Management report to Council

Agenda item 6.8

Borrowing Policy

Council

Presenter: Michael Tenace, Chief Financial Officer and General Manager Finance and Corporate

28 April 2020

Purpose and background

1. The purpose of this report is to seek endorsement on the Council Borrowing Policy

Background:

2. On 29 November 2019, Council held a Councillor Planning Day to review Council's key priorities for 2020 and consider the key strategic, operational and Annual Plan Initiatives. Key Borrowing Principles that are embedded in the Borrowing Policy were presented on the Planning Day and requested to be formally adopted by Council.

3. It is appropriate to have a robust Borrowing Policy to ensure that any borrowings are undertaken in the best interest of Rate Payers and is transparent to key stakeholders as well as being financially prudent.

4. The Borrowing Policy has been benchmarked against other similar Councils and is consistent with legislative requirements.

5. A series of recommendations is outlined in the Borrowing Policy on suitable borrowing limits based on the Victorian Auditor General's Office and the Local Government Reporting Performance Framework.

Key issues

6. Adopting the Borrowing Policy will assist Council in undertaking debt that will enable funding for capital projects while ensuring a sustainable financial position and a tolerable risk profile.

7. The Borrowing Policy has been updated to incorporate the current Force Majeure Event (COVID-19 pandemic) to enable Council to respond to the adverse changes in the economy.

8. If the Borrowing Policy is approved by Council, any material changes to the Borrowing Policy will require further feedback from the Executive Leadership Team (ELT) and Council approval.

Recommendation from management

9. That Council:

   9.1. Adopts the Borrowing Policy (refer Attachment 2 of the report from management).

   9.2. Authorises the General Manager Finance and Corporate to make any further minor editorial changes to the Borrowing Policy prior to publication.

Attachments:

1. Supporting Attachment (Page 2 of 12)
2. Borrowing Policy (page 3 of 12)

Legal

1. The Borrowing Policy is in line with Council's obligations in the *Local Government Act 1989*.

Finance

2. Borrowing will be limited as per the Borrowing Policy and any additional borrowings will need to be factored into the budget and approved by the Council. Borrowing costs may be capitalised and may increase budget of projects that are being funded by borrowings and may increase Council's asset base.

Conflict of interest

3. No member of Council staff, or other person engaged under a contract, involved in advising on or preparing this report has declared a direct or indirect interest in relation to the matter of the report.

Health and Safety

4. In developing this proposal, no Occupational Health and Safety issues or opportunities have been identified.

Stakeholder consultation

5. In developing this documentation, Council has engaged the relevant stakeholders and incorporated appropriate feedback.

Relation to Council policy

6. This Borrowing Policy adheres to the existing Council policies.

Environmental sustainability

7. The Borrowing Policy takes into account implications of lenders in regards to their support towards the tobacco and fossil fuel industry.

CITY OF MELBOURNE

Borrowing Policy

Effective Date 28 April 2020

Version 1

Contents

1. Purpose and Objectives

Council recognises that borrowings for productive purpose or linked to Council's significant major projects is a source of funding as the usage of the borrowings will be used to benefit present and future ratepayers.

The Borrowing Policy provides the appropriate parameters for Council to undertake borrowings without compromising the application of sound fiscal management principals. The policy framework allows Council the flexibility to respond to funding requirements while minimising risk.

The Borrowing Policy ensures that Council has a sound financial framework on which to:

a. undertake borrowings
b. manage its loan portfolio; and
c. adhere to the provisions of the Local Government Act 1989.

The objectives of the Borrowing Policy are:

a. to ensure Council's new borrowings are sustainable and comply with legislative requirements
b. loan type and term will be treated on a case-by-case basis in order to optimise Council's total loan value and minimise borrowing costs
c. to manage cash flow
d. to safeguard future generations by providing a sustainable financial policy to operate within a dynamically growing city and changing environment.

2. Scope

The Policy

a. applies to Council when considering and determining the annual budget
b. applies to all Councillors and Council employees who make decisions or provide advice regarding borrowings and those involved in the development and adoption of budgets and long term financial plans
c. will be adhered to in developing Council's budget long term financial plan and all borrowings are to be identified in the plan.

Council officers must consider the application of this policy when:

a. considering new borrowings
b. refinancing existing borrowings (where long term benefits of refinancing are greater than the cost of exiting the loan).

3. References

a. Local Government Performance Reporting Framework (LGPRF)

   The Victorian Government established the Local Government Performance Reporting Framework (LGPRF) in 2014. It outlines the measures Council must report in its performance report, which forms part of Council's Annual Report. Certain indicators must also be included in Council's Annual Budget and Strategic Resource Plan (SRP).

This framework includes measures in relation to Council's obligations (to determine whether debt and other long term obligations are appropriate to the size and nature of Council's activities).

b. The *Local Government Act 1989*

The *Local Government Act 1989* (the Act) provides Councils the power to borrow. Section 136 of the Act specifies the principles of sound financial management.

- Section 136 (1) states that "A Council must implement the principles of sound financial management"
- Section 136 (2) states that "The principles of sound financial management are that a Council must:
    a. manage financial risks faced by the Council prudently, having regard to economic circumstances
    b. pursue spending and rating policies that are consistent with a reasonable degree of stability in the level of the rates burden
    c. ensure that decisions are made and actions are taken having regard to their financial effects on future generations
    d. ensure full, accurate and timely disclosure of financial information relating to the Council."
- Section 136 (3) states that "The risks referred to in subsection (2)(a) include risks relating to:
    a. the level of Council debt
    b. the commercial or entrepreneurial activities of the Council
    c. the management and maintenance of assets
    d. the management of current and future liabilities
    e. changes in the structure of the rates and charges base"
- Section 144 (1) of the Act states 'Subject to the principles of sound financial management, a Council may borrow money to enable the Council to perform the functions and exercise the powers conferred on the Council under this Act or any other Act'.
- Sections 145 to 150 of the Act specify amongst other things, the circumstances in which the power to borrow may be exercised, securities to be used for local government borrowings, and how the borrowings should be disclosed.
- Council must approve all borrowings and Section 98(1)(c) of the Act stipulates that Council may not delegate the power to borrow money. Section 146 of the Act provides that money cannot be borrowed unless details of the proposed borrowings are included in the annual budget or revised budget.
- Section 193(1) of the Act states that "For the purpose of performing any function or exercising any power conferred on a Council by or under this Act or any other Act a Council may:
    a. participate in the formation and operation of a corporation, trust, partnership or other body; and

b. subscribe for or otherwise acquire and dispose of shares in or debentures or other securities of, a corporation; and

c. become a member of a company limited by guarantee; and

d. subscribe for or otherwise acquire and dispose of units in a trust; and

e. acquire and dispose of an interest in a partnership or other body; and

f. enter into partnership or into any arrangement for sharing of profits, union of interest, co-operation, joint venture, reciprocal concession or otherwise, with any person or corporation carrying on or engaged in, or about to carry on or engage in, any business or transaction capable of being conducted so as to directly or indirectly benefit the Council."

- Section 193(5G) of the Act specifies that before a Council does anything under Section 193(1) that would include participation in the formation or operation of, or any partnership, arrangement or venture with, an entity which would have the power to borrow money in its own right, the Council must obtain the approval of the Minister.

c. Victorian Auditor General's Office (VAGO)

VAGO examines and reports on the management of resources within the public sector.

4. Definitions

Productive Purposes means all activities, including economic reactivation activities post Force Majeure Event, that would enable Council achieving higher capability to generate own-source revenue while considering the full cost impact to the Council or achieving cost efficiency.

Significant Major Projects means a long term investment project, including economic reactivation project post Force Majeure Event, requiring relatively large sums to acquire, construct and/or renew a capital asset (such as buildings). The project would result in a new, expanded or replaced asset that is aligned to Council's strategic goals and ideally generating commercial return to Council.

Force Majeure Event means any circumstances not within the reasonable control of Council, but only if and to the extent that:

a. such circumstance, despite the exercise of reasonable diligence and the observance of good financial conduct, cannot be or be caused to be, prevented, avoided or removed by Council

b. such circumstance, materially and adversely affects the ability of Council to perform business as usual and Council has taken all reasonable precautions, due care and reasonable alternative measures to avoid the financial hardship effect of such event, and to mitigate the consequences thereof.

5. Borrowing Principles

Council's Borrowing Policy is in accordance with the applicable law and regulations and is underpinned by the following principles:

a. Council will not borrow to fund operating expenditure. This type of expenditure is to be funded from operating revenue streams.

b. Council will not borrow to fund recurrent or regular capital works which is inclusive of acquisition, replacement or renewal of assets (e.g. road resurfacing, new or upgraded pavilion, promenades). This type of expenditure is to be funded from operating revenue streams.

c. Borrowings are only to be used to finance items used for Productive Purpose or linked to Council's Significant Major Projects and not be drawn down until the commencement of the project.

d. Cash flows will be phased in order to consolidate the principle and interest requirements of approved capital projects. Any borrowings undertaken must include a repayment plan.

e. The term of any loan/borrowings should not exceed the expected economic life of the asset.

f. Borrowings must not exceed VAGO's medium level risk ratio of indebtedness.

g. Any proposed borrowings must be accompanied by a business case.

6. Borrowing Ratios and Limits

VAGO requirements

a. VAGO reviews and reports on the financial sustainability of the local government sector. Two indicators best assess the financial sustainability risks associated with borrowing. Council will report on the following indicators:

Indicator	Formula	Description	Risk
Internal financing (%)	Net operating cash flow / net capital expenditure	This measures the ability of an entity to finance capital works from generated cash flow. The higher the %, the greater the ability of the entity to finance capital works from their own funds Net operating cash flow and net capital expenditure are obtained from the cash flow statement	High: Less than 75% Medium: 75-100% Low: More than 100%

Indicator	Formula	Description	Risk
Indebtedness (%)	Non-current liabilities / own-sourced revenue	Comparison of non-current liabilities (mainly comprising borrowings) to own-sourced revenue. The higher the % the less the entity is able to cover non-current liabilities from revenues the entity generates itself. Own source revenue is used rather than total revenue because it does not include grants or contributions	High: More than 60% Medium: 40-60% Low: 40% or less

b. Council will operate within the medium target ratio of indebtedness in order to have sound financial management and ensuring payment is not dependent on grants or contributions. Borrowings will not be undertaken if the effect of such borrowings is projected to result in indebtedness ratios greater than VAGO's medium level risk ratio of indebtedness.

c. Council will report on the internal financing and indebtedness ratios as part of the budget process and in the annual report

LGPRF

To measure whether the level of debt and other long term obligations is appropriate to the size and nature of Council's activities, LGPRF use the following ratios: :

a. Debt Commitment Ratio measured as interest and principal repayments on interest bearing loans divided by rate revenue.

b. Borrowing Rates Ratio measured an interest bearing loans and borrowings divided by rate revenue.

To assist Council in making assessment of the appropriate level of long term obligations, LGPRF provided the below expected range:

a. Debt Commitment Ratio: 0 – 20% (as per LGPRF February 2019).

b. Borrowing Rates Ratio: 0 – 70% (as per LGPRF February 2019).

Council will report on Debt Commitment and Borrowing Rate Ratios as part of the budget process and in the annual report.

As explained by LGPRF, "No two councils are the same and as such it is important that performance results are contextualised to the local municipality", therefore it's sensible for Council to consider other own-sourced revenue as part of Council's financial ability to borrow fund. As such, it's recommended for Council to be assessing itself on Borrowing to Own-Sourced Revenue Ratio (measured as interest bearing loans and borrowings divided by own sourced revenue). Council will aim to operate within the 0 - 60% as the target expected ratio.

Credit Rating

Council's credit rating will be assessed as part of the borrowings when applicable, and will be disclosed to Council when the rating is available for disclosure.

7. Cost Allocation of Borrowings

If the capital project is for a service that is funded by user charges (e.g. leisure services or waste) then the business cases will be updated to reflect the total borrowing costs (principal and associated costs).

If the capital project is for a service that is **not** funded by user charges, borrowings should only be considered where the project is determined by Council to be beneficial to the majority of ratepayers. Finance and Investment will review the project proposal and will provide an appropriate recommendation that will also be considered by the Executive Leadership Team and other key stakeholders as necessary.

8. Borrowing Type and Term

When entering into borrowing arrangements, Council will seek to minimise total overall costs of borrowing (including interest costs, initial costs, rating costs, etc) over the long term.

a. In determining a lending institution, Council will assess the appropriateness of the lending institution, including but not limited to:
b. Bank
c. Local Government Funding Vehicle
d. State Government
e. Federal Government
f. Global partner institutions

If bank debt is chosen as the appropriate source of funding, requests to appropriate lending institutions will be made in accordance with Council's Procurement Policy inviting written quotations on Council's borrowing requirements. Written quotations must include the:

a. interest rate
b. term and type of loan
c. repayment intervals (when applicable)
d. repayment instalment amount
e. applicable fees
f. loan break costs
g. exposure and support of the institution towards tobacco industry and fossil fuel sector
h. any other fees or charges that may be applicable.

Council will complete an analysis of the market to enable a recommendation of the borrowing type (lease, bonds, bank loans, other type of borrowing), loan term (number of years), and the interest rate type (fixed or variable). Council will consider the appropriateness of the various types of debt products available (including savings offset arrangements) and optimise flexibility to balance between timing and the cost of debt

9. Loan Repayments

To avoid a perpetual debt cycle, sensible loan repayments should be undertaken. The following is recommended:

a. Principal and Interest (P&I) payments on loans will be factored into budget estimates each year

b. Prior to commitment to any loan, the forecast debt commitment ratio must not exceed the LGPRF recommendation to allow for future P&I payments

10. Leases

Leasing as a funding option forms part of Council's overall borrowing strategy therefore it should follow Council's Borrowing Policy.

There are three types of lease:

a. An ***operating lease*** is where Council hires the asset for a set fee per period and at the end of the agreed time ownership of the asset remains with the lessor or the hire company. Council can terminate the lease at any time without incurring a penalty.

b. A ***finance lease*** is where Council agrees to a series of payments and a residual value for the asset. There is a penalty for terminating the agreement prior to the finishing date. At the end of the period it it's expected that Council purchase the asset for the agreed residual value.

c. A ***ground lease*** is where Council agrees to lease its land so that a third party can develop the property during the lease period, after which it is turned over back to the Council

Council will undertake a lease versus buy analysis for assets:

a. Which diminish in value quickly (e.g. motor vehicles, IT and gym equipment).

b. Where assets will be disposed of in a short timeframe.

c. Where the lease option transfers responsibilities to the asset owner for maintenance and disposal.

11. Restrictions

Council will abide by the Act, including section 146 which provides money cannot be borrowed unless details of the proposed borrowings are included in the annual budget or revised budget.

12. Ethics and Conflict of Interest

Officers shall refrain from personal activities that would conflict with the proper execution and management of Council's borrowings. This includes activities that would impair the officer's ability to make impartial decisions.

This policy requires that officers disclose to the Chief Executive Officer any conflict of interest that relates to borrowings.

13. Policy Review

The Borrowing Policy will be reviewed:

a. annually by the Income and Investment Panel

b. as required by changed circumstances, including changes to legislation,

and any material changes will be reviewed by Audit and Risk Committee and endorsed by Council.