degree to which it can be relied on.
- Characteristics demonstrating transparent management and reporting practices generally include a well-structured budgeting process, adequate and timely financial reporting, the adherence to high accounting and reporting standards and early adoption of new rules.

## Issuer-Specific Financial Risk Factors

### KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our review of key metrics to a small sample of critical ratios. Presented below for each of those critical ratios are ranges within which the variable would be considered as supportive of the rating category presented at the top of the column. However, the wide range of municipalities in existence throughout Canada, especially in terms of size, location, economic diversification and wealth, makes any attempt at generalization challenging and potentially misleading. As such, the values provided below are for Canada's larger cities, with populations exceeding 300,000, as their credit profiles are generally supported by diversified economies and sophisticated management frameworks.
- This rating methodology can still be used for smaller municipalities, although unique strengths or weaknesses, such as overreliance on a single industry or location in a shrinking, economically challenged region, may distort the analysis and reduce the relevance of the guidelines significantly, requiring financial metrics considerably stronger than noted below for a rating category.
- Furthermore, the ratings in the matrix below should not be understood as the final rating for a large city with matching metrics. This would only be the case to the extent that the economic profile and operating risk of the municipality and a wide range of other financial and operating metrics were also supportive. The final rating is a blend of both the operating risk and financial risk considerations in their entirety.

### Canadian Municipal Government Industry Financial Metrics

| Key Ratio  | AAA     | AA               | A                  | BBB       |
|--|---------|------------------|--------------------|-----------|
| Net tax-supported debt per capita <sup>1</sup>               | < \$500 | \$500 to \$2,500 | \$2,500 to \$4,000 | > \$4,000 |
| Net tax-supported debt as a percentage of taxable assessment | < 0.5%  | 0.5% to 2%       | 2% to 6%           | > 6%      |
| Interest costs as a percentage of operating expenses         | < 1.5%  | 1.5% to 9%       | 9% to 15%          | > 15%     |

1. Refer to Appendix 1 for an explanation of DBRS adjustments to reported financial figures.

- While the metrics in the above table are recognized as key factors, they are not sufficient to provide a complete overview of the financial risk pertaining to a particular government. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be boiled down to a limited number of metrics, regardless of how critical these may be. We would also note that DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate our opinion on future metrics, a subjective but critical consideration. Nevertheless, the key ratios are very useful in providing a good starting point in assessing a government's financial risk.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS considers when evaluating the financial risk profile of a government, we now provide a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.
- DBRS's review includes five key areas: economy, fiscal balance, revenues, expenditures and additional measures for balance-sheet and financial flexibility. Within each area, DBRS focuses on key metrics and considerations that are assessed over time, recognizing that the trend in the ratios is also important to the rating and that ratios alone cannot be used as an absolute test of financial strength.

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## Key General Considerations in Evaluating a Canadian Municipal Government's Financial Risk Profile

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In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis of Canadian municipal governments.

### ECONOMY

- 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 the following 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 Indicators*

- Real GDP growth (when available).
- Taxable assessment growth and per capita.
- Housing starts.
- Employment growth and unemployment rate.
- Population growth.

### 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 budgets, although large capital investments may at times translate into sizable 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 sizable 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 rather than a structural imbalance about which a government is showing little initiative. DBRS refers to this practice as "rating through the cycle."

#### *Key Indicators*

- Surplus or deficit (pre- and post-capex).
- Track record of fiscal results and medium-term outlook.

### REVENUES

- The 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 such as water and waste management; 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 it is at the expense of more limited revenue growth prospects.
- Special emphasis is put on the resilience of major revenue sources, on overreliance 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 analyzed closely.

- DBRS may make certain adjustments to reported revenue figures in order to exclude non-recurring items and, ultimately, better reflect the underlying fiscal situation of a municipality.

#### *Key Indicators*

- Revenue diversity, stability and growth trend.
- Key tax rates and user fees relative to peers.
- Tax arrears as a percentage of current levy.

### **EXPENDITURES**

- 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 the marked ramp-up in capital investments observed in recent years.
- DBRS analysts seek to get a clear understanding of current and future capital requirements faced by the municipality, 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 meaningful portion of a government's budget. As a result, the stability and trend of a municipality's interest and debt payments are an especially important consideration.
- In analyzing debt-servicing requirements, particular attention is paid to the municipality's debt structure and management strategy, incorporating findings from the analysis of the debt and liquidity profile. DBRS notes that in the current low-rate environment, the importance of debt-servicing requirements is probably understated; therefore, increased emphasis on a municipality's debt maturity profile and refinancing strategy is warranted.

#### *Key Indicators*

- Expenditure volatility and growth trend.
- Actual expenditures-to-budgeted expenditures.
- Program and capital expenditures per capita.
- Interest expense as a percentage of total expenditures.
- Capital expenditure trend.



## BALANCE-SHEET AND FINANCIAL FLEXIBILITY CONSIDERATIONS

- The sustainability of a municipality's debt burden is a central consideration in the determination of a credit 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.
- 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 municipality 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 municipality as represented by its taxable assessment. It is also analyzed relative to total tax revenues on a per capita basis. Although other financial commitments, such as capital lease obligations and unfunded pension liabilities, are not included in the calculation of tax-supported debt, they 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 municipal 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 municipality and is highly unlikely to require government support.

### *Key Indicators*

- Tax-supported debt per capita and as a percentage of taxable assessment.
- Debt structure – maturity profile, currency and interest rate exposure.
- Debt servicing as a percentage of operating expenditures.
- Gross borrowing needs and borrowing strategy.
- Capital program and expected impact on debt.
- Cash balances, reserve funds as a percentage of expenditures.

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## Appendix 1: DBRS Adjustments to Reported Financial Figures

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In certain circumstances, DBRS may adjust the financial results reported by a municipal government in order to (1) allow for a better comparison among peers; (2) capture all material tax-supported debt; (3) exclude debt deemed to be self-supporting within the reporting entity; and/or (4) present fiscal results that are more reflective of the impact of government activities on indebtedness. The most frequent adjustments relate to the following areas.

(1) **Tax-Supported Debt:** In an effort to capture the full extent of debt obligations to the account of taxpayers, DBRS adds up the debt of all activities and entities supported in a significant fashion by tax proceeds, such as public transit, road investments and general facilities. However, DBRS also excludes from its calculation of tax-supported debt certain debt items related to activities that are deemed self-supporting (i.e., activities that are funded in a significant fashion by user fees and that could potentially be monetized to repay the related debt obligations if the municipality faced a serious financial squeeze). These activities include electricity generation and distribution, water treatment and distribution and social housing.

(2) **Capital Expenditure Treatment:** DBRS converts capital expenditures from an amortization basis to a “pay-as-you-go” basis to get fiscal results that are more reflective of the full extent of municipal government spending and of external financing needs for a given year.

(3) **Non-Recurring Items:** Fiscal results sometimes include extraordinary items that introduce distortions in results and hinder year-over-year comparisons of results. These may include asset sales performed to boost revenues and balance budgets in challenging fiscal times, restructuring costs or write-offs of tax receivables. DBRS attempts to remove all material non-recurring items from reported results in order to better understand the underlying fiscal position of a municipality.

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## Appendix 2: Short-Term and Long-Term Ratings

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- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled “[Short-Term and Long-Term Rating Relationships](#)” and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

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