Local Government Association Tasmania

DEBT FUNDING GUIDELINES
FOR LOCAL GOVERNMENT

The Context

Local government financial statements, like those of other sectors of government and the corporate sector, include many items of considerable financial value. One item that tends to receive negative and disproportionate attention is debt.

The nature of councils' activities and the way they are managed are generally 'low risk'. Their income streams are much less volatile than the private sector. However, councils have tended to take a very conservative approach to debt and borrowing by local government to fund capital spending is still far from common practice in councils across Australia. It has only been in recent years that the State Government approach to local government borrowing has also changed, making it possible to take a more long-term plan.

A Review of the Financial Sustainability of Local Government in Tasmania, (Access Economics Report, March 2007) found that in recent times Tasmanian councils reliance on borrowings – in all forms – is super conservative and has fallen well below a level which can be warranted.

Figures supplied by the Municipal Association of Victoria (MAV) recommend that borrowings should not exceed 60% of annual rate revenue, with some justification for this to rise as high as 80%.

The audited financial statements for the South Australian Local Government sector for 2004-05 highlighted that the net debt of 2.2% was equivalent to a family living in a $250,000 home with a mortgage of only $5,500 and no other debts.[1] The net interest expenses of 1.1% of operating revenue for that period was described as extremely modest.

Access Economics[2] assessment that Tasmanian local government debt levels are below benchmark levels, is based on a 60% debt-to-total revenue ratio, based on a

[1] LGA Financial Sustainability Program – www.lga.sa.gov.au/goto/fsp
[2] 'Access Economics (2007*), A Review of the Financial Sustainability of Local Government in Tasmania,* A report for the Local Government Association of Tasmania, Access Economics Pty Ltd, Hobart.

normalized operating revenue to total revenue ratio of about 90% and a normalized interest-to-debt ratio of about 6%.

Tasmanian Treasury, in its *Local Government Loan Council Allocation Process* Discussion Paper (January 2005) has established as its benchmark a ratio of 40% for Net-Debt-to-Revenue and 7% for the Net-Interest-Cost-Ratio. It is therefore appropriate for councils to look at their long term capacity to service debt in order to address major infrastructure purchases.

Is There a Legislative Basis for Borrowing by Councils?

The State Government is exposed to a financial risk should a Local Government Authority (LGA) default on a borrowing. This could result in both political and financial implications (and embarrassment) for State Government. Therefore there exists a robust methodology for determining Local Government Loan Council allocations.

The Treasurer is bound by both the *Financial Agreement Act 1994* and the *Local Government Act 1993* when approving loans to LGAs. While historically the amount of debt in local government has been modest, the sum of total requests is on the increase according to the Local Government Loan Council Allocation Process Discussion Paper (Dept of Treasury & Finance Jan 2005). In order to best address to borrowing needs of LGAs into the future, this Discussion Paper[3] sets out a series of recommendations about assessing debt funding of LGAs. This is based on established 'Net Debt to revenue ratio' benchmarks as explained in the Treasury Discussion Paper.

When to Consider Going into Debt?

A council operating in a financially sustainable manner has operating revenue sufficient to meet the full cost of providing services. Even a well running council operating in this way is likely to use debt.

Debt does not necessarily mean a council is acquiring things it cannot afford. It merely provides an alternative and immediate form of capital. The important thing to understand is that the purpose to which the borrowings are deployed will ultimately determine their impact on the council's overall sustainability.

Borrowings must not be regarded as revenue. They do not replace the need to generate adequate revenue but may be used to provide a new infrastructure asset, or to replace and rehabilitate specific assets that the council already owns. Borrowing is useful when it enables a change in capacity, for example through building additional infrastructure. The funding of existing infrastructure renewal has to be balanced against any decision to pour maintenance money into an older asset towards the end of its' life.

Therefore borrowing is an appropriate means of financing long-lived infrastructure assets. The benefit that debt provides is to enable work to be done sooner. It does not increase financial capacity unless the investment generates additional revenue,

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[3] Department of Treasury and Finance (2005), *Local Government Loan Council Allocation Process Discussion Paper*, Version 1.0, January, Department of Treasury & Finance, Hobart.

the cost of which would be delayed and may increase in the absence of borrowing. Such delay is likely to result in an increase in the capital outlay required at a future date.

If a council increases its loan debt to the maximum amount possible, without either an increase in revenue, or decrease in operating costs, it is hard to see how the use of debt will improve the financial sustainability of the council.

How Much Debt is Okay?

Undertaking borrowing creates both an asset (the funds provided) and a liability (the obligation to repay the money borrowed). Borrowing money therefore does not change the value of a council's equity (the difference between assets and liabilities shown on the balance sheet).

There is no right or wrong level of debt, but it must be supported by the council's rates and cash flows. Those councils that rely more on grants from other governments and less on their own-source revenues have access to relatively low levels of additional financial capacity compared to councils (e.g. large urban centres) which have far greater resources and revenue streams.

While it has historically been considered desirable to keep debt levels as low as possible, borrowing is a valid and appropriate option available to councils to help finance ongoing infrastructure requirements. Deferral of infrastructure/replacement is often a 'greater sin' than borrowing to finance such renewal/replacement spending. This spending may be justified due to the greater cost in future years through deferring the spending activity. It may also be something that has intergenerational benefits, and therefore can expect to be funded by generations of ratepayers.

There is no specific amount of debt that is right for any one council, and a council with a high debt level can be more (or less) financially sustainable than one with lower debt levels.

Generally a council with an operating deficit would find it difficult to justify additional debt. However if the council is using debt to replace old assets with high operating expenses, and can demonstrate the case for greater efficiencies through the purchase of new equipment, the debt may be warranted.

Rather than just focusing on level of debt, a more useful measure is the council's net financial liabilities. This is the difference between the liabilities and the value of any financial assets (cash, investments, receivables, pre-payments etc).

Councils have a more certain revenue raising environment than private sector firms. Unlike the business sector who rely on liquidity (available cash), councils can optimize their treasury management practices and financial sustainability by having negligible cash investments, raising funds through borrowing only as cash needs necessitates.

What about Credit Rating Agencies?

Obtaining a credit agency rating may provide access to cheaper borrowings, and demonstrates to their community the strength of council's financial position. There seems to be no benefit for a council to pay an independent agency to rate their credit worthiness as local government enjoys a State Government guarantee of it's borrowings. Effectively the council thus enjoys the same credit rating as the government, and this ensures that interest rates paid by councils are based on the credit rating of the State.

When to Borrow?

Interest charged is generally higher than that earned through investments. Therefore it makes little sense for councils to borrow money when they already have cash reserves and liquid investments available to meet immediate and foreseeable funding needs. This could be compared with paying a minimum credit card payment while sitting on money in the bank for a rainy day.

Some councils may have traditionally used existing internal financial assets using 'internal borrowings'. This concept can encourage a 'silo' mentality to managing financial assets and is fading from use in today's more holistic financial environment.

What about Interest Rates?

All borrowers are exposed to rises in interest rates, and councils are no different. Fixed interest rates can be favoured for some borrowings and there is a benefit in not having 'all the eggs in one basket'. Short-term rates may be lower than long term rates, and variable rates may be more attractive than fixed. Movements in interest rates are not deemed to be a high risk to councils overall. A council with a high level of debt to income may prefer a balanced debt portfolio. Alternatively a council with low debt or good capacity to pay may choose to take the variable route.

Isn't it more responsible to reduce debt?

A zero debt policy is often inappropriate for local government as it implies that the current ratepayers are expected to meet the full cost of infrastructure assets, while in reality most of the benefit will actually be gained by future ratepayers.

On inter-generational grounds it is considered that additional borrowings can be considered to fund enhancement capital expenditure, and such capital expenditure gives rise to infrastructure enhancement that benefits future as well as existing ratepayers.

This way, the cost of the asset is matched by the benefits from consumption of service over the life of the asset, and it promotes inter-generational equity, which is only reasonable given the future benefit of the asset.

Therefore a zero debt policy usually results in under-investment in a council's infrastructure assets, and is a burden on the current ratepayers.

What sort of purchases should be considered?

Where infrastructure costs can be directly attributable to individual property owners, it is more equitable to recover them through developer charges. Infrastructure assets with a long lifespan, and delivering broad benefits to the wider community can be considered for funding through debt. These items are those with a high initial/replacement cost, making them difficult to fund from reserves. This also applies to assets that create an income stream. They also have dispersed beneficiaries, and this is better reflected through avoiding rates or 'user pays' method of funding.

Very significant plant and equipment, roads and bridges, and the acquisition of community/real estate assets can all fall within this category. Payment of recurrent fixed costs, wages, superannuation and routine maintenance should never be considered for funding through raising debt.

How do I sell this to the ratepayers?

Debt management has to be linked to a clear macro-economic framework within the council, and coordinate with current fiscal and monetary policies. Can council produce the evidence that this is activity is consistent with council's core activities and agreed priorities?

An important factor to consider is the outcomes and deliverables that flow from the investment. A properly conducted 'cost benefit analysis' should produce figures that will support the borrowing.

An examination of the relationship between the level of council's infrastructure investment and debt funding may provide support for the borrowing.

The method of deciding how to secure the upfront costs of an infrastructure asset depends on the characteristics of the asset, e.g. whether it has a short or long life span, or the payback period. The case must be accompanied by a thorough business plan reflecting the scale, duration and complexity of the proposal. This will include an options analysis of long/medium/short term debt alternatives, including different lease options and combinations of equity, reserves and debt funding.

Questions that a council can ask include:-

- What services do we deliver?
- What is the cost of delivery and maintenance of these services?
- Who is the ultimate beneficiary of these services and therefore who should pay for them?
- When should it be paid for?
- What does the community want and when??
- What is the life of the asset or service being funded?