A guide to the responsible use of debt

Introduction

Councils that found themselves with the requirement for significant levels of debt in the 1980s and early 1990's when interest rates were at historic highs, felt under pressure to minimise borrowings. The legacy of those times has been a factor in councils being averse to borrowing, even when interest rates are at historic lows. Yet the effective use of debt has meant that communities have been able to enjoy a wide range of services, from improved transport networks to CWMS schemes to recreational facilities, which have been paid for over time through structured borrowings, prudent rate increases and reasonable user charges.

The South Australian Local Government sector as a whole has very low levels of debt relative to their income and assets they are responsible for. If the sector's debt was represented by an individual's debt on their home loan, it would equate to something like $15,000 worth of debt on a $500,000 property. The LGFA applies stringent credit criteria to assess the ability of a council to meet its repayment requirements for any borrowings. Recently, applying those criteria on a state-wide basis, the LGFA calculated that the sector could comfortably borrow an extra 2 or 3 times current debt levels to provide further benefits for local communities.

This paper has been written by the LGFA to give a better understanding about the responsible use of debt by the South Australian Local Government sector.

The paper has been prepared for mayors, chairs, councillors and council management teams and sets out to answer some of the questions commonly asked by councils during our visitation program.

Debt is a renewable resource and is an effective financial tool that can be utilised by councils, when required.

Councils should not be afraid of debt, they should embrace its' responsible use.

Use of Debt

Councils are infrastructure intensive organisations. For some councils the issues are largely the renewal of existing infrastructure; for some councils the issues are largely the provision of infrastructure to meet the demands of a growing population and for other councils the issues are largely the need to improve and upgrade infrastructure that does not meet the needs of a modern community. South Australian councils prepare long-term financial and asset management plans. These plans indicate to councils their need for funds to acquire, upgrade and renew their infrastructure. The prudent use of debt can allow councils to bring forward their plans to acquire, upgrade and renew their infrastructure and provide their communities with the services in an equitable manner.

Debt should be a key element in a council's long-term financial plan as its correct use helps with the acquisition of planned infrastructure and the renewal of existing infrastructure as it supports intergenerational rating equity. This ensures that ratepayers in the future, who will benefit from a council's infrastructure, effectively contribute to its provision or replacement rather than this burden falling just on ratepayers at the time of acquisition or replacement. To 'save' for infrastructure means that ratepayers who receive no benefit from the infrastructure are effectively 'paying' for it. One of the benefits of using debt financing is that interest costs and any principal repayments on borrowings are spread, to some extent, over the life of the asset and paid for by ratepayers who benefit from the services provided by the infrastructure.

Intergenerational Equity:

The term 'intergenerational equity' often arises in a discussion about local government financial performance and financial sustainability. It is important to bear in mind in such discussions that local government service provision is very asset intensive. Many local government services involve the provision of assets (e.g. roads) that provide benefits to communities over a long period of time.

Intergenerational equity in a local government context is often considered in the context of whether payment for the cost of services is recovered over time broadly in accordance with the benefits enjoyed by service recipients. In the case of the road example above it wouldn't be intergenerationally equitable if it was paid for by ratepayers over a short-term (e.g. by funds from ratepayers in one year) yet benefitted ratepayers over many years (the ratepayers over time will change and are not the same as the ratepayers when the road was built – even if they don't change it may be difficult or unfair to expect a person to pay 'up front' for services they will benefit from over many years).

Of course, an assessment of whether council rating and service provision policies are intergenerationally equitable can't be determined by looking at a single asset. Councils have many assets built at different points in time. The best assessment of whether a council's rating and charging decisions are intergenerationally equitable relative to service provision is by comparing underlying ongoing operating revenue with underlying ongoing operating expenses. Operating expenses include depreciation which simplistically results in the capital cost of an asset being recognised progressively over its useful life. If an organisation maintains a breakeven/small surplus operating result it is likely to be operating on an intergenerationally equitable basis. Large operating surpluses or deficits over several ongoing years imply a council is not operating on an intergenerationally equitable basis.

Council Debt versus Individuals Debt:

Councils have a significant advantage over individuals and private corporations in both access to debt and in servicing the debt. Councils taxing powers to raise rates provide them with a high level of certainty in their incomes. The fact that the LGFA secures loans over the general revenue of councils indicates the importance of that power to tax. Another important advantage is that a council is considered to have an unlimited life as an organisation; it will remain an 'on-going' entity.

Interestingly, there are very few business corporations in existence that have no or low debt policies. Well managed corporations will be continually scanning the environment in which they operate and their growth or expansion plans will include the use of profits, debt and equity as funding mechanisms. Although councils are corporations in their own right, with many in the state actually being very large corporations, they do not have the same flexibility in the way they finance their operations. Instead they must finance their infrastructure plans and requirements from rate income, government grants, their own cash resources and via the prudent use of debt. Just like corporations sometimes need to borrow to undertake investments so do councils. Borrowing for either cashflow or specific infrastructure projects is a normal operating activity and the local government sector should develop the same attitude.

Long-Term Infrastructure and Long-Term Debt:

Councils are encouraged to have treasury management policies and to consider borrowings as an organisational response to the need for funds for capital projects or cashflow, without specifically borrowing for a particular project. The term of any borrowings, whether fixed interest or whether floating interest rate borrowings are sought should be determined under the Councils' Treasury Management policy.

(LGA Financial Sustainability Information Paper No. 15 includes an illustrative model treasury management policy.)

Interest Rate Risk:

Interest rate risk is the potential loss in an investment or borrowing decision resulting from movements in interest rates. For example, investing surplus funds at a fixed interest rate when the next movement in interest rates is up or borrowing at a fixed interest rate when the next movement in interest rates is down.

It is not possible to avoid interest rate risk. Trying to anticipate interest rate movements is purely speculative and should not be practised by councils. The best that can be done is to pursue an investment or borrowing policy that attempts to minimise the adverse effect of movements in interest rates. If looking primarily at the interest rate risk associated with a council borrowing funds, interest rate risk can be managed by having a balanced portfolio of fixed and variable interest rate debt so that the adverse impact of movements in interest rates are minimised and that in the medium to long-term a Council's interest rate expense risk exposure is optimised.

Over the past 50 years, the Reserve Banks of Australia has only moved interest rates higher in periods of high inflation. Because increases to council rate revenue are usually linked to inflation, rate revenue should increase during times of high interest rates, which should offset the higher interest costs associated with floating rate debt. Despite this inherent risk mitigation councils would be adversely affected by large unexpected interest rate rises that occur within a year.

Financial viability of a Council:

Elected bodies around the state are usually concerned about fostering strong communities and maintaining/providing the appropriate infrastructure in a financially responsible way. However, what constitutes a strong viable council can often be misunderstood.

Debt levels and net financial liabilities ratio:

As described in this document there are many reasons why a Council will use debt, so looking at a Council's level of debt in isolation is a poor way to judge its overall financial performance and long-term viability.

Newly elected members often grapple with the large dollar figures of debt that a council may have but they should remember that even though an average sized Council may have around $10 million dollars of debt they also have total assets of around $360 million.

When people in the sector talk about debt they usual consider a council's net debt as a percentage of a year's operating income. The resulting ratio is the net financial liabilities ratio which equals total liabilities (including debt & other commitments) less financial assets (deposits and investments) divided by the operating income for the year.

The LGA recommends that net financial liabilities ratio is between zero and 100% of total operating income, but possibly higher in some circumstances.

There is no right or wrong target range for the net financial liabilities ratio. Different councils (or the same council at different points of time in its long-term financial plan) could appropriately have very different target ranges and each could be equally responsible and financially sustainable, depending upon their circumstances.

Operating result:

An operating surplus (or deficit) arises when operating income exceeds (or is less than) operating expenses for a period (usually a year). Just like any household or other organisation, a council's long-term financial sustainability is dependent upon ensuring that, on average over time, its expenses are less than associated income. In essence, this means that current day citizens fully meet the cost of services provided for them by their council in most circumstances.

If a council was operating with a significant deficit over several years and its strategic management and long-term financial plans did not provide clear proposals for this to be turned around then it would be inevitable that the council would face major financial shocks in the future. The council effectively would be in the same position as an individual or family living beyond their means. Sooner or later they would be caught by the consequences. For a council, the problem would likely come to a head when existing major assets failed. The council would then need to choose between large rate rises or not replacing assets thereby effectively lowering its standards of service to its community.

Focusing on a council's underlying operating result, over a number of years, is the best way to judge its financial performance as the operating result reflects the council's cost of service provision including the cost of maintaining existing assets, as the result allows for asset depreciation.

Resources

Comrie, J., (2014), *Debt is Not a Dirty Word: Role and Use of Debt In Local Government,* UTS Sydney

Hope, D., (2002), *Debt – A Renewable Resource*, Unpublished

LGA-SA, (2015), *Financial Sustainability Information Paper No 15 – Treasury Management*, LGA-SA, Adelaide

LGA-SA, (2015), *Financial Sustainability Information Paper No 10 – Debt*, LGA-SA, Adelaide

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