

# **Mechanism and benefits for Victorian Local Government to raise debt finance direct from wholesale investment markets.**

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## **Executive summary**

This report provides an overview for a new aggregated debt funding model for Victorian Local Government. A key deliverable is that it details a shared service model that provides a mechanism for Regional Cities Victoria (RCV) members to access *direct* financing from wholesale investment markets for their funding requirements. It does this by obtaining an 'investment grade' long term credit rating. Current RCV financing is accessed *indirectly* through financial institutions. This debt has significant premiums to cover bank credit risk, funding costs and profit margins. Identifying a mechanism for accessing wholesale funding markets is important as it greatly reduces the risk of local governments being exposed to high cost finance.

The project uses quantitative analysis of secondary data as its research methodology. The results showed that an appropriately structured model would reduce interest costs on debt by approximately 2.5% p.a. before administration and issuing costs. At current RCV debt levels this is equivalent to a saving of \$5.2 million p.a. This reduction would support higher municipal debt levels with a smaller interest cost burden to the benefit of improved council services to Victorian communities.

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## 1 Introduction

Easy access to cost effective and appropriately structured debt finance is an important tool for Victorian Local Governments. When a municipality has insufficient capacity to internally generate funds, external debt assists with providing community services and infrastructure that are demanded by legislative, regulatory and social forces. Due to smaller population bases, regional centres are particularly reliant on external funding sources to provide new infrastructure for supporting population growth. This project investigates the rationale and mechanisms for a discrete group of regional Victorian local governments to aggregate their borrowing requirements. This aggregation would provide the scale of economy to allow them direct access to wholesale investment markets through the issuance of bonds.

Gaps have been identified in previous research which this project aims to address. The first of these gaps is there is no analysis quantifying what the cost savings might be from pooling Australian Local Government borrowing requirements. Second, there is no workable mechanism or model for these municipalities to access bond markets, thus achieve an improved scale of economy to realise potential benefits. The final gap is that there exists no empirical evidence that these desired benefits could be achieved in actual practice.

In recognition of common needs, the ten largest regional Victorian cities have long had a representative body to investigate various shared services. Government 'shared services' are where municipalities co-operate to achieve a scale of economy to more efficiently provide community services. This representative body, made up of CEO's and mayors, is known as the Regional Cities Victoria (RCV). The municipalities it represents are Bendigo, Ballarat, Geelong, Warrnambool, Horsham, Mildura, Shepparton, Wangaratta, Wodonga and Latrobe. The project uses the analysis of this municipal group as a proxy to assist in drawing conclusions on the benefits of applying a shared service wholesale financing model to all Victorian local government municipalities.

Victorian local governments (LG's) currently access finance either via local bank branches or by utilising individually established relationships with financiers. Each municipality currently

manages its financing requirements separately. Thus these debt parcels are highly fragmented, relatively small and not attractive to professional investors. The only mechanism to service this demand is via banks. This is defined as *indirect* financing (Hunt & Terry 2011). Although many LGs may be of investment grade credit rating quality in their own right, small non-wholesale parcels will attract retail pricing, especially when the funding request is filtered through a bank's branch network. A feature of indirect funding is that it has significant cost premiums built into it to cover a financial institutions credit risk, cost of funds and profit margins (Hunt & Terry 2011). As a result, this bank sourced debt is typically far more expensive than the bond coupon costs paid by the Victorian and Commonwealth Governments.

The project focuses on analysis of the RCV to investigate the financial benefits from implementing a shared services model to pool their borrowing requirements. It has five sections. First it orients the reader with background on literature in this field, the RCV and how a shared service for local government debt funding became the area for investigation. The next section describes the data used in the report as well as how it was collected and analysed. The following section discusses key findings from comparative analysis of the financial data and various shared services models to obtain the desired economic benefits. Evidence is then provided that these benefits can be achieved in practice. The report ends with a brief conclusion.

## 2 Orientation

Local governments' role is to provide services and infrastructure demanded by the community when private enterprise is unwilling to supply them. It manages the prioritisation and delivery of these services via professional administrators who are overseen by democratically elected community representatives. Victorian Local Governments (LG's) are related entities, bound by both institutions and legislation.

The South Australian Financial Sustainability Review Board (2005) describes local government shared services as municipal co-operation for provision of "a practical and cost effective way for councils to share experience and resources, tackle common tasks, or take advantage of economies of scale" (Dollery et al 2009). This project relies on this definition of 'shared services'.

The project provides an overview for a new shared service aggregated debt funding model for RCV LG's. The purpose of the model is to provide them a low cost external financing alternative to minimise upward pressure on growth in Council rates. A deliverable of the model is that it allows the RCV members to access direct financing from wholesale investment markets. Increased scale creates the opportunity for these municipalities to access wholesale investment markets as a group, rather than each fulfilling its borrowing requirements individually through the banking sector. To quantify the benefit of this, research is required on RCV existing debt costs, comparable cost of finance via the wholesale funding markets and the most efficient mechanisms to access these wholesale markets.

The model establishes a central shared funding agency to the benefit of RCV members. This agency is the mechanism which, when appropriately structured, would attain an investment grade credit rating for use in raising funds in wholesale markets. Compared to RCV members negotiating debt individually, this provides the maximum leverage for negotiating the best possible terms. For the purposes of this paper, the model for this central funding body will be called the Victorian Local Government Treasury Agency (VLGTA). The VLGTA

model acts as a financing aggregator, administrator and distributor to intermediate between RCV members and wholesale investment markets.

The RCV would access significant benefits from identifying and implementing such a model. These include procurement savings, access to additional skills and expertise, lower staff costs and improved compliance with legislation and standards (Dollery et al 2009). A key non-financial benefit would be improved compliance with Victorian Auditor General Office (VAGO) requirements. It will also reduce risk associated with negotiating and pricing debt; expertise in which is not a core competency of local government. By rolling out the shared service model to the remaining 69 Victorian Councils it could create additional benefits for RCV due to increased scale diluting rating agency costs and lowering the cost of funds.

A search of published research papers into aspects of shared services for local government revealed that none have investigated the mechanisms and rationale for municipalities pooling financing needs to achieve benefits from improved scales of economy. There are however, two that have investigated the benefits that increased scale of economy in professional services can bring to local government. The first, authored by Dollery B, Akimov, A & Byrnes, J (2009) is *Shared Services in Australian Local Government: Rationale, Alternative Models and Empirical Evidence*. This built on pioneering work on analytical foundations of shared services was undertaken by Oakerson (1999) in his *Governing Local Public Economics* (Dollery et al 2009). The paper highlighted the need for analysis of the economic benefits for undertaking a shared service including “feasible alternative models for shared service arrangements and available empirical evidence on the economic efficacy of shared services” (Dollery et al 2009). The application of these three ‘highlights’ forms the framework for the project structure and guides the design of its research questions.

The second paper authored by Dollery B, Hallam, G & Wallis, J (2008) is titled *Shared Services in Australian Local Government: A Case Study of the Queensland Local Government Association Model*. It built on previous studies about the widespread financial unsustainability of local governments and investigations on how to address the issue. It highlighted that structural reform via compulsory Council amalgamations had generally not met improved efficiency expectations, but how shared service arrangements showed much

greater potential for achieving the desired outcomes. The paper reiterated how little is known about shared service models due the lack of “empirical evidence on the outcomes of shared service arrangements” (Dollery et al 2008). It concluded that the shared services that were the most successful and efficient all had a “focus on ‘back office’ functions rather than on service provision *per se*” (Dollery et al 2008). This finding has also guided the development of the shared service ‘model’ for this project as financing is also a back office function and not a community service.

In addition to these academic studies, the project draws on a wide variety of other material. These include government studies, financial and annual reports. An Essential Economics report (Noronha & Rossiter 2012), *Implications of Population Growth on Infrastructure and Resources in Regional Cities*, identified the need for the RCV municipalities to invest approximately \$680 million by 2021 on additional infrastructure to support forecast population growth. This then led to the report on how best to fund this infrastructure called *Financing for Growth* (Irish 2012). Its findings confirmed the overwhelming need for growth related infrastructure and reinforced the highly positive economic benefits to both the regions and the state from population growth and its concomitant economic activity. Part of the solution for infrastructure funding in the Financing for Growth report included comment on municipal borrowing capacities and the need for increased use of debt finance. It concluded with a recommendation for the establishment of a government backed loan facility. This recommendation immediately ran into significant opposition from Victorian State Government. As an alternative it encouraged RCV to investigate methods and mechanisms for aggregating, issuing and managing debt instruments. This project takes up this challenge.

The Australian Centre of Excellence for Local Government (ACELG) (Comrie 2014) report *Debt is not a Dirty Word - The Use and Role of Debt in Local Government*, also plays an important role in the conversation around this project. It provides input and context on local government service responsibilities, debt levels, intergenerational equity in financing infrastructure, accessing expertise in debt management and understanding appropriate debt levels. Hunt and Terry (2011) titled *Financial Institutions and Markets* is used as the prime source of information on the operations of Australian financial markets.

To analyse the financial benefits to the RCV from implementing this type of LG shared services model, the project investigates four key research questions. First, what are the existing and expected debt levels and the current cost of these funds? Second, how should a shared services model be structured? Third, what would be the interest and administrative costs for this structure to issue bonds? Finally, it looks to empirically quantify the financial benefits to the RCV in implementing an aggregated borrowing and bond issuance agency.

## **2.1 Case businesses**

The research method used in this project is quantitative and utilises secondary data from two main sources. The first of these is financial information from the annual reports of the ten municipalities in the RCV group. This involved the compilation of six years of information from financial data published in each municipality's income statement, balance sheet and cashflow statement into a single table. Table 1.0 is the consolidation of these 180 financial reports.

Data in the municipal annual reports is used to analyse the quantum and growth of RCV debt, as well as the groups average cost of finance. This is then compared to coupon costs on wholesale bonds over the same term. Bond pricing is published on Thomson Reuters Eikon (TRE) financial markets subscription information systems. Undertaking this comparison will provide empirical evidence of financial benefits of a direct financing strategy verses the current indirect financing approach.

The second main data source quantitatively analysed are *RatingsDirect* reports published by Standard & Poors (S&P). Standard & Poors are a respected independent international credit rating agency whose reports analyse and assign a credit strength (or rating) to countries, governments, corporations and financial constructs globally. The S&P reports detail a number of examples of municipal aggregated wholesale financing vehicles elsewhere in the world in similar economies, such as Scandinavian countries, Japan and New Zealand. These are used as case studies.



Analysis of RatingsDirect reports provide the criteria to allow recommendations for optimising the VLGTA financing vehicles structure. The reports also provide supporting data to forecast the likely credit ratings any bonds it issued would attract. The main criteria S&P take into account to assess a credit rating are an issuers strategy, ownership, management, credit rating support, capitalisation as well as risks for market, funding and liquidity (S&P 2013). Although RatingsDirect reports are not published in the public domain, S&P provided them on specific request by the author.

### 3 Data collection and analysis

The data providing the foundations for this project is quantitative and comes from secondary sources (Saunders et al 2012).

#### 3.1 Regional Cities Victoria financial data

Six years of financial statements from each of the 10 municipalities in the RCV group were compiled and analysed. These annual reports are published online. The summary of this data is provided in table 1.0. Data from balance sheets, income and cashflow statements provides revenue information which allows for calculation of maximum regulatory debt levels. It also provides information on debt levels, their growth rate and average interest costs the group have incurred to access bank finance.

**Table 1.0**

#### Regional Cities Victoria aggregated financial data 2009 to 2014

		Totals \$,000's						
		2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Average Rate of Change
Adjusted Total Revenue	<i>a</i>	843,000	876,381	949,212	1,039,972	1,045,033	1,054,272	4.64%
Adjusted Total Expenses	<i>b</i>	820,597	872,591	955,628	1,064,388	1,039,615	1,089,200	
Net	<i>a-b</i>	<b>22,403</b>	<b>3,790</b>	<b>(6,416)</b>	<b>(24,416)</b>	<b>5,418</b>	<b>(34,928)</b>	
Total Rates & Charges		612,444	647,637	693,868	737,080	782,581	830,350	
Liabilities Debt	<i>c</i>	141,901	152,657	149,243	154,869	171,303	207,991	8.23%
Interest expense	<i>d</i>	6,787	9,142	9,817	9,988	10,684	12,211	13.02%
Average interest cost	<i>c/d</i>	<b>4.78%</b>	<b>5.99%</b>	<b>6.58%</b>	<b>6.45%</b>	<b>6.24%</b>	<b>5.87%</b>	

The *Adjusted Total Revenue* and *Total Rates & Charges* for RCV in 2014 were \$1.05 billion and \$830 million respectively. The *Total Rates & Charges* figures are important as these are revenues LG's are able to generate internally. These two figures allow for the calculation of

the maximum debt and interest costs the group could commit to under regulatory guidelines imposed by the Victorian Auditor General (VAGO 2015).

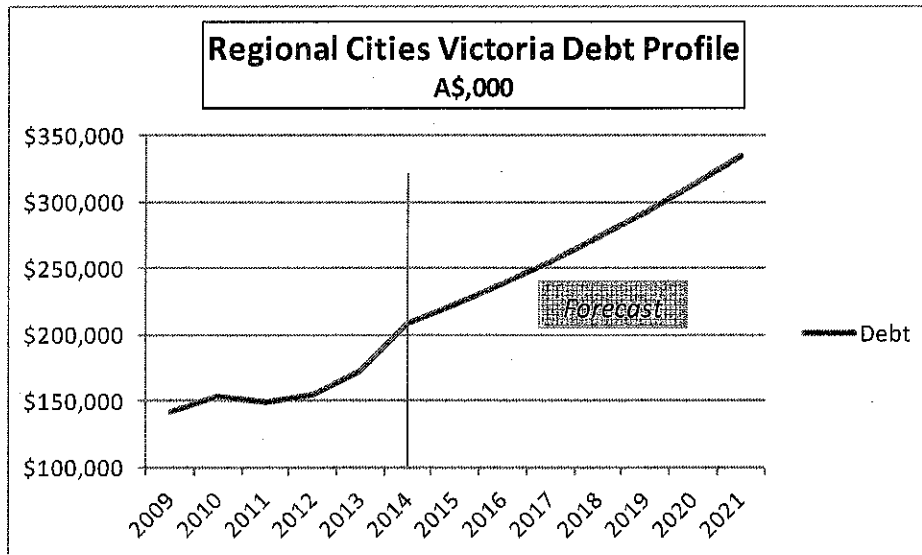
"The Victorian Auditor General's Office has set risk assessment criteria regarding local government financial sustainability indicators" (VAGO 2015). To stay within the VAGO indebtedness ratio low risk 'green' zone, total debt must remain below 40% of *total rates and charges* for a municipality (VAGO 2015). On current figures this indicates that the RCV, in aggregate, could increase borrowings from \$208 million to \$330 million and still be in the low risk category with regard to 'indebtedness'. Debt may rise as high as 60% of total rates and charges and still remain in the medium risk zone. This implies a maximum RCV debt levels can potentially be increased to \$500 million, based on current rates and charges income.

VAGO (2015) requirements state the maximum debt servicing costs must also stay below 5% of *total adjusted revenue* to remain the green band for prudential debt management. Assuming amortisation over 20 years, at the June 2014 RCV five year interest rate of 5.83% (see table 1.2); this implies a maximum debt ceiling for the group of \$613 million on current revenues. The difference in the debt ceilings for the maximum indebtedness ratio and the maximum debt service ratio (\$330 million compared to \$613 million) is due to the current low interest rate environment proportionally increasing the amount of debt that could be serviced. Both these figures indicate that the RCV has ample room to increase debt levels and still remain within conservative gearing ratios.

Table 1.0 shows total RCV debt has been growing at a rate of 8.23% since 2008/09. It has increased from \$142 million to \$208 million over the reported period. At this rate of growth, RVC debt is on track to reach \$330 million by 2021 (See graph 1.0). This is well above *adjusted total revenue* growth of 4.6% p.a. over the same period (See table 1.0). In an environment of constrained revenue growth from internally generated sources, this mismatch reflects the need for the increased use of debt for infrastructure projects.

Graph 1.0

RCV forecast debt at 8.2% p.a. growth



### 3.2 Standard & Poors data

For the RCV to issue bonds directly into the wholesale investment market a mechanism must first be identified to support this outcome. This is typically via an appropriately structured entity to function as the issuance vehicle. Bonds issued by this entity must then be assessed by credit rating agencies who allocate a risk (or credit) rating to the issue. It is critical that the structure of this entity is optimised to achieve the highest credit rating possible to maximise investor demand and minimise overall financing costs. To analyse the optimal issuance structure the second main set of data collected for this project is via *RatingsDirect* reports, published by Standard & Poors Ratings Services (S&P). These are financial analysis reports on organisations or entities that quantify their financial strength. This strength is then expressed in an overall credit ratings.

**Examples of 'like' local government funding agencies internationally**

Globally, there are a number of relevant examples of different structures municipalities have used to aggregate debt. Each of the ones listed has been created to act as a shared service to provide access to wholesale investment markets for local government funding needs. These include funding vehicles in Scandinavia, such as *KommuneKredit* in Denmark and *Kommuninvest* in Sweden. Finland and Norway also have similar vehicles. In Japan, the *Japan Finance Organization for Municipalities* is the major funding vehicle for the local and regional government sector. In New Zealand the *Local Government Funding Authority* (LGFA) is the main provider of finance to municipalities (S&P 2014).

A number of these agencies are relevant to this project as they function without higher government guarantees to support their credit ratings. These are agencies in Denmark, Sweden, Japan and New Zealand (S&P 2014). The New Zealand model is particularly pertinent. It has been developed post the global financial crisis and operates under virtually identical legal and financial systems to those in Australia. Analysis shows that all of the agencies listed above have achieved the same credit ratings on their bonds as that of the relevant sovereign government. For the VLGTA this indicates it should be able to achieve a S&P credit rating of *AAA/Stable/A-1+* (S&P) for its bonds. This is the highest possible long and short term investment grade credit rating. Such a rating would facilitate easy access to issue bonds into both domestic and international capital markets. The recommended structures for the VLGTA model in the 'Key findings' section are broadly based around those used by the New Zealand LGFA.

The LGFA was established by nine council members in 2011 (S&P 2013). As the significant cost savings it provided participating municipalities became visible, it quickly grew to become the major funding vehicle for municipalities. As at November 2013, 41 of the 78 New Zealand local governments were using its services and its assets totalled A\$2.2 billion (S&P 2013). The LGFA now plays an important part in providing liquidity and diversity to New Zealand's capital markets. It is envisaged that the RCV could play the same role as the nine founding New Zealand councils.

### Ratings agency criteria

Analysis of S&P RatingsDirect reports provide the criteria for recommendations to optimise a financing vehicles structure. They also provide data for predicting what credit rating its bonds would likely attract. The main criteria S&P take into account to assess a credit rating are the strengths and weaknesses of an issuers business profile, support and ownership, strategy, underlying credit risks, funding profiles and liquidity risks, market risks, capitalisation, industry outlook and undertakes comparative analysis with its peers (S&P 2013). The most appropriate model design would mitigate risks associated with each of these factors as much as possible. By focusing on these key aspects, the following model would have a substantial likelihood of achieving a AAA credit rating.

TRE financial markets information services provide all historical bond pricing data. This provides comparative data for 'like' rated bond issues to simply calculate the credit risk premium a correctly structured municipal financing agency will pay relative to a sovereign bond issue. This premium may reasonably be added to the Australian sovereign debt pricing, over the same period, to calculate VLGTA bond issue pricing. Table 1.1 shows the credit risk premium the LGFA paid in comparison to New Zealand Treasury bonds over a range of periods. For the purpose of this analysis the 5 year period is used. The LGFA had a risk premium of 55 basis points compared to the New Zealand Government bond as at June 2014.

Table 1.1

#### New Zealand sovereign cost of funds compared to the New Zealand LGFA

as at 29th June 2014

	<b>NZ Government</b>	<b>Local Gov Fund Auth</b>	<b>Credit Risk Premium</b>
1 Year	3.6	3.95	0.35
3 Year	3.83	4.28	0.45
5 Year	4.05	4.6	0.55

Standard & Poors Ratings Services. Domestic currency AA+ (stable outlook)

Source: Thomson Reuters Eikon

The third set of secondary quantitative data collected is comparative pricing and information on risk premiums (yields/interest rates) of Victorian and Australian Commonwealth Government bond issues in Australia. This information is also sourced from TRE financial markets information systems. Both the Commonwealth Government and Treasury Corporation of Victoria (TCV) are rated AAA by S&P. Bond pricing for both is detailed in table 1.2.

**Table 1.2**

**Comparative risk premiums against Treasuries for TCV and Local Government**

as at 30 June 2014

	<b>C/wealth Government</b>	<b>Treasury Corp Vic</b>	<b>Credit Risk Premium <sup>(1)</sup></b>	<b>Local <sup>(3)</sup> Government</b>
90 Day	2.50	2.68	0.18	5.00
3 Year	2.66	2.85	0.16	5.36
5 Year	2.92	3.14 <sup>(2)</sup>	0.22	5.83

(1) Credit risk premium compared to 'Risk Free' Commonwealth Treasury Bonds

(2) Pro-rata price between 3 and 10 year bond

(3) Bank quotes for funding as at 30 June 2014

Par coupon yield priced from respective issuer's zero curve

Source: TCV, RBA, RCV members & Thomson Reuters Eikon

As these are international markets, the sovereign risk premium for the New Zealand LGFA can be used in conjunction with Australian Government bond pricing to extrapolate an expected pricing forecast for bonds issued by the VLGTA. The City of Greater Bendigo assisted with comparative data for this project by providing cost of funds information for indirect financing (bank) interest rates on new floating, 3 and 5 year fixed debt as a 30 June 2014. This data is also detailed in column 4 of Table 1.2. It is used as a proxy for the RCV group for comparative analysis purposes.

The final analysis uses all these data sets. It compares expected bond pricing for the VLGTA with pricing on bank sourced debt by the RCV at the same points in time. By using RCV existing and expected debt levels, this allows for an empirical calculation of financial

benefits to the RCV from implementing a structure to raise funds directly from the wholesale investment markets.

As the VLGTA will have a higher credit rating than the LGFA, the risk premium it will be required to pay in comparison to 5 year Treasury bonds is expected to be between the 55 basis points paid by LGFA (on the high side) and the 22 basis point pricing achieved by TVC (Table 1.2). This data indicates that for a five year bond issued by the VLGTA would likely attract a premium of approximately 40 basis points over Treasury bonds. On 30 June 2014 this would have been an interest rate of 3.32%. As the cost of five year bank finance for the RCV on 30 June 2014 was 5.83%, before administration costs, this equates to a reduction in annual interest costs of 2.51%. On 2014 debt levels of \$208 million this is equivalent to a cost saving of \$5.2 million per annum before administration costs.

Additional data and supporting analysis to compliment the three secondary data sets described will be sourced from published material provided from various entities including banks, the RBA, text books, the Victorian Auditor General and the Victorian *Local Government Act*.



## 4 Key findings – The four research questions

### 4.1 Existing and expected RCV debt levels and the current cost of funds.

Data shows that as at 30 June 2014 the combined debt of the RCV was \$208 million (Table 1.0). Analysis of this data shows that RCV debt has increased on average 8.2% p.a. since 2009.

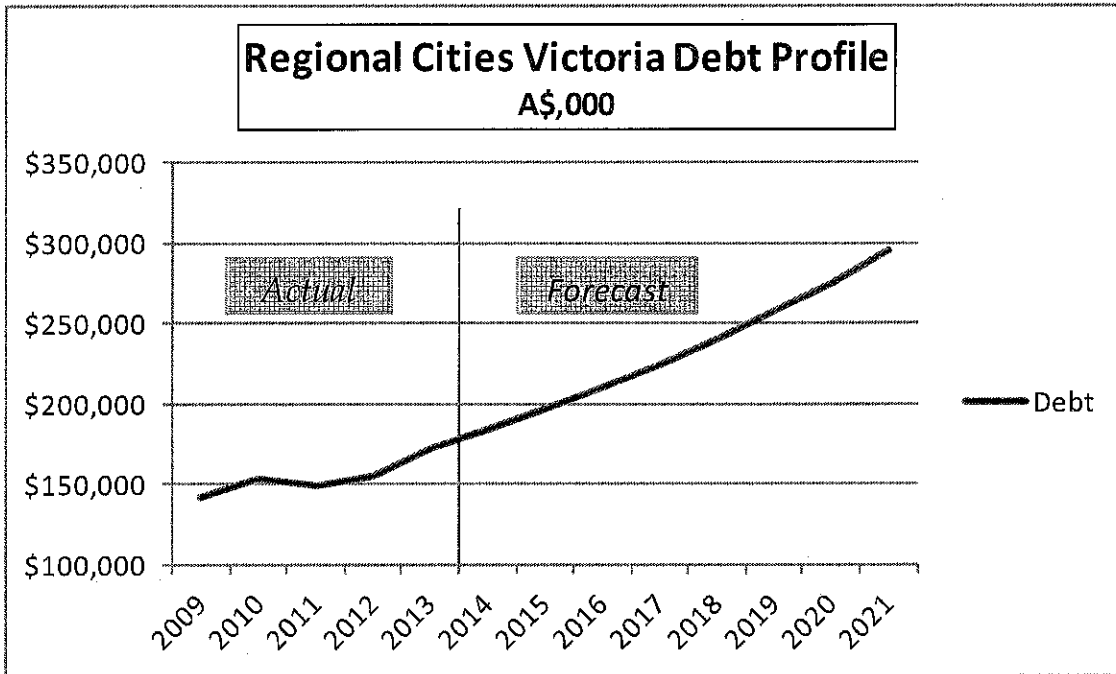
#### Forecast future debt levels

The Regional Cities Victoria: Financing for Growth report (Irish 2012) identified that regional cities will need to invest over \$680m by 2021 in growth-related infrastructure. The report detailed the required investment is to support expected population growth from 742,300 in 2012 to 950,300 by 2031. Of this requirement, developer contributions are forecast to contribute \$170m, leaving a shortfall in financing new infrastructure of \$510m. Debt is expected to make an important contribution in funding this shortfall.

The Lamont & Brown (2013) RCV Growth Framework and Diagnostic Tool (2013) forecast the rate of growth in debt is anticipated to increase at 7% p.a. for the next 10 years to fund the forecast growth infrastructure requirements as detailed in *Implications of Population Growth on Infrastructure and Resources in Regional Cities* (Noronha & Rossiter 2012). This indicates that by 2021, RCV as a group will collectively have \$300 million in debt (Graph 1.1). At June 2014 interest rates, service costs on these debt levels would cost rate payers approximately \$17.6 million p.a.

Graph 1.1

**RCV forecast debt at 7.0% p.a. growth**



**4.2 Structures to maximise the shared service models credit rating**

**4.2.1 Goals and objectives of the shared service model**

The Dollery et al (2008) study highlighted the ‘moral hazard’ of shared service models that were not structured to act as an agent for all of “it member municipal ‘principals’ on a non-profit basis.” To achieve this outcome, access the required financial benefits and align the strategic and commercial goals of its members it is recommended that the ownership, financial, operational and management structures of the RCV shared service should reflect the following:

- Create a dedicated shared service resource owned and controlled by its members to manage this process. This makes it directly accountable to its members, rather than just having to take them into account when making strategy, policy and management decisions.

- Service RCV funding requirements at the lowest possible interest costs via wholesale capital markets by addressing the profit dilemma created by the business model of finance providers.
- Access the highest possible credit rating for RCV funding requirements.
- To provide services to manage the distribution and servicing of funding programs on RCV's behalf.
- Provide a market return on capital invested of the cost of funds rate plus a fixed margin and return excess revenues to Victorian communities.
- To initiate a dedicated shared service resource to provide members with support over a range of value-add treasury and financial risk management services.

#### **4.2.2 Ownership structure**

The suggested model for achieving these objectives has been provisionally called the *Victorian Local Government Treasury Agency (VLGTA)*. The term *treasury* is used because under this model the agency would closely resemble the services and structure the treasury operation of a large organisation typically provides to operationally independent divisions.

It is recommended that the VLGTA is 100% owned by LG members and acts as an agent on their behalf. As such the VLGTA “does not have incentives to ‘cheat’ its members” (Dollery et al 2008). This supports a number of positive outcomes. First, it is similar to other rated municipal funding entities for which the wholesale market has a known appetite for bonds to invest in. It negates the third party profit dilemma of the entity by making the key stakeholders shareholders to which all profits are distributed to, or retained for the benefit of members. It creates a shared service that could also provide unbiased financial risk management advice and support services to its members. By being government owned it also simplifies the support mechanisms in event of major financial distress. This is via minimising barriers that would prevent its bonds being purchased by either the state or the RBA. Finally, it makes the entity directly accountable to its members.

### 4.2.3 Statutory financial oversight

Advice would need to be sought as to which was the appropriate regulatory body to supervise the VLGTA. The entity will not be an authorised deposit-taking institution (ADI) and not a service provider in the payments systems. As such it is envisaged that ASIC, rather than APRA is likely the best placed entity to provide this supervision (Hunt & Terry 2011).

### 4.2.4 Financial structures

Councils are the shareholders. All councils that borrow over a certain threshold will be required to become shareholders. This provides a mechanism for capitalising the VLGTA. Enshrined in the VLGTA shareholders agreement would be a requirement that the entity must pay a dividend to shareholders (S&P 2013). Apart from earnings to pay dividends and maintain capital requirements, its key commercial characteristic will be its not-for-profit focus.

### 4.2.5 Capitalisation

To achieve the desired credit rating, the VLGTA would need to maintain a certain capitalisation ratio. However these would be minimal compared to other financial institutions if it were appropriately structured.

By way of example, the LGFA is currently rated AA+ by Standard & Poors (S&P 2013). This is the same as the New Zealand sovereign credit rating. It achieves this despite having a net capitalisation of only 2.4% (S&P 2013). The capitalisation is made up of shareholder funds and subordinated convertible debt securities called *borrower notes* (S&P 2013).

Shareholders are required to purchase shares to the value of 1% of the funds they wish to borrow. However not all LGs are shareholders. The balance of the capital is from the *borrower notes*. Borrowers are required to purchase borrower notes equivalent to 1.6% of their aggregate outstanding borrowings. These notes are automatically converted into capital if the LGFA is in imminent risk of default. The LGFA pays dividends on the shares (fixed at 2% above the cost of funds) and interest on the borrower notes (S&P 2013).

The same capital structures applied to the VLGTA model would most probably support an AAA credit rating.

#### **4.2.6 Guarantee structure of VLGTA**

To become a member of the agency and access its services, each local government must sign a joint and several guarantee to cover the agencies' commitments.

The guarantee would be structured in such a way that each member's ultimate exposure would be limited to its own share of any liability on which the VLGTA defaults. This is effectively the same liability position councils are in now when they individually borrow funds from banks. This guarantee structure is similar to that of the LGFA and would be a key element underpinning its credit rating (S&P 2013).

#### **4.2.7 Credit risk of local government**

Victorian councils have a good aggregate credit rating as borrowings are secured against stable 'rate' income. Additionally there has never been an instance of loan default with these entities. In the event of financial distress in a LG it is highly likely that the State government would provide support. The VLGTA would deal only with Victorian councils.

S&P has noted that there is geographic and sector concentration in such a loan portfolio. "However this is offset by the strong institutional and legislative framework supporting the sector" (S&P 2013). Local governments are also required to undertake long term financial sustainability planning and must comply with conservative financial ratios. These are monitored by the Victorian Auditor General's Office (VAGO 2015).

#### **4.2.8 Funding and liquidity risk**

There are three main mechanisms the VLGTA could use to maintain high liquidity ratios and thus minimise funding and refinancing risks. The first of these is to issue more bonds than the entity needs for immediate financing (Hunt & Terry 2011). These funds are then placed on deposit with highly rated entities (banks) for instant access in times of reduced liquidity.

The second is establishing standby committed loan facilities. These may be drawn on in a stress event. In other territories, the controlling government typically provides access to a facility that is small, relative to the size of the total loan portfolio.

Thirdly it would be prudent to structure the bonds so they can potentially be purchased by the RBA in extreme stress events. As the RBA has no restrictions on the amount of Australian dollars it can issue, this would provide the VLGTA access to a potential bond buyer of last resort that has access to unlimited liquidity.

#### **4.2.9 Market risk**

The VLGTA would accept minimal/no market risk from exposure to interest rate movements due to mismatches between its funding and lending profiles. Firstly this would be done by matching funding raised on domestic markets with that required by the borrower. However where this was not cost effective, interest rate profiles would be matched via the use of financial interest rate derivatives. This in turn creates counterparty exposure to the banks with whom VLGTA enters into these contracts. This counterparty exposure can be managed through the use of ISDA master agreements and CSAs (Credit Support Annex).

### **4.3 Bond issuing, administration and interest costs benchmarked against government and financial peers**

#### **4.3.1 Cost of funds for VLGTA**

Commonwealth Government domestic bonds are perceived by the wholesale investment market as being essentially risk free. This is because of the ability of the Commonwealth Government to issue currency to cover any repayments. Despite having the same credit rating, Treasury Corporation of Victoria bonds are perceived as having a slightly higher risk than Commonwealth bonds due to the states inability to issue currency. As at 30 June 2014 this equates to a credit risk premium of 0.22% for a five year bond (Table 1.1).

The major banks have a much higher cost of funds than the Victorian and the Commonwealth Governments. This is driven by a combination of their lower credit ratings, the requirement to hold substantial capital and the need to diversify their funding from sources that are not as cost effective as wholesale markets. High level analysis of the Commonwealth Bank of Australia (CBA) indicates their all up cost of funds on deposits was 4.65% (CBA Annual Report 2014). The CBA annual report (2014) stated the “majority of the amounts are due to be settled in the next 12 months.” The average net interest margin for the Australian majors in 2014 was 213 basis points (KPMG 2014). Their cost-to-income ratio for the same period is reported to be 45% (KPMG 2014). This means that to cover overheads a margin of approximately 1.0% must be added to the cost of funds to recover administrative expenses. As such for five year funding, the all up real cost for CBA was approximately 5.65% at as 30 June 2014. When banks lend to a client, margins for capital risk premium and profit margins are added to this consolidated cost of funds base. As such the five year borrowing rate quote of 5.83% for local government shown in table 1.2 is an entirely realistic figure for where bank finance would be priced. This pricing is 2.69% above that achieved by the Treasury Corporation of Victoria as at 30 June 2014.

#### **4.3.2 Cost of funding**

Correctly structured, the VLGTA should achieve a AAA credit rating. However it is expected that the cost of funds for the agency would be slightly more expensive than that of the TCV.

Analysis of credit premiums paid by other AAA rated municipal entities (without government guarantees) suggests margins would be in the vicinity of 30 to 40 points more expensive than that of the Commonwealth for a five year bond. Table 1.1 shows that the LGFA pays a credit risk premium of 0.55% on five year funds over New Zealand sovereign bonds. The premium for the VLGTA should be less than this due to its expected higher credit rating. After administration costs this equates to a saving of between 2.0% and 2.1% for RCV members compared to where funding can currently be accessed from banks. This data indicates the RCV group would be able to borrow funds at an all up cost to its members of 3.55% for three years and 3.85% for five years. This is significantly lower than where the major banks can currently fund their own loan portfolios.

#### **4.4 Financial benefits to RCV of moving to aggregated wholesale debt structure.**

A preliminary estimate, using the author's experience in corporate finance, is that administrative costs for VLGTA would equate to 0.6% p.a. of aggregate debt. This figure is made up of 0.2% for issuing costs, 0.3% for office and wages and the balance for providing shareholders a return on their investment. This figure is lower than the 1% reported major banks as there is no need to support large branch - bricks and mortar - networks (Dickinson & Pollari 2014). Thus the overall expected savings in interest costs to RCV members from accessing wholesale markets would be approximately 2%. At current debt levels of \$208 million this equates to an annual saving to the RCV \$4.1 million p.a. The savings for the group would rise to \$6.6 million p.a. by 2021 if current trend growth in debt continues. If the forecasts detailed in the *Financing for Growth* report were reached debt could rise to \$480 million and annual interest savings would increase to \$9.6 million p.a (Irish 2012). This debt figure includes the \$150m in additional debt for growth infrastructure for the RCV. VAGO reported that total debt across all 79 Victorian municipalities was \$830 million in 2013. A reduction of interest costs by 2% on this amount would save Victorian local governments' \$16.6 million per year in interest costs. The findings of this research provide empirical evidence that the desired results can be achieved in actual practice, unlike shortcomings highlighted in previous studies (Dollery et al 2009).



## 5 Conclusion

Analysis indicates that local government in Victoria could access significant savings in borrowing costs by aggregating their debt requirements and issuing bonds into wholesale investment markets. There are a number of international models that function as shared service intermediaries, which would provide a mechanism to support this approach. The common denominator in these shared service models is that they provide 'back office functions' rather than 'hard' community services. Analysis of credit rating agency reports strongly indicates the model for the VLGTA detailed would likely achieve the highest possible investment grade rating of AAA for bond issues. Quantitative analysis of bonds markets and pricing indicates this rating would reduce total costs on LG debt by 2% p.a. On reported RCV debt as at June 2014 this would equate to a saving of \$4.1 million p.a. (and a saving of \$16.6 million p.a. if applied all LG debt). The shared service would also provide access to additional finance to invest in growth infrastructure to support expected population growth and economic development in regional areas. Critically, these municipalities could achieve this using their own resources and without the need for a state government guarantee.

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