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Research Update:

City of Edmonton Outlook To Negative From Stable On Weaker-Than-Expected Budgetary Performance And Higher Debt Burden

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Table Of Contents

1902420 | 301760114

Table Of Contents (cont.)

Research Update:

City of Edmonton Outlook To Negative From Stable On Weaker-Than-Expected Budgetary Performance And Higher Debt Burden

Overview

- We believe there is an increasing chance that the City of Edmonton's recent weakening in after-capital deficits and increase in debt burden, currently assumed to be temporary, could be sustained over the medium term, depending on the magnitude, timing, and funding profile of additional projects, including stage two of the Valley Line LRT.
- As a result, we are revising our outlook on Edmonton to negative from stable.
- We are also affirming our 'AA+' long-term issuer credit and senior unsecured debt ratings, and our 'A-1+' short-term rating on the city.
- We could lower the ratings by one notch in the next two years if we came to believe that the rollout or announcement of additional capital projects will likely keep Edmonton's after-capital deficits above 5% of operating revenues and its debt burden above 120% of operating revenues on a sustained basis.

Rating Action

On Aug. 17, 2017, S&P Global Ratings revised its outlook on the City of Edmonton, in the Province of Alberta, to negative from stable. At the same time, S&P Global Ratings affirmed its 'AA+' long-term issuer credit and senior unsecured debt ratings and its 'A-1+' short-term rating and 'A-1(High)' Canada scale commercial paper rating on the city.

Outlook

The negative outlook reflects our view that there is an increasing chance that we could downgrade Edmonton by one notch in the next two years if we came to believe that the rollout or announcement of additional capital projects will likely keep Edmonton's after-capital deficit's above 5% of operating revenues and its debt burden above 120% of operating revenues on a sustained basis.

All else equal, we could revise the outlook to stable in the next two years if improving visibility on the city's medium-term capital funding profile indicates that Edmonton's fiscal position is likely to strengthen, with after-capital deficits declining below 5% of operating revenues and tax-supported debt dropping to less than 120% of operating revenues.

Rationale

The outlook revision reflects our view that there is an increasing chance that we could downgrade Edmonton by one notch in the next two years if we came to believe that the rollout or announcement of additional capital projects will likely keep Edmonton's after-capital deficits above 5% of operating revenues and its debt burden above 120% of operating revenues on a sustained basis. In our view, this will likely depend on the magnitude, timing, and funding profile of additional projects, including stage two of the Valley Line LRT.

Sustained capital spending will weigh on the city's credit profile in the next two years.

Edmonton's 2016 operating revenues increased less than we previously anticipated, primarily due to weaker user fees and revenues from sale of goods and services. This, coupled with the transfer of the drainage operations to EPCOR Utilities Inc. (the city's wholly owned utility), will result, in our view, in fairly modest growth in 2017 and 2018 operating revenues. As a result, we expect operating margins to average about 19% on average from 2015-2019, which is below our last year's forecast average. With the construction of the Valley Line LRT (stage one) progressing to its scheduled end in 2020, in addition to other significant projects, Edmonton expects to see its capital spending grow in the near term. As a result, we believe this will put pressure on its after-capital balances, which we expect to remain elevated, averaging 6.2% from 2015-2019.

We expect large capital spending to require the city to borrow substantially. The city estimates that its tax-supported debt will grow to about C$4.5 billion in 2019, from C$3.5 billion at the end of 2016. As a result, we estimate that Edmonton's tax-supported debt to operating revenues will reach about 144% at the end of 2019, up from 122% in fiscal 2016. Despite the city's higher debt, we expect that the average interest expense will remain stable, at 4.9% of operating revenues, in 2016-2018. Our measure of tax-supported debt comprises debt issued by the city for its own purposes as well as on behalf of EPCOR; of note, as of the end of fiscal 2017, the debt on-lent to EPCOR will include the debt related to drainage projects transferred by the city.

The city's contingent liabilities are low. They largely relate to standard employee benefits and landfill postclosure liabilities, and totaled C$157 million, or 5.5% of adjusted operating revenues at year-end 2016. In addition, we consider the C$1.9 billion issued by EPCOR in its own name to be a contingent liability. We believe that Edmonton's support for EPCOR in the event of the utility's financial distress would be limited to less than 10% of the city's operating revenues, given EPCOR's large size, its self-supporting status, and our assessment of a low likelihood of extraordinary government support. As a regulated entity, EPCOR has the ability raise rates and fees to recover losses.

Approximately 90% of Edmonton's operating revenues are internally modifiable (largely property taxes) and we believe the city has some ability to defer

1902420 | 301760114

some non-critical capital projects if required under a stress scenario. However, Edmonton faces some practical constraints typical of Canadian municipalities, namely provincially mandated municipal programs and personnel costs, many of which are subject to collective agreements, and which limit the city's ability to cut spending. In addition, given Edmonton's greater focus on large capital projects, such as transportation, we believe that the city has little ability to defer such a capital program over the next few years. We estimate that the city's capital expenditures will account for nearly a third of total expenditures in the next two years.

Edmonton continues to benefit from exceptional internal liquidity support and strong access to external liquidity for refinancing needs, given its proven ability to issue into various markets, including that for public debt, and the presence of a secondary market for Canadian municipal debt instruments. Edmonton can also draw up to C$100 million in promissory notes and access the Alberta Capital Finance Authority for term debt financing. We estimate that the city's cash and liquid assets total about C$1.9 billion in the next 12 months, which is sufficient to cover about 3x the estimated debt service for the period.

Predictable institutional framework and financial management remain credit rating strengths.

We believe Canadian municipalities benefit from a very predictable and well-balanced local and regional government framework that has demonstrated a high degree of institutional stability. Although provincial governments mandate a significant proportion of municipal spending, they also provide operating fund transfers and impose fiscal restraint through legislative requirements to pass balanced operating budgets. Municipalities generally have the ability to match expenditures well with revenues, except for capital spending, which can be intensive. Any operating surpluses typically fund capital expenditures and future liabilities (such as postemployment obligations and landfill closure costs) through reserve contributions.

In our view, the management team is experienced and qualified to effectively enact appropriate fiscal policies, as well as effectively respond to external risks. The city has a robust set of financial policies and annual financial statements are comprehensive, audited, and unqualified. In addition, it provides transparent disclosure of pertinent information and prepares detailed multiyear operating and capital budgets. Management of debt and liquidity is prudent, and the business plan details formal risk-management strategies and policies.

The greater Edmonton region is the design and fabrication center for most of the equipment used in the oil sands and other oilfield development. This results in high income levels but represents a substantial economic concentration. However, as the provincial capital, Edmonton has a notable public sector, which partly insulates the labor force from economic cycles. While nominal GDP per capita data are not available at the local level, we estimate that it would be in line with the provincial level, which is estimated to average close to US$65,000 for 2015-2017.

Key Statistics

Table 1

City of Edmonton -- Selected Indicators

	-- Fiscal year ended Dec. 31 --					
Mil. C$	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Operating revenues	2,633	2,808	2,875	2,961	2,987	3,137
Operating expenditures	2,121	2,263	2,297	2,410	2,430	2,552
Operating balance	512	545	578	550	557	586
Operating balance (% of operating revenues)	19.4	19.4	20.1	18.6	18.7	18.7
Capital revenues	310	293	306	445	600	509
Capital expenditures	954	988	1,114	1,148	1,480	1,293
Balance after capital accounts	(132)	(150)	(229)	(153)	(323)	(198)
Balance after capital accounts (% of total revenues)	(4.5)	(4.8)	(7.2)	(4.5)	(9.0)	(5.4)
Debt repaid	113	421	416	485	430	447
Gross borrowings	610	558	702	795	1,011	730
Balance after borrowings	365	(13)	57	157	258	85
Modifiable revenues (% of operating revenues)	87.8	88.7	89.6	90.0	90.1	90.6
Capital expenditures (% of total expenditures)	31.0	30.4	32.7	32.3	37.9	33.6
Direct debt (outstanding at year-end)	3,116	3,239	3,510	3,813	4,356	4,516
Direct debt (% of operating revenues)	118.3	115.4	122.1	128.8	145.8	144.0
Tax-supported debt (outstanding at year-end)	3,116	3,239	3,510	3,813	4,356	4,516
Tax-supported debt (% of consolidated operating revenues)	118.3	115.4	122.1	128.8	145.8	144.0
Interest (% of operating revenues)	4.3	4.6	4.5	5.0	5.2	4.6
National GDP per capita (single units)	55,792	55,405	55,876	57,800	59,340	60,780

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. bc--Base case.

Ratings Score Snapshot

Table 2

City of Edmonton -- Ratings Score Snapshot

Key rating factors	**Assessment**
Institutional Framework	Very predictable and well-balanced
Economy	Strong
Financial Management	Very strong
Budgetary Flexibility	Strong
Budgetary Performance	Average
Liquidity	Exceptional

Table 2

City of Edmonton -- Ratings Score Snapshot (cont.)

Key rating factors	Assessment
Debt Burden	High
Contingent Liabilities	Low

Note: S&P Global Ratings' credit ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the foreign currency rating on the government.

Key Sovereign Statistics

Sovereign Risk Indicators, July 6, 2017.Interactive version available at www.spratings.com/SRI.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Americas Economic Snapshot, July 26, 2017
- Annual International Public Finance Default Study And Rating Transitions, June 30, 2016
- Public Finance System Overview: Canadian Municipalities, Dec. 1, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the budgetary performance and debt assessments deteriorated. All other key rating factors were unchanged. Key rating factors are reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion.

The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Edmonton (City of)		
Issuer Credit Rating	AA+/Negative/A-1+	AA+/Stable/A-1+

Ratings Affirmed

Edmonton (City of)	
Senior Unsecured	AA+
Commercial Paper	
Canada scale	A-1(HIGH)
Global scale	A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.