Borrowing Strategy

2019-20

HOBSONS BAY CITY COUNCIL

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Introduction

Hobsons Bay's borrowing strategies previously focused on debt reduction up until 2014-15. Rates, grants, cash and investment reserves were used to fund capital works programs. Internal and external funding, rather than borrowings were identified as important sources to fund capital works, resulting in a general decline in cash and a reduction in debt servicing costs.

Council recognises that loans can be a responsible option in addressing infrastructure backlogs, delivering improved assets and services and maintaining equity between those generations of ratepayers who will actually benefit from the capital investment. Council acknowledges that it has the capacity to increase its debt, whilst maintaining a financially sustainable position, within acceptable debt levels.

Reviews conducted on Council's 10 year Capital Works Program indicated a need to increase spending on capital works renewal. Council was also required to fund the 2012 defined benefit superannuation shortfall. As a result, previous borrowing strategies, long term financial plan's (LTFP) and annual budgets have included:

- loan borrowings of $9.2 million to fund the 2012 defined benefit superannuation shortfall, currently held with the Municipal Association of Victoria (MAV) established Local Government Funding Vehicle (LGFV) as a seven year interest only bond
- loan borrowings of $5 million to fund additional capital works renewal expenditure in 2014-15, currently held with the LGFV as a ten year interest only bond

Council has determined that no further borrowings will be included within the current strategy but is mindful that:

- further borrowings may be included in future borrowing strategies after other options are considered and when Council can be assured that it has the ability to fund repayments, whilst ensuring financial sustainability
- it is important to maintain Council's capacity to borrow, so it can borrow when required
- future defined benefit superannuation calls are expected and it is likely that they will need to be funded out of borrowings when they occur
- ongoing reviews are being conducted in relation to the 10 year Capital Works Program and it is important that adequate asset renewal expenditure is included in each budget to ensure that the current asset infrastructure backlog does not increase
- current total capital expenditure levels outlined in the existing 'draft' 10 year Capital Works Program are well above the level that can be funded under the current financial constraints, contained within the existing LTFP
- in the long term, borrowing does not increase the amount of money available to spend. It allows a higher level of expenditure in a given year, but as it must be repaid (with interest) it requires a reduction in expenditure in future years

Financial sustainability and appropriate levels of debt

An Australian Local Government Association's (ALGA's) definition of financial sustainability is *"A Council's long-term financial performance and position is sustainable where planned long term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services."*

Another way of looking at it is to ensure that the Hobsons Bay community receives good quality services and enjoys well maintained facilities and infrastructure at an affordable level of property rates both now and into the future. However it is defined, it is important to have some agreed quantifiable measures of sustainability to judge where Council is now and what corrective action may need to be taken.

The indicator that the Victorian Auditor General's Office (VAGO) uses to measure appropriate debt levels in relation to determining a Council's financial sustainability is **indebtedness**, being non-current liabilities as a percentage of own-source revenue. The indebtedness indicator requires a percentage of less than 40 per cent to obtain a 'low' risk assessment from VAGO.

There are other key debt management indicators which indicate a council's capacity to repay its debt.

The **debt servicing ratio** identifies the capacity of a council to service its outstanding debt. This ratio is calculated as interest as a percentage of total revenue and has a target of less than five per cent; and

The **debt commitment ratio** identifies a council's debt reduction strategy. This ratio is calculated as interest plus redemption costs as a percentage of rate revenue and has a target of less than 15 per cent.

Council debt – An historical perspective

Indebtedness, Debt servicing and Debt commitment ratios

The VAGO report on Local Government: Results of the 2017-18 Audits provides information in relation to the **indebtedness** of inner metropolitan councils, including Hobsons Bay.

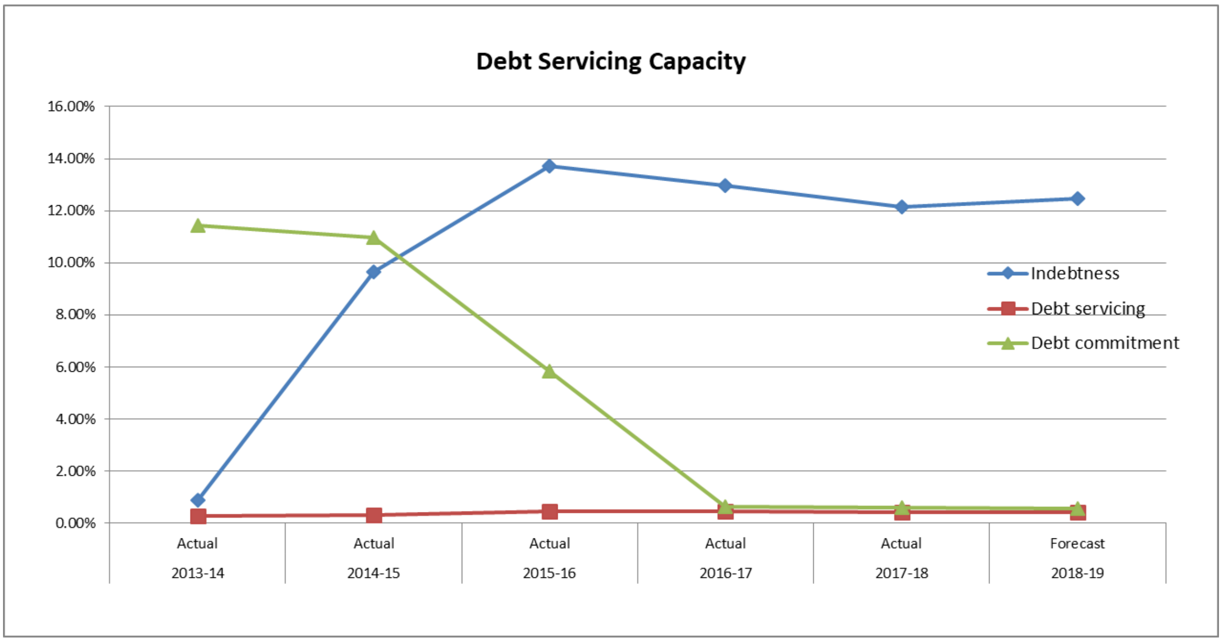
Hobsons Bay's indebtedness indicator (0.88 per cent) in 2013-14 was artificially low as virtually all of Council's debt was treated as short-term at that date. When existing loans of $9.2 million were transferred to a seven year bond, the indicator increased to a more realistic level (9.65 per cent) in 2014-15. The indebtedness indicator increased again in 2015-16 (13.71 per cent) as a result of transferring a $5 million short term loan to a longer term ten year bond. Since that time, Council's loan borrowings have remained unchanged, which has ensured reasonably consistent indicators in 2016-17 (12.96 per cent) and 2017-18 (12.16 per cent). It is forecast that this consistency in the indebtedness indicator will remain in 2018-19 (12.46 per cent).

These levels are all well below the VAGO threshold target of 40 per cent and firmly within the 'low' risk category.

The **debt servicing** ratio has been insignificant due to Council's low level of debt. Despite an increase in total borrowings in 2013-14 and 2014-15, interest on loans compared to total revenue remains extremely low and well below the target mentioned above (5 per cent).

Council's **debt commitment** ratios between 2013-14 and 2015-16 reflects Council repaying Vision Super for the defined benefit superannuation shortfall and transferring loans to the LGFV. These results are still below the target mentioned above (15 per cent) and the ratio is predicted to be 0.58 per cent by 30 June 2019. Debt commitment remains whilst Council does not pay any principle amounts in relation to its loans.

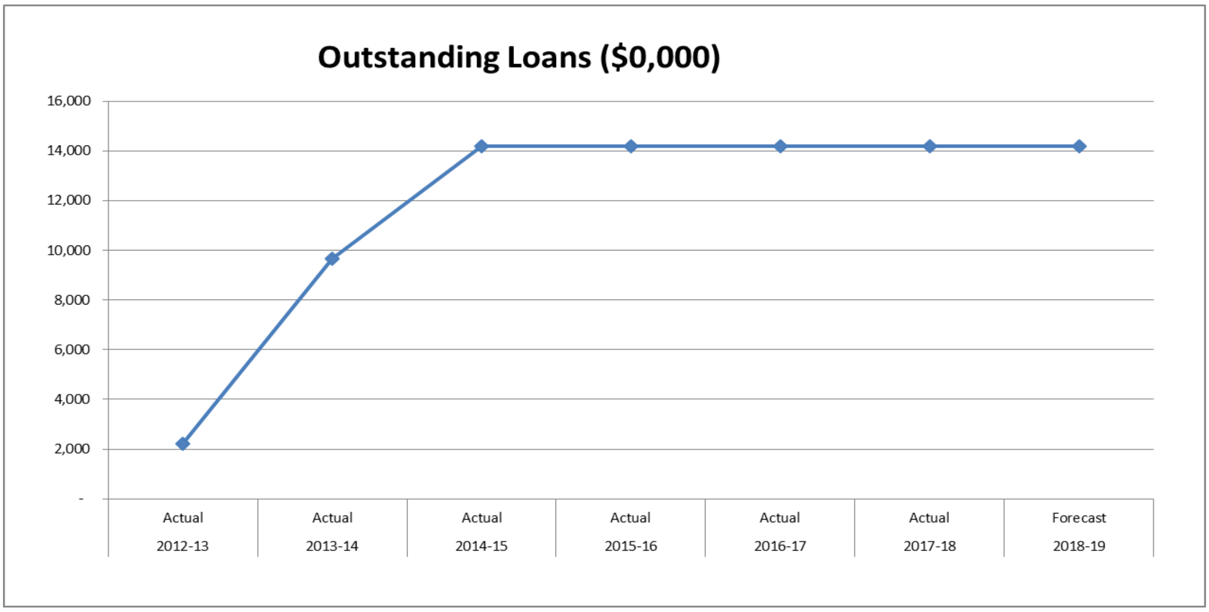
The following graph outlines Hobsons Bay's debt servicing capacity since 2013-14:



Total Debt

The extent of debt across inner metropolitan councils varies substantially. Hobsons Bay and all other councils have been impacted by the superannuation calls as well as an increased focus on asset renewal. A number have borrowed as a result.

The following graph outlines Council's total outstanding loans since 2012-13. It highlights the low levels of debt under the previous debt reduction strategy, additional borrowings required to fund the defined benefit superannuation shortfall in 2013-14 and borrowings in 2014-15 to fund additional capital works renewal expenditure.



Council's outstanding loans were reduced to $2.206 million by the end of 2012-13 before Council was required to borrow in 2013-14 to fund a defined benefit superannuation shortfall. This increased outstanding loans to $9.648 million in 2013-14 and loans were increased again in 2014-15 to $14.2 million to fund additional capital works renewal expenditure.

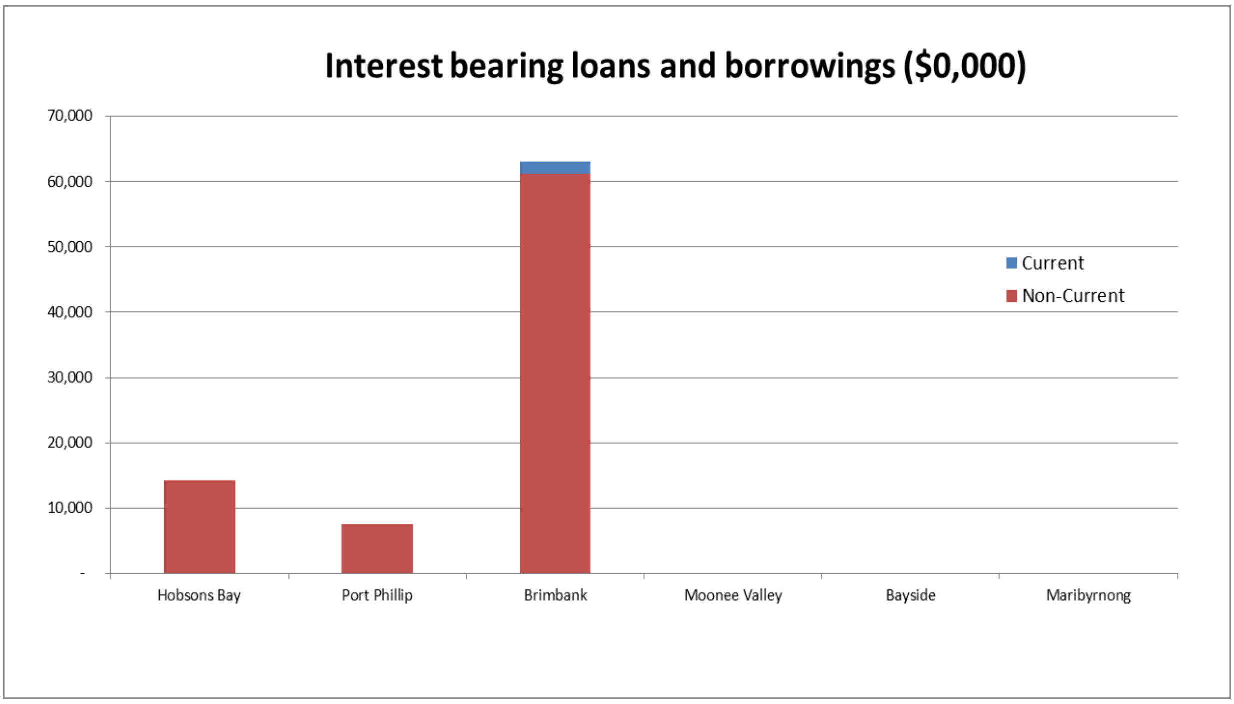
Since the end of 2015-16 all existing outstanding loans have been held as part of the LGFV. Initially loans have been held as part of the short term borrowing arrangements until they have been converted to longer term bonds. Currently Council's loan portfolio includes:

- $9.2 million held as part of the LGFV seven year interest only bond
- $5 million held as part of the LGFV ten year interest only bond

Benchmarking

Council has undertaken a benchmarking exercise to compare Hobsons Bay's level of loan borrowings against five similar councils for the 2017-18 financial year.

The graph below shows the level of current and non-current loan borrowing for each comparable local government.



Hobsons Bay has the second highest loan borrowings ($14.2 million), compared to Brimbank which is significantly higher ($63.121 million). Port Phillip's total borrowing are third ($7.5 million), whilst the other three council's, Moonee Valley, Maribyrnong and Bayside were debt free at 30 June 2018. Bayside had outstanding debt ($2.126 million) at 30 June 2017, but paid their borrowings of and became debt free during the 2017-18 financial year.

Council debt – Into the future

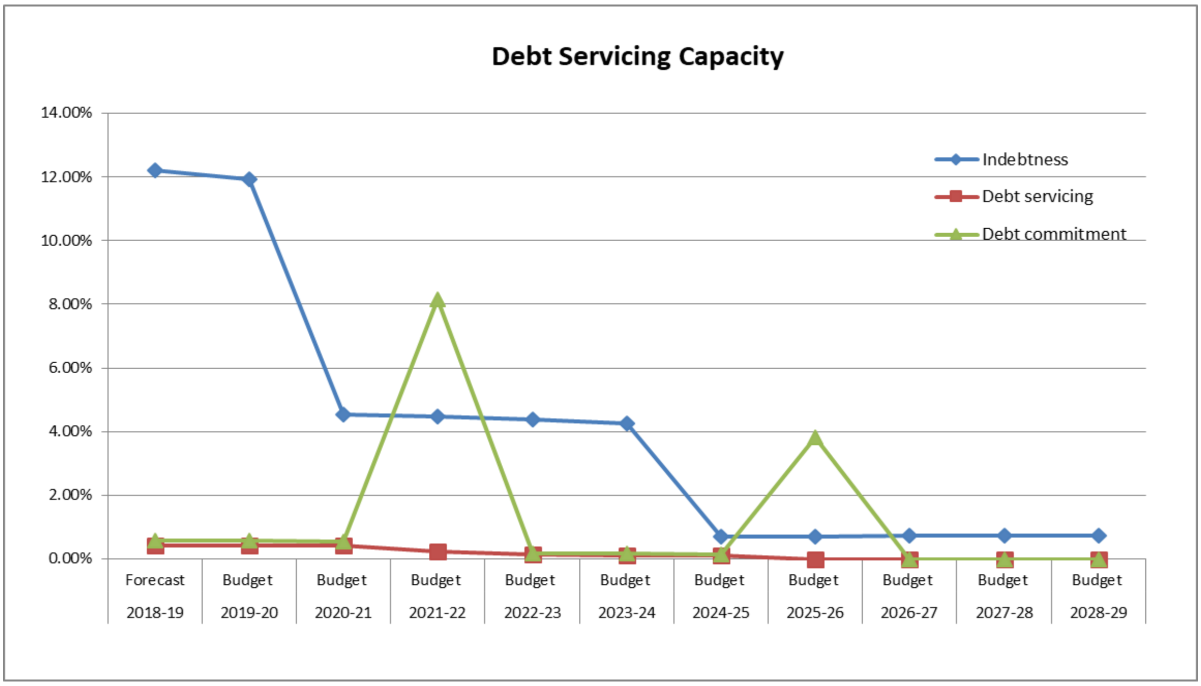
Indebtedness, Debt servicing and Debt commitment ratios

It is estimated that Hobsons Bay's **indebtedness** indicator will be 12.46 per cent by June 2019 as all of Council's borrowings are in the long term (non-current) classification. The indicator reduces slightly each year due to expected increases in Council's own-source revenue. The sharp decreases in 2020-21 and 2024-25 are a result of the two bonds being reclassified as current liabilities the year before they are repaid. With borrowings being repaid in this strategy and the LTFP, Council is expected to remain firmly within VAGO's 'low' risk category.

The **debt servicing** ratio remains insignificant throughout the strategy and LTFP as interest on loans compared to total revenue remains extremely low.

Council's **debt commitment** ratio from 2018-19 to 2020-21 is expected to remain extremely low as it relates only to interest payments on the LGFV bonds. The results of repaying the bonds are highlighted by the spikes in the indicator during 2021-22 and 2025-26.

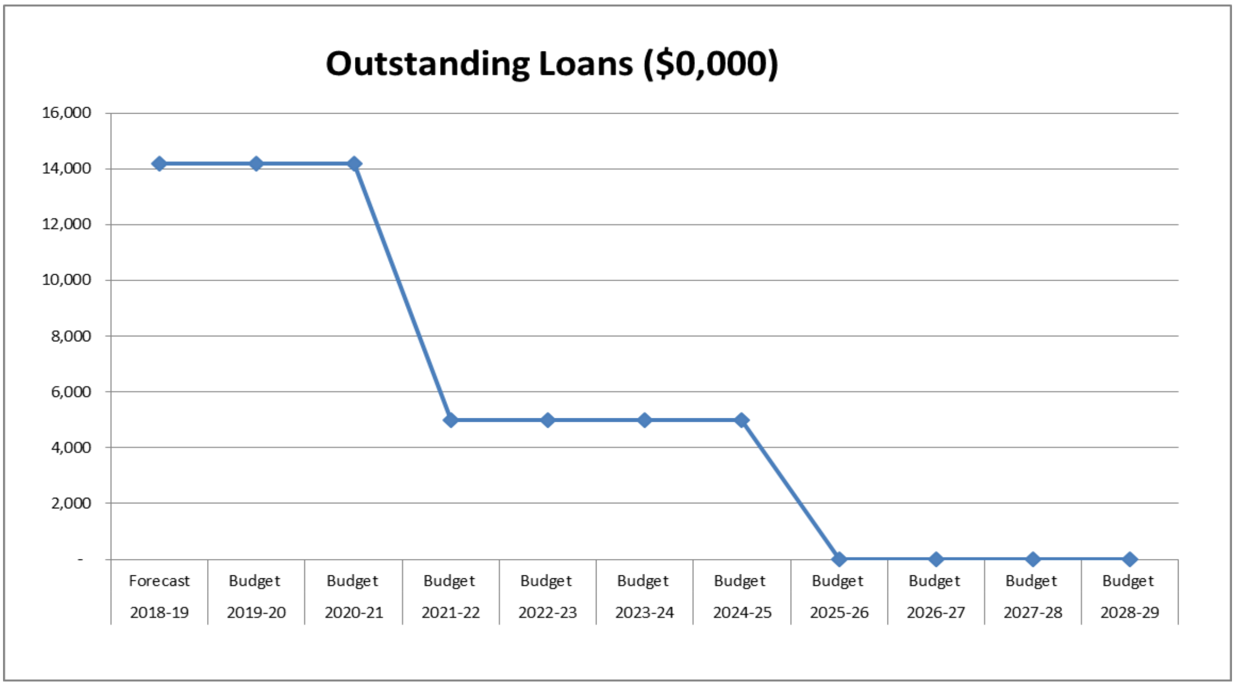
The following graph outlines Hobsons Bay's debt servicing capacity for the remainder of the LTFP. It indicates that all debt servicing capacity indicators will be within acceptable levels under the borrowings outlined in this strategy.



Total Debt

As mentioned earlier, this borrowing strategy is based on no further borrowings for the duration of the current strategy and the LTFP.

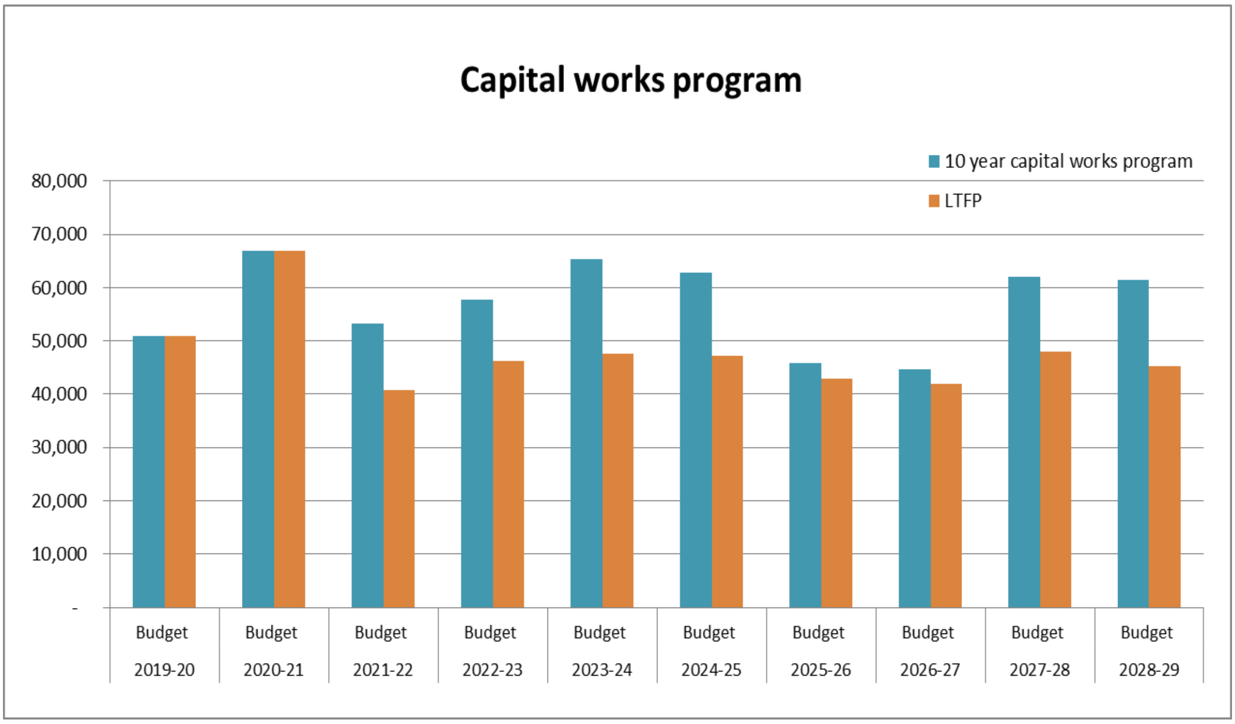
The following graph outlines Council's outstanding loans over the remainder of the LTFP. Existing loan borrowings ($14.2 million) are held in two separate LGFV bonds. The graph indicates that $9.2 million will be repaid in 2021-22 and $5 million repaid in 2025-26, completely extinguishing Council's loans.



Funding the Capital Works Program

Council officers have recently updated Council's 'draft' 10 year Capital Works Program, including adding additional projects as a result of recently conducted internal and community pre-budget submission processes. It has been impossible to include all of these projects within the LTFP as they cannot all be funded in a sustainable manner under the current financial constraints.

The most recent version of the 'draft' 10 year Capital Works Program provides for $571.053 million to be spent on capital over the next 10 years, whilst the LTFP currently estimates that $477.803 million is available in relation to capital works expenditure. The following graph highlights the difference of $93.259 million over the 10 year period. Whilst 2019-20 and 2020-21 are fully funded (largely due to significant transfers from the infrastructure reserve in 2020-21), there is insufficient funding available for every other year of the LTFP. Council must consider alternative measures prior to considering the option to borrow further.



The amount of capital works expenditure included in the 'draft' 10 Year Capital Works Program needs to be reduced to reflect the levels available in the LTFP. It is important that when these levels are reduced, that Council continues to prioritise renewing its existing assets. If Council cannot sustain adequate levels of asset renewal, then borrowing additional money may be one option to consider.

Whilst it is important that the Council addresses its infrastructure renewal requirements, the current LTFP results indicate that additional borrowings may not necessarily be the answer. Further borrowings may ‘fix’ the funding issue in a given year, but repayments that include interest will actually decrease the amount of capital funding available in the long term, which could exacerbate the problem in the years that follow.

In the long term, borrowing does not increase the amount of money available to spend. It allows a higher level of expenditure in a given year, but as it must be repaid (with interest) it requires a reduction in expenditure in future years.

Further borrowings should only be included after other options are considered and when Council can be assured that it has the ability to fund repayments, whilst ensuring financial sustainability.

Other options and issues to be considered

In determining whether the Council should borrow other funding sources and options should also be considered.

Prioritisation of the 10 year capital works program

As mentioned above, the most recent version of the ‘draft’ 10 year Capital Works Program provides for $571.053 million to be spent on capital over the next 10 years, whilst the LTFP currently estimates that $477.803 million is available, based on the current financial constraints and assumptions of the LTFP.

Council has a key challenge in relation to the expanding ‘capital needs’ and the growing community expectations in relation to delivery of its capital works program. Council can not necessarily complete all of the projects that it would like and must prioritise by differentiating between what is necessary versus what would be good to have.

Service reviews and efficiency and cost saving program

For the past few years Council has conducted an efficiency and cost saving program that has achieved significant savings. The review has continued in 2018-19 and it is expected that further operational savings will be realised when compared to both the annual budget and the most recent forecast.

Efforts are being made to determine the efficiency and cost savings that could continue on an ongoing basis. It is a significant challenge to ensure that these efficiency and cost savings are reflected in the 2019-20 annual budget and on an ongoing basis throughout the LTFP.

Additionally, Council should concentrate on service reviews to determine the most effective and cost efficient way that services are provided to the community. This includes reviewing service delivery methods, which could mean adjustments to the services provided internally by Council.

Rate increases

Hobsons Bay’s current LTFP indicates rate increases of 2.5 per cent per annum over the life of the plan, consistent with the rate cap.

Rate capping and the fact that Hobsons Bay’s average rates per assessment and rate reliance percentage are already considered high, indicates that Council has limited capacity to increase its rates income through an application to vary rates above the maximum allowed. Council has not proposed a variation above the rate cap of 2.5 per cent in 2019-20.

Fees and charges

Council's Revenue Strategy is currently being updated. The strategy attempts to determine an integrated approach to the setting of both its rating structure and its fees and charges. The purpose will be to determine the most appropriate and affordable revenue mix which, in conjunction with other income sources, will adequately finance the objectives proposed in the council plan, annual budget and strategic resource plan.

Through the strategy, Council may strive to determine a Pricing Policy that is used each year as a basis to determine the appropriate fees or charges that will be applied. Changes made previously to fees and charges have generally had minimal impact on the expected income generated, or the financial result predicted within each annual budget or future years contained within the LTFP.

Many of Council's statutory fees are predetermined by legislation and are not controlled by Council. For example, the State Government decision to approve a new fee structure for planning applications to ensure that applicants covered a greater percentage of the cost to provide planning services has had a considerable positive effect on the LTFP. Fees were increased in October 2016 and since then have been indexed annually, where previously they had not been updated or indexed consistently since 2000.

Sale of assets

Any opportunities to raise income from land sales must be very carefully considered prior to inclusion in annual budget figures. Council needs to be assured that the land sales will actually occur in a particular financial year and that there is enough time to go through the process for:

- ensuring a proper valuation of the land by the Council's independent contract valuer
- a public notice advertising that the Council intends to sell
- possible objections / submissions in relation to the Council intention to sell
- resolution to objections / submissions in relation to the Council intends to sell

The last two points above can extend the process indefinitely so land sales should be carefully managed through Council's infrastructure reserve to ensure that they are not committed to fund capital works until these points in the land sale is complete.

Local Government Funding Vehicle

Historically all councils tendered for their loan borrowings on an individual basis. Due to the increased demand for loan borrowings across the local government sector it was determined that an amended funding procurement model should be investigated.

The Local Government Funding Vehicle (LGFV) was established to drive significant financial savings. In aggregating sector wide borrowings, savings are being generated due to councils' high credit ratings, accessing wholesale debt markets, economies of scale and collective bargaining. Victorian councils, as a collective, can now deal directly in the wholesale bond market to generate savings.

Hobsons Bay initially borrowed $9.2 million, which is now part of a LGFV seven year interest only bond that was drawn down during the 2014-15 financial year. In addition, Council also borrowed $5 million, which is now part of a LGFV ten year interest only bond that was drawn down during the 2015-16 financial year.

These bonds are premised on interest only payments with no principal repayments.

Public Bonds

A bond is an instrument of indebtedness of the bond issuer to the holders. It is a debt security, under which the issuer owes the holders a debt and depending on the terms of the bond, is obliged to pay interest, usually payable at fixed intervals and to repay the principal at a later date, termed the maturity date.

Thus, a bond is a wholesale version of a loan, the holder of the bond is the lender (creditor), the issuer of the bond is the borrower (debtor), and the coupon is the interest. Bonds provide the borrower with external funds to finance long-term investments, or in the case of government bonds, to finance current expenditure, defined benefit superannuation calls and capital works programs.

It is expected that bonds will provide cheaper funding than banks for highly rated borrowers (such as councils) and will attract investors such as superannuation funds, banks and foreign governments. Bonds are a key funding source for the Federal and State Governments as well as local governments internationally, particularly in New Zealand, USA, Canada and Europe. Bonds are simply a loan from a different source and considered best practice, given it is the cheapest source of funding.

Financial Treatment

Future debt required to fund defined benefit superannuation shortfalls or additional capital works asset renewal would be expected to be drawn down under the LGFV, unless alternative funding can be identified.

As the LGFV model is currently based on interest only repayments, Council ensures that adequate funding is available to repay principal when required by transferring amounts on a yearly basis to the discretionary Loan Payment Reserve over the period of the bond. This process is included in Council's LTFP for existing loans and is highlighted in the following graph: