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## Research Update:

# City of Thunder Bay Ratings Raised To 'AA' From 'AA-' On Strong Budgetary Performance; Outlook Is Stable

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## Table Of Contents

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Overview

Rating Action

Outlook

Rationale

Key Statistics

Ratings Score Snapshot

Key Sovereign Statistics

Related Criteria

Related Research

Ratings List

## Research Update:

# City of Thunder Bay Ratings Raised To 'AA' From 'AA-' On Strong Budgetary Performance; Outlook Is Stable

(**Editor's Note:** This article, original published June 27, 2017, misstated some scores in the Ratings Score Snapshot. A corrected version follows.)

## Overview

- The City of Thunder Bay's 2016 budgetary performance was stronger than we had expected, resulting in a modest after-capital surplus.
- Although we expect that higher capital expenditures in the next several years will drive modest after-capital deficits, overall we expect that budgetary performance will remain robust.
- We are therefore raising our long-term issuer credit and senior unsecured debt ratings on the city to 'AA' from 'AA-'.
- The stable outlook reflects our expectation that over the next two years Thunder Bay will generate largely consistent budgetary performance, despite significant capital spending, while maintaining a stable debt burden and liquidity.

## Rating Action

On June 27, 2017, S&P Global Ratings raised its long-term issuer credit and senior unsecured debt ratings on the City of Thunder Bay, in the Province of Ontario, to 'AA' from 'AA-'. The outlook is stable.

## Outlook

The stable outlook reflects our expectation that the city will continue to demonstrate robust budgetary performance, with after-capital deficits averaging less than 5% of total revenues, while maintaining a low debt burden and liquidity balances that exceed 100% of the next 12 months' debt service.

## Downside scenario

We could lower the ratings over the next two years if weaker-than-expected economic growth were to cause significant deterioration in the city's budgetary performance, resulting in after-capital deficits greater than 5% of total revenue, and a decline in liquidity balances to less than 1x debt service coverage.

## **Upside scenario**

Although we view an upgrade as unlikely over the next two years, we could raise the ratings if Thunder Bay demonstrated consistent political willingness to further improve its long-term planning and budget sustainability, while maintaining sufficient internal capital funding. In addition, we would expect that the tax-supported debt burden, after peaking in 2019, would begin to trend downward to less than 30% of consolidated operating revenue before an upgrade were likely.

## **Rationale**

The upgrade reflects an improvement in average budgetary performance expected throughout our 2015-2019 forecast period. In 2016, Thunder Bay closed two long-term care homes that no longer met provincial standards. This resulted in a substantial decline in associated conditional grants from the province. However, this was more than offset by the reduction in related personnel expenses as well as other cost-saving measures enacted by the city in the past several years. In addition, the city spent slightly less than we had expected on capital, which combined to result in a modest after-capital surplus for the year. Over the next two years, we expect that capital spending will trend higher but will not require significant issuance of net new debt given Thunder Bay's efforts to increase its ongoing internal contributions to capital funding.

### **Effective cost controls and increasing internal financing of capital will keep operating performance robust and the debt burden manageable.**

Thunder Bay's assessment base has grown slowly, less than 1% in the past two years, partly reflecting the demographic challenges facing the city. Consequently, operating revenues are expected to grow at a modest average of 1.9% through 2019. The city has been largely effective in controlling the growth of operating expenses and we expect that operating balances will remain stable over our 2015-2019 forecast horizon at more than 14% of operating revenues on average. These robust surpluses facilitate the city's ability to internally finance its capital plan and limit the requirement for debt financing. However, Thunder Bay plans to increase its capital spending in the next several years to help address its infrastructure deficit. Consequently, we expect that modest after-capital deficits averaging almost 2% of total expenditures in 2015-2019 will result.

The closure of the long-term care facilities and the reduction in associated operating grants have resulted in a higher proportion of own-source revenues (predominately property taxes). This increase to modifiable revenues (expected to reach almost 90% of operating revenues in 2019 from 84% in 2014), together with high levels of capital spending (equal to about 20% of total expenditures in the next several years), contributes to the city's substantial budgetary flexibility. However, in line with our view of other Canadian municipalities,

we believe that Thunder Bay has limited ability to materially cut spending due to a high degree of municipal services that the provinces mandate and that leaves local governments little discretion concerning the costs. Wages and benefits account for more than half of operating expenditures and are often subject to collective agreements, which can further limit budgetary flexibility.

The city has indicated that the average capital spending in 2017-2019 could approach almost C\$120 million, with the majority of the tax-supported plan designated for maintenance-related road work, facilities renewal, and fleet and equipment replacement. The forecast also includes the capital plan of Tbaytel, the city's wholly owned and fully consolidated telecommunications company. In the 2017 budget, Thunder Bay continued to implement an additional tax levy allocated to its enhanced infrastructure renewal program, which is designed to help reduce its infrastructure gap. In 2017, this additional levy will generate C\$8.4 million, stable from 2016.

The increasing internal contributions to its capital program will help to limit the city's debt requirements in the next several years, despite the increased level of capital expenditures. In 2017-2019, we expect the city to borrow close to C\$100 million in gross debt, about half of which will help finance the expansion of Tbaytel's fiber optic network. However, given large principal payments due over the same period, we believe that the net impact on the tax-supported debt burden will be modest and that the ratio of tax-supported debt to consolidated operating revenues will be largely stable at about 42% by 2019, while interest costs will account for a very manageable 1.5% of operating revenues.

Thunder Bay's credit profile benefits from what we view as an excellent liquidity position. We expect its free cash and liquid assets (S&P Global Ratings-adjusted) to average about C\$74 million in the next 12 months and cover nearly 2x the debt service payable over the same period. Although we view this level of coverage to be healthy, it remains weaker compared with that of domestic peers, which tend to carry large liquid balances. We believe Thunder Bay's access to external liquidity is satisfactory through its access to a strong and diversified pool of domestic banks.

We do not believe that Thunder Bay's exposure to contingent liabilities has a material impact on its credit profile. They stem largely from some ongoing litigations, the operations of Thunder Bay Hydro Corp. (a wholly owned provider of regulated and unregulated electric utility services and complementary commercial services), and standard future employee benefits and liabilities and landfill postclosure costs (the latter items total about 10% of operating revenues and the city has reserves in places to cover a portion of these liabilities). We believe that in the unlikely event of financial stress at the utility, the city's support would be limited to less than 5% of its operating revenues.

**A large public-sector presence helps to mitigate broader economic challenges while a supportive institutional framework engenders good financial management practices.**

Thunder Bay is the center for many government services for northwestern Ontario and thus its economy focuses largely on the public sector (health care, school boards, and municipal and provincial administration), which acts as a stabilizing force, in our view. The manufacturing, retail, and mining sectors also contribute to the local economy. While GDP data are not available at the local level, we believe the city would generate nominal GDP per capita largely in line with that of Ontario of about US\$44,200, based on its income levels and higher value-added of some local industries. The census metropolitan area had median total income per household of C\$84,350 in 2014, compared with the provincial average of C\$78,790.

We believe that a weaker demographic profile, characterized by a declining population and a larger proportionate number of elderly residents, constrains its economic profile and could affect revenue growth and expenditure needs in the future. According to the 2016 Census, Thunder Bay's population was 107,909 in 2016, a decline of 0.4% since 2011. The city's proportion of residents aged 65 and over was 20.0%, compared with 16.7% in Ontario, reflecting Thunder Bay's growing popularity as a retirement destination.

We believe Thunder Bay exhibits financial management practices largely in line with those of similarly rated peers. The experienced management team has a good relationship with council, which has exhibited broad political consensus on fiscal policies in the past several years, specifically those aimed at increasing sustainable capital funding and reducing in-year budgetary volatility. The city's annual operating and capital budgets, which we view as realistic, reflect the broad goals outlined in the five-year financial plan. Thunder Bay adheres to prudent debt and liquidity management policies, and monitors cash flows on a daily basis.

We believe Thunder Bay, like other Canadian municipalities, benefits from a very predictable and well-balanced institutional 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.

## **Key Statistics**

**Table 1**

City of Thunder Bay -- Selected Indicators						
	--Year ended Dec. 31--					
(Mil. C\$)	2014	2015	2016	2017bc	2018bc	2019bc
Operating revenues	520	539	530	535	549	562
Operating expenditures	463	469	451	455	467	479
Operating balance	57	69	80	80	81	82
Operating balance (% of operating revenues)	11.0	12.9	15.0	14.9	14.8	14.7
Capital revenues	25	17	18	24	25	23
Capital expenditures	101	108	85	120	122	115
Balance after capital accounts	(19)	(22)	12	(16)	(16)	(9)
Balance after capital accounts (% of total revenues)	(3.5)	(3.9)	2.2	(2.9)	(2.8)	(1.6)
Debt repaid	26	28	29	28	30	32
Gross borrowings	20	45	35	26	37	34
Balance after borrowings	(26)	(5)	18	(18)	(9)	(7)
Modifiable revenues (% of operating revenues)	84.0	85.3	87.6	89.3	89.5	89.8
Capital expenditures (% of total expenditures)	18.0	18.7	15.9	20.9	20.7	19.3
Tax-supported debt (outstanding at year-end)	199	224	230	228	235	237
Tax-supported debt (% of consolidated operating revenues)	38.3	41.5	43.3	42.6	42.9	42.2
Interest (% of operating revenues)	1.5	1.5	1.5	1.5	1.5	1.6
National GDP per capita (single units)	55,792	55,405	55,857	57,465	59,005	60,636

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 Thunder Bay -- Ratings Score Snapshot	
Key Rating Factors	Assessment
Institutional Framework	Very predictable and well balanced
Economy	Strong
Financial Management	Satisfactory
Budgetary Flexibility	Strong
Budgetary Performance	Strong
Liquidity	Exceptional
Debt Burden	Low
Contingent Liabilities	Low

\*S&P Global Ratings bases its ratings on local and regional governments on the 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 rating.

## **Key Sovereign Statistics**

- Sovereign Risk Indicators, April 10, 2017. Interactive version available at <http://www.spratings.com/sri>

## **Related Criteria**

- 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**

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, April 21, 2016
- Public Finance System Overview: Canadian Municipalities, Dec. 1, 2016
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study and Rating Transitions, May 8, 2017

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 had improved. 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**

Upgraded

	To	From
Thunder Bay (City of)		
Issuer credit rating	AA/Stable/--	AA-/Positive/--
Senior unsecured	AA	AA-

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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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