National financing authority for local government
Options assessment

Department of Regional Australia, Local Government, Arts & Sport
Dear Matty McConchie
Assistant Secretary
Local Government and Territories
Department of Regional Australia, Local Government, Arts & Sport
GPO Box 803
Canberra, ACT, 2601

Private and confidential

National financing authority for local government - Options assessment

21 March 2013

Dear Matty

In accordance with Official Order 10008238 dated 30 October 2012 pursuant to the Deed between the Commonwealth as represented by the Department of Prime Minister and Cabinet and Ernst & Young dated 15 June 2010, we are pleased to present our report on options for aggregating the debt finance sought by the local government sector in Australia.

This report has been prepared on your instructions solely for the purpose of providing advice on options for aggregating the debt finance sought by the local government sector in Australia, and should not be relied upon for any other purpose. Any use such third parties may choose to make of our report is entirely at their own risk and we shall have no responsibility in relation to any such use.

Yours sincerely

Darrin Grimsey
Partner
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Executive summary

Local infrastructure is the backbone of our communities and our regions. Providing and maintaining this infrastructure is one of the most important responsibilities faced by Australian councils, but it also presents one of their largest challenges.

Strong Foundations for Sustainable Local Infrastructure, the Ernst & Young report launched by the Australian Government in June 2012, suggested that there is a suboptimal use of debt finance within local government which is contributing to an under-provision of infrastructure by the sector. Building on recommendation 3 of the report, Ernst & Young has been engaged to develop this finding further.

The objectives of this study are:

- to test the strength of the case for federal and state/territory government representatives to support an initiative which aggregates the debt finance sought by the local government sector
- to identify a set of feasible models for debt aggregation (including models for a collective financing vehicle), explore the relevant design issues and select and develop the preferred option(s).

The case for action

National local government financing vehicles operate effectively in a number of countries, and in some cases have been in existence for over a century. In other countries where they do not currently exist, notably France and the UK, planning is relatively advanced.

Precedent alone does not justify change in Australia. Indeed, it is widely acknowledged that Australian councils already have good access to debt finance, in the form of bank credit or - in some jurisdictions - loans from treasury corporations or a collective vehicle.

But the fact remains that councils in Australia are not taking advantage of the opportunities they have to use debt as a resource to contribute to the growing infrastructure task. They continue to think that borrowing is “bad”, it is too expensive, and that it introduces significant financial risk that they are unable to manage.

We do not underestimate the risks and costs that come with debt. Nor are we in the business of telling councils that they must borrow more. However, we do see a strong case for offering councils greater confidence in accessing finance at the best possible rates and the same opportunities that other governments enjoy in terms of tapping into a pool of institutional investment that is hungry for low-risk credit products.

The incentives for intervention include:

For the Commonwealth:

- encouraging the local government sector to manage its own future and contribute to local and regional economic prosperity and community wellbeing
- using its unique status to bring together diversified stakeholders, make the case for reform and provide support and direction for policy intervention.

For state and territory governments:

- supporting councils as they continue towards financial self-sufficiency and ultimately reduce their reliance on their state and territory supervisors
- contributing to policy goals around asset management, capacity building and financial sustainability in the local government sector
• maintaining oversight and legislative supervision of the sector within each jurisdiction.

For local government:
• retaining the responsibility for delivering infrastructure and decision making on the best use of available funding
• pooling their requirements and collective creditworthiness (supported by the implied backing of the states and territories) to create the critical mass needed to issue financial instruments into the capital markets
• accessing lower arrangement and servicing costs for debt products
• accessing the support of specialist resources and market expertise
• using responsible borrowing to deliver infrastructure priorities sooner and more efficiently, while sharing the costs amongst all beneficiaries.

Recommendation

*Strong Foundations for Sustainable Local Infrastructure* suggested that a national collective financing vehicle for the local government sector could assist address the suboptimal use of debt in the sector by:
• providing easily-available and competitively priced debt to the local government sector by aggregating risk and supply across many councils
• increasing the pool of finance by offering structured products to the institutional investment market, hence establishing a conduit between councils and capital lenders
• encouraging a cultural shift away from the reluctance to borrow
• enforcing governance and reporting arrangements to ensure the sustainability of councils is not jeopardised
• providing financial and legal assistance and expertise to those councils with limited in-house capacity.

Importantly, a national collective vehicle must be designed so that it achieves these objectives with a minimal impact on the relationship between the local government sector and the Commonwealth, states and territories.

It will be an “enabling” organisation, with a role of giving councils access to cost-effective debt, without forcing them to take it on where not appropriate or desired. Nothing about the organisation should take away from each and every council the responsibility for sound financial management and decision-making.

There are a number of different models for collective financing vehicles overseas. We have evaluated a long-list of 11 options which satisfy the broad requirements set out above but are distinct by virtue of different permutations of factors of ownership, the providers of any credit enhancement and the nature of any credit enhancement. The evaluation criteria applied address the key success factors around purpose and function, impacts on other governments, market credibility and participation rates.

The option which scored highest in the evaluation represents a tailored structure which we believe would be suitable to the unique Australian landscape:
The preferred model is a collective financing vehicle established by a group of councils with the objective of issuing debt securities to the capital markets and on-lending the funds to members. It has the following features:

- The authority would be an incorporated entity established and controlled by the local government sector and would operate under a voluntary membership arrangement.

- Each member would be required to provide a minimum amount of capital which could for example be proportional to average rates revenue. Capitalisation of the authority would satisfy ongoing capital adequacy requirements and could fund establishment costs including any losses in the early years.

- Each member would be required to implement a mutual guarantee over the authority’s liabilities, which would be capped in proportion to its financial position or level of borrowing from the authority.

- There would be no explicit credit enhancement provided by the Commonwealth, states or territories.

- The authority would aim to achieve the best possible credit rating, which would be based upon the combined creditworthiness of participating councils, strong integral liquidity arrangements, the mutual guarantee provided by members, and the implied support of the local government sector by other tiers of government.

- The liquidity and mutual support provisions would ensure that the likelihood of step in by state/territory governments would be extremely low, thus minimising the amount of financial risk that states/territories would have to take on in return for their continued implied support of the local government sector.

- The authority would build a presence in the bond markets and issue debt securities to raise funds.

- The authority would provide targeted debt products to its members at cost-effective interest rates and with flexible terms. It would develop a suite of policies to govern access to lending based upon the capacity of each applicant to repay the amount of debt sought.

- The authority would provide advice to its members on the process for accessing debt and related financial products, and other services related to councils’ capital structuring.

- The authority would be incentivised to keep its cost base low, rather than to achieve a profit.
In identifying a preferred option, we acknowledge that the evaluation undertaken suggests that several models are closely ranked. This outcome largely reflects the broad similarities among the commercial characteristics and structure of the options. Some features and benefits are, as a result, found in all the options identified. These include the potential to provide financial benefits, for those entities which borrow, in the form of lower arrangement and servicing costs, and the potential to stimulate a higher rate of investment in priority projects which produce positive economic, social and/or environmental outcomes.

However, the evaluation process suggests that marginal differences in the credit support structures and the proximity to councils could have a significant impact on stakeholders and processes.

The following factors, when combined, were crucial in differentiating the preferred option from other options, and demonstrating a benefit when compared to the status quo:

- **Cost-effective debt finance**
  The preferred model has the potential to achieve pricing outcomes which represent material savings compared with the estimated borrowing costs of many councils.

- **Promoting a culture of sustainable debt use**
  The preferred model could contribute positively to promoting a culture of sustainable debt use.

- **No explicit support from other tiers of government**
  The preferred model does not require explicit credit support from other tiers of government and is unlikely to require substantial legislative change. These are important factors in measuring the cost - including time - and risk inherent in a subsequent implementation process.

**International precedents**

In developing the case for a national financing authority in Australia, there are a number of lessons that can be learnt from international experience. In particular:

- **New Zealand** has the most recent experience of establishing a collective financing agency for local government. The New Zealand Local Government Funding Agency was incorporated in December 2011. With nine founder members, it now has 30 councils as members. It has already released 10 bond tenders, raising in excess of NZ$1.5 billion, and consistently achieving highly competitive margins over New Zealand Government Bonds. Standard & Poor’s and Fitch have both assigned the agency a domestic currency rating of AA+ (the same as the New Zealand Government) and the outlook on these ratings is stable. The New Zealand Government does not explicitly guarantee the agency’s liabilities.

- **Local government in Scandinavia** has a long history of using the services of a collective financing vehicle - Denmark’s agency has been operating since 1898. While each has different structures and established relationships with other tiers of government, these can provide some important lessons for Australia. In Sweden, for example, the three largest municipalities (Stockholm, Gothenburg and Malmo) are not members of the collective financing vehicle, but it has still been able to function extremely well for a number of years. This demonstrates that a critical mass might be achievable even without the participation of the very largest councils.

- **In Canada**, the Municipal Finance Authority of British Columbia (MFA) is a good example of the mutual guarantee model. Local governments within each regional district are joint and severally liable for each others’ long-term debt borrowings through the MFA. When a municipality passes a borrowing bylaw and presents it to...
its regional district for the purpose of issuing security, all municipalities in the region must vote on their acceptance of the borrowing. Approval of the bylaw binds each municipality with joint and several obligations.

• In France, a local government financing authority is currently being established, and the UK Government is also considering the case for action.

Throughout this report there is a strong focus on identifying and capturing the lessons from overseas. A comparative analysis of the international agencies is provided in Appendix D.

Next steps

Moving to the next stage of development will need a concerted effort by all tiers of government. If there is appetite to take this initiative forward, we anticipate that the next steps should be:

1) policy consultation with federal, state and territory stakeholders
2) further commercial and legal investigation of the preferred option, including consultation with the local government sector to test demand
3) identifying commitments, costs and resources to move into the ‘build’ phase.

We recognise that the establishment of a national financing authority for local government would be a considerable challenge.

Firstly, a national financing authority will only succeed if a minimum number of councils are minded to join it. A critical mass would be required to give the authority the buying power in the market to raise funds and pass on capital to councils at low interest rates.

Secondly, the idiosyncrasies of the Australian federal system, the different conditions and arrangements in different jurisdictions, and the multitude of stakeholders, mean that the path to reform has many obstacles.

However, we urge the Australian Government to continue to work with jurisdictions and local government on this initiative. Providing the apparatus for councils to develop the same market presence and fund raising capacity as other governments could present a real opportunity for the sector to move to an optimal debt load and ultimately reduce the substantial backlog of priority infrastructure projects which create and sustain amenity in local communities.

This objective is, we believe, consistent with the vision for strong and sustainable Australian councils which is shared by all tiers of government.
1. The case for action

This section provides context to the recommendation for a national financing authority by identifying and substantiating the case for action. In particular, it:

- articulates and validates the problem identified in *Strong Foundations for Sustainable Local Infrastructure*, namely that the suboptimal use of debt in the local government sector is having a negative impact on the ability of councils to address the growing infrastructure task
- explains that the lack of scale and coordination within the sector is preventing the participation of private investors, who have a demonstrated appetite for low-risk highly-rated debt instruments
- demonstrates how a national financing authority for local government could provide a solution to the problem
- identifies key features and considerations which we believe to be “prerequisites” for a future national financing authority in Australia if it is effectively to address the problem.

The analysis in this section is developed further in Appendix A.

Debt and the infrastructure task

Local infrastructure is the backbone of our communities and our regions. Underinvestment in this infrastructure results in constrained economic activity, reduced amenity for communities and declining social equity. But the costs of infrastructure are high and lumpy, and at a time when there are many competing demands on revenues, meeting these costs places significant pressure on council budgets.

Leveraging core revenue sources to access debt is an option open to all councils as a means of contributing to the significant upfront costs common to most infrastructure projects, and can be the difference between a project going ahead or not.

Borrowing is a common feature of private sector capital structures and does not mean that a council is acquiring things it cannot afford. Rather, in the context of sound financial management and project planning, the key benefits of debt are that it can:

- enable councils to deliver new infrastructure when it is required and earlier than they otherwise would have been able
- allow the smoothing of the payments for new investment over time
- prevent the need to divert funds from internally-generated renewal and maintenance budgets to capital expenditure
- enable councils to invest in the renewal and lifecycle costs of existing infrastructure, which are time-sensitive and if not delivered can increase the whole-of-life cost of an asset
- allow the cost of infrastructure to be shared with future generations who will enjoy the benefit of the asset
- open the door to new sources of investment, for example from institutional finance providers, which bring additional rigour and discipline.

Overlooking debt as a source of capital can prevent infrastructure investments from going ahead because councils often do not have adequate alternative resources to fund projects with lumpy cost profiles. The consequence of delay and non-investment is that the infrastructure gap gets bigger - or at the very least, it does not get smaller - and the local
government sector’s capacity to deliver economic, social and environmental benefits and contribute to national productivity, is significantly weakened.

**Debt in the context of local government funding**

Debt is a source of finance, and it is important to understand that this is not the same as funding.

Funding is how infrastructure is paid for. Finance describes the money that has to be raised upfront to deliver the infrastructure, and - unlike funding - it needs to be repaid. In other words, infrastructure must be funded, irrespective of how it gets financed.

This means that while financing can support funding, it is ultimately a secondary consideration. Local infrastructure is (and will remain) funded by the community through taxation and user charges and revenues received from other tiers of government. Meeting the infrastructure task will always be dependent upon the quantum of this funding.

Additional finance may make possible individual projects or programs when funding is constrained, but it is not the solution to the underlying issues of sustainable funding.

But while financing will always be dependent upon funding, it can be crucial to the timely delivery of key community infrastructure projects. Debt finance enables councils to deliver infrastructure earlier than they otherwise would have been able and to spread the costs amongst future generations who will enjoy the benefit of the investments.

**The suboptimal use of debt**

It is widely acknowledged that most Australian councils do have access to debt finance, either in the form of bank debt or services provided by the state/territory government or an existing collective agency - and hence there is no demonstrable failure of the market to provide finance.

But the fact remains that - as a general rule - Australian councils continue to adopt a cautious approach to borrowing. There remains a clear reluctance to borrow as an appropriate method of paying for infrastructure. Most councils prefer to use current year funding in the form of rates and grants receipts for this purpose, rather than utilise debt finance to match the incidence of the costs to the benefits, and ensure that current ratepayers are not shouldering a disproportionate burden.

This is caused in part by an information asymmetry between councils as borrowers and the providers of finance that arises because councils often do not have the background and skills to make informed judgements about the risk of borrowing. The evidence of the reluctance to borrow supports the view that councils make an overly pessimistic assessment of the risks of using debt, despite possessing what lenders clearly consider to be sound credit fundamentals.

Related to the information gap is the fact that the local government sector does not currently have the tools to tap into or create an interface with the institutional investment markets. Most Australian councils are relatively small entities and as such get less “attention” from capital markets than, say, state or territory governments or large corporations. And because they issue debt in a fragmented way and typically in relatively small quantities, the costs incurred are significantly greater than would be the case if there was the opportunity to work together.

**Aggregation as the key to unlocking the markets**

A targeted policy intervention is required to facilitate the introduction of additional private capital into the local government sector and to enable the reluctance to borrow to be overcome. A coordinated effort by all tiers of government is necessary to spread awareness of the implications of unduly low levels of debt for councils’ ability to invest in their assets.
The central objective of action should be to assist the aggregation of the smaller borrowing needs of councils through a collective vehicle, which would develop a communal buying power and the required security to gain a strong credit rating. This in turn would enable councils to access lower cost borrowings, while also introducing operational efficiencies and administrative synergies to drive costs down.

In current market conditions, there is likely to be a strong demand for low-risk government or quasi-government instruments, which a collective vehicle would be able to satisfy by issuing bonds into the capital markets, and on-lending the proceeds to participating councils.

Providing access to debt in this way is not to say that every council should participate and should be seeking to increase its borrowings and financial gearing. Ultimately the capacity to raise debt will be a function of the capacity to fund debt servicing payments for the term of the loan, and to repay the principle once the term has expired. It must never be forgotten that the availability of finance will always be a secondary consideration to the availability and application of funding.

**Towards an Australian national financing authority**

If it is to fulfil this role and bring substantive benefits to the local government sector, there are some overarching principles, design features, or prerequisites, which are inherent in accessing wholesale finance markets and must be present in a national financing authority for Australian local government.

These features (articulated below and in more detail in Appendix A), should be present in any option taken forward for further consideration.

- **Purpose**

  The purpose of the national financing authority would be to pool the borrowing needs of participating local government bodies and fulfil them by issuing financial instruments.

  The principal role of the authority would be to obtain cost-effective finance for its members, and not to ‘pick winners’ or take responsibility for investment decisions. Importantly, the availability of new debt products should not dilute the responsibility or incentives for councils to mitigate the risks of delivering specific infrastructure projects. As such, councils should remain focussed on managing their levels of financial risk.

- **Ownership and governance**

  The national financing authority should be a corporatised entity in public sector ownership and should have clear lines of accountability to the participating local government entities. There will be a role in the governance structure for the state/territory governments, potentially the Commonwealth, and independent experts to ensure and demonstrate the competence and procedural rigour built into the authority’s structures and processes.

  The national financing authority would need to comply with all legal obligations including those related to the Corporations Act, National Competition Policy and state and territory local government acts. In issuing financial products and instruments, the national financing authority would be required to comply with the regulatory requirements of the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulatory Authority (APRA) and potentially the Reserve Bank of Australia (RBA).

- **Membership and participation**

  To receive any services from the national financing authority, a council would need to become a member. Membership would not represent an obligation to use the authority exclusively, and members would retain the right to source services and finance from other entities including banks (subject to any restrictions imposed by state or territory legislation).
Membership should be voluntary. Any council could choose to apply to be a member, and equally, could choose to leave the authority. Ultimately, individual councils need to make their own evaluation of the overall benefits of membership.

As membership of the national financing authority would be voluntary, the number of participating entities would be expected to fluctuate over time as individual councils consider their own case for membership. Precedent authorities overseas have been founded by an initial group of members and expanded over time. The stability of the organisation will be a function of the level of “skin in the game” taken on by members, and the incentives provided to continue participation.

A minimum level of participation in the national financing authority is likely to be important because its ability to generate benefits will depend upon achieving a critical mass to provide an attractive proposition for inward investors. This means not just joining the authority but doing so with the intent of making use of the facilities available, possibly via a commitment similar to the one undertaken by founder members of the New Zealand Local Government Funding Agency.

- Intergovernmental considerations

The structure and role of the authority would need to be consistent with Australia's unique structure of government and sensitive to the concerns and needs of multiple stakeholders. These stakeholders will rightly need to be persuaded of the need to support the initiative, which will be a function of their understanding of the benefits and the risks, including implementation considerations, outturn set up costs and longer-term impacts.

We contend that ultimately the motives for supporting the objectives of a collective entity are consistent with the policy intent of the Commonwealth and jurisdictions to promote a self-sustaining local government sector that is capable of leveraging its “own-source” revenues to deliver the community's infrastructure requirements, while reducing its reliance on other tiers of government.

A national financing authority could create the conditions to help councils invest their own revenues in much-needed infrastructure projects and accelerate their journey toward financial sustainability. It would give further momentum to initiatives to promote capacity building, financial self-sufficiency and consistency of standards in local government. These initiatives reflect the objectives of the Commonwealth and all jurisdictions to help the sector grow and prosper.

- Functions

The national financing authority would have four primary functions: lending to local government, fund raising, supporting liquidity and credit quality, and providing advisory services.

1) Lending to local government

The national financing authority would provide targeted debt products to its members at cost-effective interest rates and with flexible terms. It would aim to become the “natural choice” for it members when it comes to borrowing.

The key features of the authority's function as a lender would be:

- **Low cost**: the authority would deliver low borrowing costs for its members, which would be set at a level sufficient only to fund the repayment of securities, cover the costs of the authority (including issuing costs) and accrue a prudent reserve.

- **Equitable**: the same low costs would be available to all members. This would mean that small councils wanting to borrow smaller amounts would be able to access the same interest rates as large councils with larger requirements.
- **Responsible**: the authority would develop a suite of policies to govern access to lending and provide a framework for a loan request acceptance process. This would incorporate components of the credit approval processes used by commercial banks and other public sector financing agencies.

2) **Fund raising**

The national financing authority would build a presence in the bond market and issue debt securities into the capital markets to raise funds on behalf of councils. In doing so, it would achieve what individual councils are currently unable to - namely bundling smaller debt requirements into larger bond issuances, pooling the needs of the sector and creating a consolidated and strong creditworthiness.

It is anticipated that the national financing authority would create a new class of highly rated bonds targeted at banks, insurance companies and super funds. Market consultation indicates that there could be considerable appetite for these instruments as they would be seen to be relatively low-risk investments, because councils enjoy steady and secure income streams in the form of rates and untied or general purpose government grants, which can be used to meet debt servicing obligations and to secure debt facilities.

Funds raised would be held by the entity for the purpose of lending operations, maintaining liquidity through reserves or other treasury instruments, and operating expenses.

3) **Supporting liquidity and credit quality**

Adequate credit support arrangements would be required to satisfy the concerns of investors around the ability of the authority to meet its liabilities over the short and long run.

It is anticipated that the national financing authority’s liabilities will in the first instance be secured by debentures providing a charge over council general revenues. Any additional credit enhancement from participants (such as through the provision of risk capital or guaranteeing the authority's obligations) - or from other tiers of government - would have the potential to enhance the likelihood of being assigned the best possible credit rating.

The liquidity of the products issued by a national financing authority is an important consideration and impacts on the appetite for, and pricing of, those products. A core role of the management of the national financing authority would be the management of liquidity, which would require sustaining sufficient volumes of ‘benchmark’ product in the market. The implicit assumption made is that the debt requirements of the local government sector are large enough to support a market for such debt instruments. As discussed in Appendix C, this report estimates a total debt requirement for the sector in excess of $10 billion. While this is a small amount compared with state and federal government bond programs, a take-up rate across the sector of about two-thirds is likely to support parcels of bonds large enough to attract institutional investors who hold (and trade) portfolios of similar products.

By way of comparison, two smaller states - Western Australia and South Australia - continue to maintain relatively small scale bond programs. Excluding short term paper, these programs over the last decade have had outstanding amounts as low as $7.5bn and $3.5bn respectively.

4) **Advisory services**

The national financing authority would provide advice to its members on the process for accessing debt and related financial products, and other matters related to capital structuring.
The key features of the authority's function as an advisor would be:

- **Capacity building**: the advisory role will complement capacity-building initiatives and provide an additional resource for councils to enhance budgetary discipline and financial sustainability.

- **Addressing the reluctance to borrow**: the provision of sound advice to the local government sector will enable the authority to become a counterweight - without vested interest - to voices driving the observed debt aversion.

- **Market confidence**: resourcing the authority with market experts and independent experienced individuals will be necessary to give the market confidence in the entity and ultimately expand the range of willing investors.

- **Preserving council's core responsibilities**: the advisory role must not replace the responsibility held by every council to prioritise and select infrastructure projects and appropriate procurement models in house.

It is anticipated that the focus of the advisory services provided by the national financing authority would be upon credit assessments, debt management and financial products. The focus would not be upon procurement models, prioritisation processes and asset management. As recommended in *Strong Foundations for Sustainable Local Infrastructure*, there remains a pressing need for an advisory body and guidelines for local government in these areas, but we suggest that the two advisory functions are discrete.

- **Profitability and operating costs**

The national financing authority would be created for the benefit of the community. Its role would be to minimise finance costs for the local government sector and not to make accounting profits.

Were a surplus to be made, it would be retained by the entity to build its capital base and subsidise auxiliary services. Depending on the model, a portion of the surplus could be returned to shareholders.

In the absence of the motive of profit, the national financing authority must still be incentivised to keep its cost base as low as possible in order to pass on the largest possible savings to its members. Pooled financing should lead to processing and issuing costs that are considerably lower than if the individual councils were to borrow from the capital markets on their own.

Other operating costs should be kept to a minimum. To this end, they could be benchmarked against comparable entities and performance indicators could be incorporated into annual reporting and management remuneration.
2. A national financing authority for local government

This section summarises the evaluation of options undertaken and describes the key features of the preferred model.

The detailed options evaluation is included in Appendix B.

Options

In this study, we identify 11 options for a potential national financing authority for local government in Australia:

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10 of the 11 options meet all the “core” functional requirements with respect to fund raising and lending to councils set out in Chapter 1. Each option is distinct by virtue of different permutations of factors relating to:

- ownership/ establishment
- the providers of any credit enhancement
- the nature of any credit enhancement.

The final model (Option 8) is a “pass-through model”, and as such does not meet all the “core” prerequisites previously identified. This option would involve the establishment of a vehicle to act as a financial intermediary or arranger of debt for participating councils requiring finance for specific projects or programs. It would react in response to demand and not have a regular presence in the bond market.
The options are described in more detail in Appendix B, and - where relevant - appropriate precedents are referenced.

**Evaluation criteria**

The role of the evaluation criteria is to provide a basis for differentiating between the options. While many of the concepts and practical administration considerations are common across all the identified options, there are important structural and ultimately commercial differences.

The following criteria are used in the evaluation of options for a national financing authority and are based upon the motives for action previously described. The criteria address the key success factors around purpose and function, impacts on other governments, market credibility and participation rates.

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<th>Purpose and function</th>
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<td>I  Capable of reducing the costs of debt finance.</td>
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<td>ii Capable of positively affecting the culture of debt aversion, supporting the</td>
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<td>sustainable use of debt and the transition to long-run sustainable financial</td>
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<td>management in the local government sector.</td>
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<th>Impacts on other governments</th>
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<td>iii Manageable upfront, and ongoing, impacts on the existing legislative and</td>
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<td>iv Manageable upfront, and ongoing, impacts on the existing relationships between</td>
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<td>the tiers of government.</td>
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<tr>
<td>V  Manageable upfront, and ongoing, impacts on the long-run financial position of</td>
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<td>the Commonwealth, states and territories.</td>
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<th>Market credibility</th>
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<td>vi Capable of achieving an acceptable level of financing risk by attracting local</td>
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<td>(and international) debt market investors.</td>
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<th>Participation rates</th>
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<tr>
<td>vii Capable of achieving a broad base of participation across the local government</td>
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<td>sector.</td>
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**Preferred option**

The detailed evaluation of all models is in Appendix B. The evaluation suggests several models are closely ranked. This outcome largely reflects the broad similarities among the commercial characteristics and structure of the options. However, the evaluation process suggests that marginal differences in the credit support structures and the proxy to councils could have a significant impact on stakeholders and processes. The evaluation focuses on testing those impacts.

The highest scoring option overall is 6c. This option consists of an entity established by a group of councils, with the membership required to contribute an upfront capital sum and enter into a mutual obligation in support of the entity. This obligation would be capped at a level broadly proportionate to members' borrowing or financial position and would be secured against their revenue-raising powers.

As with all options identified, the potential financial benefits, for those entities which borrow, include lower arrangement and servicing costs. The potential economic benefits include a higher rate of investment in priority projects which produce net economic, social...
and/or environmental benefits. With reference to the specific characteristics of Option 6c, the following factors (in combination) were crucial in differentiating it from other options:

- **Cost-effective debt finance**
  The option has the potential to achieve pricing outcomes which represent material savings compared with the estimated borrowing costs of many councils.
  The security features of this model could attract sufficient appetite to drive beneficial pricing outcomes.
  In particular, this option requires local government to assume responsibility for the obligations of a new entity without explicit recourse to the next tier of government. It seeks to make efficient use of the implicit support for local government from state and territory governments, which is typically inferred by commercial lenders.

- **Promoting a culture of sustainable debt use**
  The option could contribute positively to promoting a culture of sustainable debt use.
  It creates a strong incentive for councils to form collectively to achieve the scale and function within a new entity which can drive pricing outcomes. This is a critical point of difference because a central objective of this study is addressing the observed sub-optimal use of debt. While other options arguably present a higher probability of achieving competitive financing, focussing exclusively on cost and not the broader rationale for providing the sector with its own channel to debt finance could jeopardise the overall benefits of intervention.
  The option, as a council-established entity run with a strong collective ethos and sense of ownership, is aligned with the culture of the sector and consistent with sector-wide initiatives to improve long-run financial management. As noted in *Strong Foundations for Sustainable Local Infrastructure*, this could create a virtuous circle as more councils improve internal processes to manage the risks of borrowing and in-turn lower credit margins for all members and further spread the consequences of a default.

- **No explicit support from other tiers of government**
  This option does not require explicit credit support from other tiers of government and is unlikely to require substantial legislative change. These are important factors in measuring the cost – including time – and risk inherent in a subsequent implementation process.

Two key risks are identified with this option:

- **Building market credibility**
  The process of building understanding within wholesale funding markets of the nature and robustness of the structure for securing financial obligations and creating attractive financial instruments for investors may be relatively complex compared with some other options. There would need to be a balance struck between security and pricing, and between capital contribution and joint guarantee.

- **Participation levels**
  Consistent with all options, the actual level of interest from individual councils is a key variable which is hard to forecast.
  A particular consideration with the preferred model is that – given that lower interest rates cannot be guaranteed in advance – there would need to be sufficiently strong incentives for councils to make upfront capital contributions as a
precursor to participation in the authority. This would be a function of the confidence of councils in the potential of the organisation to provide future benefits in terms of pricing, security and access.

As explored in Chapter 3, this may be mitigated by securing pre-establishment commitments from councils and a shadow credit rating from ratings agencies, to build confidence in the organisation’s long-term viability.

Preferred option – key features

Although we have not developed a detailed specification for the authority, the following features and considerations are likely to be important.

• The authority would be an incorporated entity established by the local government sector and would operate under a voluntary membership arrangement.

• Each member would be required to provide a minimum amount of capital which could for example be proportional to average rates revenue. Capitalisation of the authority would serve to fund establishment costs, cover any net losses in the early years and meet capital adequacy requirements.

• Each member would be required to agree to a mutual guarantee over the authority’s liabilities, which would be capped in proportion to its financial position.

• There would be no explicit credit enhancement provided by the Commonwealth, states or territories.

• The authority would aim to achieve the best possible credit rating, which would be based upon the combined creditworthiness of participating councils, strong integral liquidity arrangements, the mutual guarantee provided by members, and the implied support of the local government sector by other tiers of government.

• The liquidity and mutual support provisions would ensure that the likelihood of step in by state/territory governments would be extremely low, thus minimising the amount of financial risk that states/territories would have to take on in return for their continued implied support of the local government sector.

• The authority would build a presence in the bond markets and issue debt securities to raise funds.

• The authority would provide targeted debt products to its members at cost-effective interest rates and with flexible terms. It would develop a suite of policies to govern access to lending based upon the capacity of each applicant to repay the amount of debt sought.

• The authority would provide advice to its members on the process for accessing debt and related financial products, and other services related to councils’ capital structuring.

• The authority would be incentivised to keep its cost base low, rather than to achieve a profit.

The features outlined above are designed to provide the starting point for a model which has the ability to develop market credibility without the need for explicit credit enhancement from jurisdictions or the Commonwealth. From a market point of view, the establishment of a national financing authority as recommended is anticipated to have the following features.

• Councils have a high quality credit profile given the ability to raise rates revenues to meet their cash flow expenditure. Such a characteristic gives comfort to lenders as this provides an enhanced ability to meet debt repayment commitments compared to other types of non-government entities.
The credit profile of individual councils would be strengthened by the diversification benefits of pooling the cash flows under the proposed authority structure. Overlaying a mutual obligation amongst the individual borrowers would further enhance the credit profile of the borrowing entity.

With a strong credit rating, the authority could attract a pool of lenders to fund its requirements, from banks (domestic and international), super funds and (potentially) retail investors.

Current levels of activity in debt markets present an opportunity for the authority as many banks have capacity to lend and requirements to comply with Basel III regulations which encourage them to lend to higher rated entities. Similarly, super fund and life fund investors (fixed interest) are also seeking long-term investment opportunities to place debt.

From a sector point of view, the benefits of participation in a national financing authority with the features outlined above would differ from council to council based upon a number of factors, including the current lending arrangements in different jurisdictions. These are summarised below.

<table>
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<tr>
<th>Jurisdiction</th>
<th>Overview of current arrangements</th>
<th>Impact of the national financing authority</th>
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| New South Wales    | • Under s622 of the Local Government Act 1993, a council may borrow by way of overdraft or loan or by any other means approved by the Minister.  
• Every council must lodge an electronic return with the Local Government Division setting out its proposed borrowings for the coming financial year, including the projects to which they relate.  
• The government does not lend directly to councils, nor does it provide a guarantee over local government debt.  
• The government has established the Local Infrastructure Renewal Scheme (LIRS) which provides a capped pool of funds to councils in the form of a 4% subsidy towards servicing debt for the purposes of approved infrastructure renewals. | • The proposed national financing authority does not appear to be inconsistent with New South Wales legislation, provided that the authority is approved as a lender under s622 of the Act.  
• The LIRS is likely to remain an attractive mechanism for councils to support finance. There will be a role for the national financing authority in cases where financing plans are not supported by the LIRS.  
• If the national financing authority is able to provide debt pricing which is competitive to the major banks, it is likely to be an attractive proposition for councils seeking finance. |
| Northern Territory | • Under the Local Government Act, Northern Territory councils may borrow only with the approval of the Minister, in consultation with the Treasurer  
• The Northern Territory Treasury Corporation lends to local governments in accordance with commercially based guidelines. | • The proposed national financing authority does not appear to be inconsistent with Northern Territory legislation. The Minister would continue to exercise his oversight of local government borrowing by approving applications for loans from the authority. |
| Queensland         | • Part 5 of the Queensland Statutory Bodies Financial Arrangements Act (SBFAA) permits local government to borrow with the Treasurer’s approval.  
• The Treasurer has provided a delegation to the Director-General of the Department of Local Government (DLO) to consider, approve or decline where a local government seeks to borrow from Queensland Treasury Corporation (QTC).  
• Borrowings from QTC are unconditionally guaranteed by the Treasurer of Queensland, on behalf of the state government.  
• Any borrowing request for non-QTC sources must be considered and approved by the Treasurer directly. | • The proposed national financing authority does not appear to be inconsistent with Queensland legislation. The Treasurer would continue to exercise his oversight of local government borrowing by approving applications for loans from the authority.  
• Transitioning to a situation where QTC is no longer the sole lender to local government would reduce the impact of local government debt on the state government balance sheet. |
| South Australia    | • Under s134 and 135 of the Local Government Act 1999, councils are permitted to borrow without the approval of the state government.  
• The state government does not lend directly to | • The proposed national financing authority does not appear to be inconsistent with South Australian legislation. |
Most council borrowings are from the Local Government Financing Authority (LGFA), which does borrow from the state government (SAFA) and is guaranteed by the government under the Local Government Finance Authority Act 1993.

### Tasmania
- Under the *Local Government Act 1993*, councils are permitted to borrow.
- Ministerial approval is required for a council to borrow additional money if the annual payments required to service the total borrowings would exceed 30% of its revenue (excluding specific purpose grants) of the preceding financial year.
- Tasmanian councils source debt from both major banks and TASCORP.

### Victoria
- Under the *Local Government Act 1989*, councils may borrow provided the loan is not for ordinary purposes or the purposes of municipal enterprises unless included in a budget or revised budget.
- Councils are unable to access finance through the TCV and must therefore seek finance on the open market.

### Western Australia
- Under the *Local Government Act 1995*, councils may borrow, subject to certain restrictions, mainly relating to the nature of the security given by councils over obligations.
- The state treasury corporation, WATC, lends directly to local government. Most borrowings are with WATC although some councils borrow from major banks.
- WATC guidelines recommend a debt service ratio of less than 10% and a net debt (gross debt less cash assets) to operating revenue ratio of less than 60%.
3. Next steps and implementation considerations

This section includes a discussion of the potential next steps with regards to developing the preferred option further and considering issues around implementation. Moving to the next stage of development will need a concerted effort by all tiers of government. In New Zealand, where it could be argued that the political landscape is easier to navigate on account of its two-tier system, three years were needed to progress the Local Government Funding Agency from a concept to reality.

Broadly, the next steps for this initiative should be:

1) policy consultation with federal, state and territory stakeholders
2) further commercial and legal investigation of the preferred option, including consultation with the local government sector to test demand
3) identifying commitments, costs and resources to move into the ‘build’ phase.

1) Policy consultation

Developing the momentum for a national financing authority will be a function of the degree of consensus among federal, state and territory governments. This consensus primarily relates to accepting the case for action and the substance of the solution.

For these reasons, it is suggested that policy authorities consider using a coordinating body such as a COAG Ministers’ Forum to prepare a consensus policy position.

It is anticipated that the main areas of discussion will be:

- Level of participation

The optimal size of a collective vehicle - or the ‘tipping’ point at which membership is sufficient - is that which creates enough issuance to drive strong competition for the entity’s securities and moves pricing to a point comparable with similar and equivalently-rated products.

There is likely to be a relationship between policy consensus and the level of participation by councils, which is a critical enabler of competitive pricing and credibility in financial markets. Consensus may not need to be unanimous, but without broad agreement, the risks to patronage would probably be unacceptable.

- Impact on existing borrowing arrangements

Many councils have long-run relationships with incumbent entities - for example, the Queensland Treasury Corporation or the Local Government Finance Authority of South Australia.

The size of borrowings in the local government sector may not be large or diverse enough to accommodate a new national financing authority which operates alongside these existing arrangements, especially in the early days of its operation.

In light of this, strong signals from the Commonwealth and state governments about their perspective on a collective borrowing vehicle would be important to build credibility and market confidence. To enable the proposed entity to establish itself and be effective, the states and territories may need to consider making a commitment to stepping back from their role as the ‘one stop shop’ for non-private lending.
2) Further commercial and legal investigation

This study is preliminary in several areas, and has not had the benefit of close access to stakeholders. To progress the investigation of options, the assessment in this study should be validated in the context of updated information and discussion. In particular, the commercial structure of the preferred option(s) needs to be further developed so that it focuses on the role and function of the entity, the risk allocation between investors, intermediaries and borrowers, and the credit risk related to lending to the authority. These aspects are explored below.

- Role and function

Further assessment should be made of the services which offer benefit to local government as borrower. As discussed in Appendix A, the role of a collective vehicle is to service the needs of local government by procuring debt finance and conducting a credit risk assessment, but the functions could be more broadly defined to include an educative function and ad hoc financial advice related to borrowing. The value of these services, and a more precise understanding of need, could be further tested with councils.

- Risk allocation

There are several areas of risk allocation which should be further investigated. The most important is patronage risk, or the rate of usage of a collective vehicle by councils. A number of assertions have been made in this study which could be tested further with representatives from the sector, primarily their view of its value and the key factors in their assessment of the benefits of membership.

This could be achieved through a structured questionnaire and consultation process, which could be used to poll, for example, 100 councils of differing characteristics across Australia. This process could also be used to raise awareness of the concept, which may be low despite the precedent overseas including recent developments in New Zealand, the UK and France.

The key commercial factors likely to be identified include the willingness to participate as credit enhancers, through providing capital funding or a guarantee in respect of financial obligations. As noted in the evaluation in Appendix B, there is likely to be a process within councils of analysing the net benefit (or cost) of participating as a guarantor but receiving margin and transaction cost savings, as well as control of the entity through the membership.

- Credit risk

The key risk for investors will be the capacity of a national financing authority to honour its financial obligations. As discussed through this study, this risk can be mitigated by issuing financial instruments enhanced by protection against arrears or defaults on either individual loans or financial distress within individual members.

The implementation process would benefit from testing perceptions of the strength of the protection implied in the preferred option with potential investors such as wholesale funding market participants, primarily local and international banks and fund managers. Our preliminary engagement with market participants has indicated that an appropriately-structured national financing authority would be well-received and there would be appetite for bonds issued by it. However, it would be worth testing this further as the preferred model is developed, possibly through a structured questionnaire and interview process.

Alternatively, assuming there is a level of consensus about the preferred option and a broad - albeit indicative - level of interest within councils, a preliminary rating process could be used. For example, the New Zealand Local Government Funding Agency
engaged the ratings agencies to assign a “shadow” credit rating prior to going live, and this was an important step in building market presence and credibility.

Completing either process would add substantially to the level of confidence in the initial rate of patronage and the ‘steady state’ rate (noting that participation in the authority would increase as the organisation builds credibility over the medium-term and demonstrates the robustness of its credit fundamentals).

### Accounting considerations

The accounting treatment of participation by councils in a national financing authority will ultimately reflect the substance of the commercial arrangements attached to membership. Without knowing the precise nature of those commercial arrangements, it is too early to offer a view on the impacts for financial reporting by councils. However, some important considerations are addressed below.

- Each member council will be responsible for repaying its own debts, meaning these amounts are likely to be recognised as debt on their balance sheets in accordance with AASB 132. It is important to be clear that the authority is not a means of shifting recognition of debts from local government.

- The treatment of the mutual guarantee in the preferred option would depend, among other factors, on the likelihood of it being exercised. Depending on the terms of a general guarantee, it could be treated as a provision on balance sheet under AASB 137 or, where payment is considered remote it could be treated as a contingent liability requiring disclosure only. Guaranteeing the performance of a specified debt – as opposed to an authority’s obligations – could be a financial guarantee under AASB 139 and accounted for as a liability.

- The consolidation of a national financing authority is also important to consider from a balance sheet perspective. Again, depending on the final structure of the entity, it is possible that members could need to consolidate part of the authority. A key test in this respect is who has management powers for the authority and who benefits from the variable returns from operations. If there is no requirement for consolidation, then membership could be considered a joint venture under AASB 11 or equity accounted as an associate. A key test with respect to joint ventures is whether management powers and decision making are contractually shared.

- A national financing authority is likely to enter into hedges to manage the interest rate exposure. If hedge accounting is to be used, there are accounting requirements for documenting and monitoring of hedges, and it will be important to ensure member councils understand any risk exposures in this regard.

### Legal review

A legal review would complement the review of commercial parameters. The purpose of a legal review is to test assertions in this study in relation to:

- the extent of legislative change required in the states and territories - this would involve a review in each jurisdiction of the current framework and whether it explicitly allows or disallows the type of arrangements which member councils would need to form with a collective vehicle, including the associated legal risks.

- the powers required by a collective vehicle to deliver its purpose, and the implications for the corporate form of the entity
• the powers which councils would need to enter into the proposed entity and
  the associated legal risks
• laws and regulations to which a collective entity would need to comply to
  fulfil its stated purposes, and the implications for corporate form.

Aspects of this review would be expected to address interpretation of laws and
regulations and represent legal advice. Accordingly, the scope of the review could be
tailored to the level of definition of the commercial structure of a preferred option. A
critical part of this work is likely to be an analysis of the amendments to legislation
required to allow councils to establish and participate in a collective vehicle. There are
clear benefits in avoiding substantial amendments to the extent possible, because the
venture would be less likely to be delayed in political processes.

A legal review may also be useful for engaging the local government sector on the form
and content of the contractual instruments likely to be required by the preferred option.
This includes for example debentures over rates revenue or an undertaking to provide a
capped or uncapped guarantee to the entity in respect of its financial obligations.

3) Commitments, costs and resources

The costs of establishing the entity would be material and early consideration of funding
them would be prudent. Costs include management, operational and advisory personnel
and training, systems and equipment, and transaction costs. Precedent models suggest
these costs could be several million dollars.

There are several ways in which establishment costs could be funded, and these options
should be identified at an early point. A contribution across the tiers of government may,
for example, be part of the process of reaching consensus on a way forward.

The approach to funding establishment costs requires consideration because it could
impact on appetite and patronage. For example, to the extent that these costs are to be
recovered from members, there may be a perception that ‘early movers’ would pay a
disproportionately larger share, which could deter membership. Further, there may be a
case for creating incentives for membership by shifting or deferring the members’ share of
establishment costs.
Appendix A
A national financing authority in context

Local infrastructure

In Australia, all three tiers of government share responsibility for planning, delivering and maintaining public infrastructure.

Local government is responsible for a stock of assets most recently valued at over $300bn, which it is required to maintain to a minimum quantity and quality to fulfil its legislative mandate to local communities.¹

Council-provided infrastructure is the backbone of our communities and our regions. It provides access to welfare, education, transport, sport and recreation. It serves key environmental functions, such as waste collection and disposal, and enables services to be produced and consumed in the community by residents, workers and visitors.

Providing and maintaining this infrastructure is one of the most important responsibilities faced by Australian councils. It also presents one of their largest challenges.

Underinvestment in the right infrastructure results in constrained economic activity, reduced amenity for communities and declining social equity. But the costs of infrastructure are high and lumpy, and at a time when there are many competing demands on revenues, meeting these costs places significant pressure on council budgets.

Together, the Commonwealth, states, territories and councils have a duty to ensure this challenge is addressed and that essential infrastructure is delivered.

Strong Foundations for Sustainable Local Infrastructure

In June 2012, the Minister for Regional Australia, Regional Development & Local Government released Strong Foundations for Sustainable Local Infrastructure, a review undertaken by Ernst & Young that examines how local government plans, finances and delivers infrastructure investments.²

The 13 recommendations contained within the report are designed to provide a way forward for the local government sector to make the most of the tools and levers it already has, while at the same time to be open-minded to new ways of doing things. The focus is on ways in which councils can get more infrastructure from existing funding sources and the recommendations cover three broad areas:

- enabling councils to leverage existing funding sources for investment in new infrastructure
- improving councils’ access to cost effective finance
- improving councils’ ability to identify and develop infrastructure and gain access to specialist skills necessary to deliver innovative financing solutions.

The report was well-received throughout the sector and by key government stakeholders. Subsequent to the publication of the report, the Commonwealth has been active in assessing the merit and practicability of the recommendations. In doing so, it will require the cooperation of state and territory governments, local government peak bodies, councils and the private sector.

¹ Australian Bureau of Statistics, 5512.0
² Ernst & Young, Strong Foundations for Sustainable Local Infrastructure: Connecting communities, projects, finance and funds, June 2012
Borrowing for local infrastructure

Councils, like any project sponsor, must consider all the associated costs of delivering their infrastructure priorities. This includes the upfront capital spend and all ongoing expenses related to repair, maintenance, renewal and financing. All these future costs should be taken into account when deciding whether or not to commit to any project.

It is the capital for upfront expenditure, however, which generally presents the largest challenge. This is because infrastructure is by its nature capital-intensive and there is almost always the need to raise significant funds at the beginning of a project to pay for the construction and commissioning of the asset.

There are many competing demands on councils’ core revenue sources (primarily rates and grants). When core sources of funds are constrained in this way, access to cost-effective finance can be the difference between a project going ahead or not.

One of the central findings of Strong Foundations for Sustainable Local Infrastructure was that there is significant capacity within the local government sector to optimise its level of borrowing for the purpose of capital spend on infrastructure. Although there is a readily accessible pool of finance available to some in the sector, there is a demonstrable preference not to use debt as an appropriate method of paying for infrastructure. This in turn is having a negative impact on the infrastructure gap.

Provided that the ongoing costs of servicing debt are affordable, then the focus of project providers can be on the economic and social benefits of investing wisely in infrastructure.

Borrowing is a common feature of private sector capital structures and does not mean that a council is acquiring things it cannot afford. In the context of sound financial management and project planning, the key benefits of debt are that it can:

- enable councils to deliver new infrastructure when it is required and earlier than they otherwise would have been able
- enable councils to invest in the renewal and lifecycle costs of existing infrastructure, which are time-sensitive and if not delivered can increase the whole-of-life cost of an asset
- allow the smoothing of the payments for new investment over time
- allow the cost of infrastructure to be shared with future generations who will enjoy the benefit of the asset
- prevent the need to divert funds from internally-generated renewal and maintenance budgets to capital expenditure
- open the door to new sources of investment, for example from institutional finance providers, which bring additional rigour and discipline.

The consequences of the suboptimal utilisation of debt finance

Overlooking debt as a source of capital can prevent infrastructure investments from going ahead because councils often do not have adequate alternative sources of capital to fund projects with lumpy cost profiles. As a result, many councils prefer to wait until capital costs are funded (in large part by federal or state government grants), which can take years to secure.

The consequence of delay and non-investment is that the infrastructure gap (also known as the infrastructure deficit or backlog) gets bigger - or at the very least, it does not get smaller.

The infrastructure gap is essentially the difference between the required investment in infrastructure - on a forward looking basis - and the actual investment. It represents an
acknowledgement that every council in Australia has identified priorities for its community which it is unable to fulfil.

Numerous attempts have been made to monetise the gap at all levels: council, region, state and national. While each attempt to quantify the gap uses a different methodology and results in a different answer, there is no doubt that the gap does exist and that, on an aggregated basis, it is very large.

Assessing the infrastructure task

The following reports are just a selection of the many studies in recent years that have focussed on assessing the financial sustainability of the local government sector and the implications of a growing infrastructure gap.


South Australia: Financial Sustainability Review Board, *Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia*, 2005


Western Australia: Western Australian Local Government Association, *The Journey: sustainability into the future, shaping the future of local government in Western Australia (Systemic Sustainability Study)*, 2008

This study does not attempt to quantify the infrastructure gap. This would be a significant undertaking, not least because the quality and standardisation of data and financial reporting across the sector is variable.

Although a substantial amount of work is underway in most states and territories to improve the level of knowledge of infrastructure, many councils are starting from a low base and even those with more sophisticated systems and processes acknowledge material gaps in their understanding of the condition of their stock of infrastructure. By way of illustration, it is telling that the Australian Local Government Association (ALGA) has recently engaged consultants to run a pilot just to establish whether there is sufficient data and information to understand the state and condition of the class of asset - local roads - which is generally considered to be the best documented.3

Eliminating the infrastructure gap should not be the aim of a national financing authority - this will ultimately come down to the community’s willingness to pay to do so and will rely on considerable effort by all tiers of government to support capacity building initiatives. A collective borrowing agency alone will not fill the gap, but could provide councils with the machinery to make significant inroads into it.

Despite the uncertainty around the precise size and composition of the backlog, at a minimum there is enough evidence of its approximate size to justify action by government to assist councils to address it themselves.

Without such an intervention, there remains a significant risk that capital investment over coming years will continue to fall well short of what is needed to meet the infrastructure needs of Australian communities.

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The difference that cost-effective finance can make – case study

There is limited consistency in how state and territory governments facilitate local government borrowing programs. This means that the actual cost of local government debt finance varies significantly between states on structural rather than practical grounds.

New South Wales and Victorian councils, for example, predominantly borrow via commercial debt sourced from the banking sector, while Queensland councils predominantly borrow directly from the Queensland Treasury Corporation (QTC).

Consultations with some of the financially stronger New South Wales councils highlighted that while availability of bank debt had not been an issue, recent pricing had been a significant deterrent in assessing a number of infrastructure enhancement opportunities.

One example noted was based on upgrading a range of sporting facilities. The package of upgrades was forecast to generate additional council revenue in the medium-term, but the short-term debt costs were judged to be too high for council to accept the cash flow risks. It was noted that a reduction in debt costs of just 50 basis points would have provided the headroom for the upgrade to be implemented. The project did not qualify for interest payment assistance under the Local Infrastructure Renewal Scheme (LIRS).

Barriers to optimising the use of debt finance for infrastructure

*Strong Foundations for Sustainable Infrastructure* found that the flow of debt financing into the local government sector is constrained by:

- a lack of financial expertise and capability
- the costs of debt (finance costs and administrative obstacles)
- the absence of structured local government debt products suitable for institutional investors.

The consultation undertaken revealed that the reluctance to borrow is often informed by a perception that the community regards a low debt position as a reflection of sound fiscal management. It does not appear to be widely understood that, in fact, a low debt position means that current ratepayers are meeting the full cost of infrastructure assets, while in reality much of the benefit will actually be gained by future generations.

This is compounded by overly pessimistic views of financial risk and the probability of distress, which is not consistent with historical evidence of local government default.

Debt will always have associated costs and risks. These costs include not just interest payments but transaction costs and complicated processes and due diligence requirements. They are costs and risks however, that can be mitigated through responsible financial planning and through taking advantage of the availability of secure and competitively priced debt products. They are costs and risks which must be weighed up against the upside of being able to deliver or bring forward key infrastructure priorities which might not otherwise have been possible.

Decisions about whether to take out borrowing facilities will remain a question for individual councils based upon the relativity of the benefit of the project and the ability to meet the payments associated with it (see below). These decisions should be informed not by a cultural reluctance to borrow, but by a considered assessment of the costs and benefits of alternative financing solutions.

How indebted is local government and what is the optimal debt load?

Levels of indebtedness, regardless of the source of debt, are very uneven across the sector. As a general rule, however, Australian councils continue to adopt a cautious approach to borrowing for infrastructure. There remains a clear preference to use current year funding in the form of rates and grants receipts for this purpose, rather than utilise
debt finance to match the incidence of the costs to the benefits, and ensure that current ratepayers are not shouldering a disproportionate burden.

A number of local mayors write with pride in their annual reports that they have succeeded in reducing their levels of debt to zero. Queensland Treasury Corporation reports that 22 of 73 councils in the state have no outstanding debt at all. Indeed, many councils (a third of councils in South Australia, for example) have negative indebtedness – that is, their financial assets exceed their borrowings. The Tasmanian Auditor-General recently concluded that “in almost every case, councils’ financial assets exceed total liabilities indicating they are in strong positions to meet short-term commitments and there is a capacity to borrow should the need arise.”

It may be that these councils are successfully managing their infrastructure backlog and have no need for additional expenditure; however this seems unlikely in light of the findings of a multitude of independent reports in almost every jurisdiction indicating that capital expenditure on existing assets is significantly less than what is required. Indeed, consultations with state governments carried out during this study have suggested that there are numerous cases of councils that are maintaining zero debt policies while at the same time having low infrastructure renewal ratios.

### Indebtedness of Victorian councils

As part of the annual report on local governments in the state, the Victorian Auditor-General conducts an analysis of councils’ indebtedness. The analysis looks at non-current liabilities (mainly comprised of borrowings) as a percentage of own-sourced revenue (as opposed to financial gearing where debt is generally compared to net assets):

![Graph showing indebtedness of Victorian councils](image)

In 2011, the Auditor-General concluded that in relation to indebtedness, only 3% of councils are at high risk (defined as “potentially long-term concern over ability to repay debt levels from own-source revenue”), with 10% at medium risk (“some concern”) and 87% at low risk (“no concern”).

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The most recent ABS data (from 2010 – 11) shows that, nationally, debt represents only 2.8% of net assets at the local government level, and that interest payments represent 1.4% of total council revenue.\(^5\) This suggests that there is greater capacity to service borrowings.

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<table>
<thead>
<tr>
<th></th>
<th>NSW</th>
<th>NT</th>
<th>QLD</th>
<th>SA</th>
<th>TAS</th>
<th>VIC</th>
<th>WA</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gearing ratio (Bank debt/ net assets)</td>
<td>2.5%</td>
<td>0.6%</td>
<td>4.6%</td>
<td>3.8%</td>
<td>1.0%</td>
<td>1.1%</td>
<td>2.5%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Debt servicing ratio (Interest expense/ total revenue)</td>
<td>1.9%</td>
<td>0.2%</td>
<td>1.8%</td>
<td>1.6%</td>
<td>0.7%</td>
<td>0.6%</td>
<td>0.6%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

Optimising the use of debt is not to say that every council should be seeking to increase its borrowings and financial gearing. There is no right or wrong level of debt, and there is considerable debate about the definition of a sustainable level. Indeed, the Nationally Consistent Frameworks on local government financial sustainability, which were introduced in 2007 to provide a set of aspirational principles and best practice guidelines, recognised the limits of tightly-defined indicators which “individually and without associated explanations ... can only ever tell part of the story”.\(^6\)

In practice, however, ratio analysis is used in some Australian jurisdictions and overseas to regulate the amount councils are permitted to borrow. The Tasmanian Treasury, for example, in its Local Government Loan Council Allocation Process Discussion Paper (January 2005) has established as its benchmark a ratio of 40% for net-debt-to-revenue and 7% for the net-interest-cost-ratio. In Canada, the Municipal Finance Authority of British Columbia stipulates that all borrowings must be within each municipality’s individual borrowing power, which in practice means that 25% of sustainable revenue may be allocated to debt servicing costs (principal and interest).

A future national collective lending vehicle would – as discussed in this report – be able to apply similar restrictions on members, if it were deemed appropriate.

**Do councils have the capacity to borrow more?**

The noticeable improvement in asset management techniques in recent years is providing councils (both elected members and officers) with a better appreciation of whole-of-life

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\(^5\) Australian Bureau of Statistics, 5512.0

\(^6\) Local Government and Planning Ministers’ Council, Local Government Financial Sustainability - Nationally Consistent Frameworks, May 2007
costs associated with infrastructure. It has been observed that this is leading to a greater awareness of the implications of unduly low levels of debt upon councils’ ability to invest in their assets.

A recent practice note issued as part of the Commonwealth's Local Government Reform Fund (2012) stated that “many councils have very low levels of net financial liabilities (debt and other liabilities less financial assets) relative to their revenue levels and the level of infrastructure assets they manage. A soundly based long-term financial plan can highlight the affordability and impact of additional borrowings (e.g. to address warranted but otherwise unachievable asset renewal). A modest increase in borrowings to fund priority needs would typically add materially very little to most councils' total operating costs. While organisations should not borrow unless necessary to satisfy their objectives, they should also not be averse to borrowing where this is warranted, to provide cost effective and affordable, desired levels of service.”

Within the limits of any restrictions which may be placed on councils’ net borrowing, ultimately the capacity to raise debt will be a function of the capacity to fund debt servicing payments for the term of the loan, and to repay the principle once the term has expired. The availability of finance will always be a secondary consideration to the availability and application of funding.

While some local infrastructure investments (such as airports, car parks and water assets) have the potential to be self-financing, the majority of local infrastructure does not have a business model that supports the generation of revenue. Debt servicing must therefore be met out of councils’ core funding pools.

As the source of funds over which councils have the most control, there is a clear nexus between the rating effort and the ability/willingness to raise finance for infrastructure. In many cases, rates increases may be required if additional debt is to be sourced. In this context, we note the view recently expressed by the Independent Local Government Review Panel in New South Wales that “keeping rates artificially low and failing to borrow when appropriate can be just as irresponsible as over spending”.

There are a small number of cases where councillors have proved that appropriate community engagement can help win support for clear and robustly developed infrastructure plans which are (partially) financed by borrowings. The City of Onkaparinga, an outer metropolitan council in South Australia, for example, has made strategic use of borrowing through its Major Projects Fund, whereby council resolved to raise rates by 1% per annum above previously determined rates increases, and to quarantine the additional income for the repayment of a debt facility to finance an infrastructure works program. The size of the facility is determined by the amount of revenue earned through the rates levy.

The justification for increasing rates to fund debt servicing will ultimately be a subjective matter for councillors and the community based upon:

- the willingness of the community to accept financing costs through rates increases
- the trade-off between competing demands on council revenues, for both infrastructure and services
- where applicable, legislative restrictions such as rate pegging in New South Wales.

Aggregation and institutional investment

While debt finance in the form of conventional bank loans (or in some states and territories, treasury corporation loans) is readily available to councils in Australia, the local

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7 Institute of Public Works Engineering Australia, Long-term Financial Planning, Practice Note 6, January 2012
government sector has not been able to tap into or create an interface with the institutional investment market.

Most Australian councils (outside of South East Queensland) are relatively small entities and as such get less “attention” from capital markets than, say, state governments or large corporations. Furthermore, because they issue debt in a fragmented way and typically in relatively small quantities, the costs incurred are significantly greater than would be the case if there was the opportunity to come together.

The sector does not, for example, issue its own bonds. The minimum bond offer required to maximise the prospects of a liquid secondary market is generally considered to be around $100m. This is beyond the needs or capacity of the vast majority of Australian councils, and it is only through aggregation that a sufficient borrowing capacity can be achieved to justify going to market.

Aggregating the smaller borrowing needs of participating councils is key to creating a communal buying power and a larger unit with the required security to gain a strong credit rating, thus enabling councils to gain access to lower cost borrowings, while also introducing operational efficiencies and administrative synergies to drive costs down.

If the scale can be created, the evidence shows that there would be considerable appetite for local government bonds. Local government instruments would be seen as relatively low-risk investments, as councils enjoy steady and secure income streams in the form of rates and untied or general purpose government grants, which can be used to meet debt servicing obligations and to secure debt facilities. The establishment of robust liquidity buffers and credit enhancement arrangements – explored later in this study in relation to different models for a national financing authority – could further boost the standing of local government securities in the eyes of investors.

In current market conditions, and in light of the introduction of APRA regulations implementing the Basel III recommendations around the quality of assets held by authorised deposit-taking institutions (ADIs), there is likely to be a strong demand for low-risk government or quasi-government instruments, which a national financing authority would be able to satisfy.

The status quo is that the institutional investment market has the capability, but not the confidence or appetite for transaction costs, to invest; whereas councils have the pressing need for private funds, but not the means to access them. Aggregation can create the scale needed to incentivise institutional investors to spend on due diligence and ultimately make funds available which in turn can be on-lent to councils in the form of cost-efficient and stable debt products, hence enabling the sector to take advantage of its fundamentally sound attributes as a borrower. A collective vehicle is a tried and tested response to these circumstances to enable this relationship to form.

A national financing authority

Making inroads into the local infrastructure gap while simultaneously building financial sustainability will require a sustained effort on the part of all tiers of government.

Strong Foundations for Sustainable Local Infrastructure suggested that centralising the provision of finance at an aggregated level might result in the creation of a critical mass which could be utilised by the sector to develop financial instruments to channel institutional investment into local government infrastructure, lower finance costs, and address the reluctance to borrow.

The national financing authority as a concept would represent a targeted policy intervention designed to facilitate the introduction of private capital into the local government infrastructure sector, to lower financing and transaction costs for councils, and to complement Commonwealth and state/territory policy objectives around financial sustainability and capacity building.
A national financing authority – essential features and considerations

There are numerous forms that a national financing authority might take and similarly there are many common elements which could be expected in all forms. Before proceeding to propose and evaluate models, it is important to lay out some overarching principles, design features, or prerequisites which are inherent in accessing wholesale finance markets and must be present to enable the authority to fulfil its role.

It is anticipated that these features, which fall into the following categories, will be present in each option (with the exception of Option 8, which is a non-lending “pass-through” model).

1. Purpose
2. Ownership and governance
3. Membership and participation
4. Intergovernmental considerations
5. Functions
6. Profitability and operating costs

1. Purpose

The purpose of the authority would be to pool the borrowing needs of participating local government bodies and draw in investment by issuing financial instruments. Participating members contemplating investment in their infrastructure priorities would benefit from low-interest rates and favourable terms, and could access a range of low-cost and flexible financial services.

The authority would focus upon using the combined creditworthiness of participants (whether or not explicitly enhanced) to attract financing from institutional investors. Its purpose would be to channel that finance to participants; it is not intended to be a fund with a particular investment mandate (i.e. to ‘pick winners’), meaning investment decisions must remain with councils.

A key principle underpinning the entity’s purpose is that the risks of delivering specific infrastructure projects will remain with local government. As such, councils should be focussed on managing their levels of financial risk. The availability of new debt products should not dilute the responsibility or incentives for councils to mitigate these risks. Councils do this now through their internal management capability and robust treasury management processes and should continue to do so.

2. Ownership and governance

There are a number of different ownership models which might be implemented, and this is a key differential between some of the options assessed in Appendix B.

It is anticipated that the authority would be owned exclusively by government entities (federal, state/territory, local or a combination). This is largely consistent with precedent municipal financing agencies which exist overseas, although the relative stakeholding of different tiers varies considerably:

- Kommunalbanken Norway (KBN) is wholly owned by the Norwegian Government.
- Kommuninvest of Sweden is wholly owned by Swedish councils (as members of the Kommuninvest Cooperative Society).
- The New Zealand Local Government Funding Agency is 11% owned by the New Zealand Government and the remainder by participating councils.
The Finnish model, MuniFin, is owned 16% by the government, 53% by municipalities, and the remaining 31% shareholding is held by the local government pension fund.

In each case, the proprietary structure of the entity is a function of the unique status held by local government vis-à-vis other tiers of government. This is no different for Australia, and is especially important given the federal or “three tier” structure of government.

The national financing authority would need to comply with the legal obligations flowing on from the Corporations Act and related regulations. As an incorporated entity, there would be a board which would fulfil a crucial oversight function and demonstrate to the markets the competence and procedural rigour built into the authority’s structures and processes.

The governance structure will need to demonstrate a clear line of accountability to the participating local government entities. The board must be appropriately skilled, understand the owners and represent their interests. The board may also (depending on the final form) include representatives from the states and territories who have legislative responsibility for local government, and there may be some role for the Australian Government.

As a government related entity, the national financing authority would also need to meet the competitive neutrality requirements of the National Competition Policy principles, and relevant state legislation.

<table>
<thead>
<tr>
<th>Competition policy and competitive neutrality</th>
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<tbody>
<tr>
<td>The National Competition Policy (NCP) came into effect on 11 April 1995. It represents a commitment by all Australian governments to a consistent national approach to fostering greater competition in the Australian economy.</td>
</tr>
<tr>
<td>The NCP is underpinned by the Competition Principles Agreement (CPA), which outlines the commitments by the states and territories to introduce and apply competitive neutrality policy and principles to local governments and government agencies.</td>
</tr>
<tr>
<td>Government owned businesses may enjoy a net competitive advantage by virtue of their exemption from various forms of taxation, regulatory requirements and other costs faced by their private sector counterparts. Such differences can distort competition and undermine market efficiency.</td>
</tr>
<tr>
<td>The objective of competitive neutrality policy is to remove any net competitive advantage enjoyed by significant government business enterprises resulting from their public sector ownership.</td>
</tr>
<tr>
<td>The following key points outline how competitive neutrality might relate to NFA under CPA policy and principles:</td>
</tr>
<tr>
<td>• Policies of competitive neutrality will apply to significant Government Business Enterprises which are classified as Public Trading Enterprises or Public Financial Enterprises.</td>
</tr>
<tr>
<td>• Where appropriate, a corporatisation model should be adopted for Government Business Enterprises.</td>
</tr>
<tr>
<td>• Competitive neutrality should apply wherever a government owned business is, or has the potential to be, in head to head competition with private firms (e.g. banks).</td>
</tr>
<tr>
<td>• Governments have agreed to apply debt guarantee fees to offset the competitive advantage provided by government guarantees.</td>
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</table>

The Local Government Finance Authority of South Australia, for example, pays a fee in return for the state government guarantee, equivalent of approximately 20 basis points of its base average liabilities. It also makes payments equivalent to company income tax. The liability is calculated on an accounting profits basis and the amounts are paid into an account established with the State Treasurer which are then made available for local
government development purposes as recommended by the Local Government Association of South Australia and agreed to by the Minister for Local Government.

In issuing financial products and instruments, the national financing authority would be required to comply with the regulatory requirements of the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulatory Authority (APRA) and potentially the Reserve Bank of Australia (RBA).

Depending on the corporate form and relationship with participating councils, the reporting obligations in state and territory local government acts may also be relevant. Member councils might be required to report their relationship with the entity in their annual financial statements, including:

- investments
- borrowings
- interest expenses
- contingent liabilities.

Transparency of reporting and compliance with law and regulation will be an essential component of establishing confidence in the entity.

3. Membership and participation

To receive any services from the national financing authority, a council would need to become a member. Membership would not represent an obligation to use the authority exclusively, and members would retain the right to source services - and finance - from other entities including banks (subject to any restrictions imposed by state or territory legislation).

Membership should be voluntary. Any council could choose to apply to be a member, and equally, could choose to leave the authority. Ultimately, individual councils need to make their own evaluation of the overall benefits of membership.

There are likely to be criteria that would need to be met prior to joining the national financing authority, such as being an incorporated local government entity and not being subject to insolvency-related legal proceedings. Membership may also be extended to include, for example, wholly owned subsidiaries of local government entities, or other public sector bodies, although for the purpose of this study we have assumed that it will be limited to councils. It is anticipated that there would probably be a role for state and territory governments in developing and reviewing any such criteria, in recognition of the need to retain their oversight of local government within each jurisdiction.

Additional criteria relating to the financial health of an entity might be considered. In Sweden, for example, the existing members of Kommuninvest have the power to set criteria for joining the agency, which are designed to ensure that every new member has an acceptable creditworthiness. The creditworthiness of members is surveyed every year with the possibility to expel members if the criteria are no longer met.

Membership criteria of this type may be appropriate for models where the creditworthiness of the authority is likely to be affected by the composition of its membership, such as if security over liabilities is to be provided by all members including those that are in a financial position that is weaker than others.

Regardless of any membership parameters, it is anticipated that participating councils will be required to meet certain criteria and covenants prior to receiving approval to borrow from the national financing authority. The purpose of lending criteria is to provide ratings agencies and investors confidence in the authority’s creditworthiness and to provide comfort to other members. In the South Australian model, for example, all councils in the state automatically became members of the Local Government Finance Authority when it
was established, however each borrowing application is assessed individually based upon defined criteria and can be refused.

As membership of the national financing authority would be voluntary, the number of participating entities would be expected to fluctuate over time as individual councils consider their own case for membership. The stability of the organisation will be a function of the level of “skin in the game” taken on by members, and the incentives provided to continue participation.

Precedent authorities overseas have been founded by an initial group of members and expanded over time. The New Zealand Local Government Funding Agency was initially supported by nine councils and now has 30 members (out of a total of 78). Kommuninvest in Sweden started life with ten participating municipalities in 1986; there are now 272 municipalities and county councils, with more joining each year.

Figure 1: Kommuninvest – number of members and total lending 2002 – 2011 (Annual Report 2011)

The level of participation in the national financing authority is important because its ability to achieve its objectives - and its capacity to generate benefits - will depend upon achieving a critical mass to provide an attractive proposition for inward investors. For example, in the assessment of a collective entity, credit rating agencies look at the proportion of the agency’s loan book exposed to a single borrower - the broader the council participation, the lower the concentration risk.

The size (in revenue terms), as well as the number, of members will be an important factor in building the authority’s creditworthiness. The optimal size - or the ‘tipping’ point at which membership is sufficient - is that which drives strong competition for the entity’s securities and moves pricing to a point comparable with similar and equivalently-rated products. While it is hard to say precisely how many councils would be required to achieve this critical mass for an Australian national financing authority, it is likely that the authority would need the support of, at the minimum, a small number of large municipalities or a large number of medium sized ones.

This is not to say that all (or even most) Australian councils would need to join the national financing authority for it to succeed in providing competitively priced debt to its members. In Sweden, for example, the three largest municipalities (Stockholm, Gothenburg and Malmo) are not members, but Kommuninvest has still been able to function extremely well for a number of years.

Inasmuch as the ability of the authority to develop marketable investment products will be a function of the borrowing needs of its members, it is important that councils not only join the authority, but also use its services.
Again, this does not mean that participating councils will need to source all of their debt from the authority (lending by Kommuninvest only represents 65% of its members’ total borrowings, for example). The genesis of the entity, however, would be greatly facilitated with some degree of commitment by members. In New Zealand, for example, of the nine original sponsoring councils, eight committed to sourcing 80% of their financing needs through the Local Government Funding Agency, with the residual sourcing 30% for three years. There is evidence to show that this commitment was taken into account by the ratings agencies in allocating a preliminary domestic currency credit rating of AA+.

“Moral hazard”

Moral hazard refers to situations where there are incentives for individuals or entities to change behaviour when they perceive the consequences of taking risks will be borne by others.

If a collective vehicle were established to facilitate access to debt, and any council could become a member, this may invite risk-taking behaviour by less creditworthy councils who perceive they can transfer the consequences of unaffordable borrowing to the providers of credit enhancement for a collective vehicle.

We contend that the risks of creating moral hazard should not be over-stated. In all the models proposed in this study, councils - and their rate payers - occupy the ‘first loss’ position. Individual councils remain liable for repaying their borrowings until the point of bankruptcy. The incidence of this level of financial distress or bankruptcy within a local government is very rare. This raises two important points:

• The revenue-raising powers of local government, even in the context of regulations imposed by state and territory governments, provide an effective means of restoring weak financial performance and for this reason local councils would be very unlikely to default on obligations.

• The reputational damage which would accompany a default is unpalatable and could be expected to drive behaviour within a council facing such circumstances. Ironically, it is the ferocious desire to demonstrate sound financial management and eliminate financial risk which has driven the sector’s debt aversion, and this point is addressed elsewhere in this report.

It is also important to recognise the critical role of borrowing criteria. A core function of the national financing authority would be to apply criteria to ensure prudent lending, and this function includes assessing the capacity to repay debt amounts sought from it. Those councils that cannot currently access the amount of finance sought (or any at all) from either the private market or public sector lenders as a result of an unacceptable default risk would not be treated any differently by the collective vehicle proposed. This approach is consistent with moving the sector to a long-term sustainable financial position.

4. Intergovernmental considerations

Although municipal financing agencies in other countries provide important lessons and precedents, an Australian authority would need to be consistent with Australia’s unique structure of government and sensitive to the concerns and needs of multiple stakeholders. These stakeholders will rightly need to be persuaded of the need to intervene, understand the benefits and the risks, including implementation considerations, outturn set up costs and longer-term impacts.

It is widely acknowledged that Australian councils do have access to debt finance, either in the form of bank debt or products provided by state or territory governments, and hence there is no demonstrable failure of the market to provide finance. However, there is arguably an information asymmetry between councils as borrowers and the providers of finance that arises because councils often do not have the background and skill to make informed judgements about the risk of borrowing. As discussed earlier, the evidence of debt avoidance supports the view that councils make an overly pessimistic assessment of
the risks of using debt, despite possessing what lenders clearly consider to be sound credit fundamentals.

Ultimately the motives for supporting the objectives of a collective entity are consistent with the policy intent of the Commonwealth and jurisdictions to promote a self-sustaining local government sector that is capable of leveraging its “own-source” revenues to deliver the community’s infrastructure requirements, while reducing its reliance on other tiers of government.

A national financing authority could create the conditions to help councils invest their own revenues in much-needed infrastructure projects and accelerate their journey toward financial sustainability. It would give further momentum to initiatives to promote capacity building, financial self-sufficiency and consistency of standards in local government. These initiatives reflect the objectives of the Commonwealth and all jurisdictions to help the sector grow and prosper.

The national financing authority envisaged in this study would not in any way diminish the quality of governance in the sector nor the level of oversight of state and territory governments. On the contrary, the authority should further strengthen the quality of financial control in the sector while retaining the ultimate regulatory control of state and territory governments. As observed in Appendix B, some models could lead to a higher level of scrutiny of local government borrowing requests than currently occurs.

5. Functions
Consistent with its purpose, the national financing authority would have four primary functions: lending to local government, fund raising, supporting liquidity and credit quality, and providing advisory services.

(i) Lending to local government

The national financing authority would provide targeted debt products to its members at cost-effective interest rates and with flexible terms. It would aim to become the “natural choice” for it members when it comes to borrowing. Once fully established, the authority will be able to lend to it members “on demand”.

The authority would deliver low borrowing costs for its members, which would be set at a level sufficient only to fund the repayment of securities, cover the costs of the authority (including issuing costs) and accrue a prudent reserve. By way of illustration, the New Zealand Local Government Funding Agency has a maximum permitted margin of 0.40%, and in the first six months of its operation, charged a “base” on-lending margin to councils that averaged 0.30%.

The same low costs would be available to all members. This would mean that small councils wanting to borrow smaller amounts would be able to access the same interest rates as large councils with larger requirements. In this context, smaller councils may have a greater incentive to participate, and the participation of larger councils will depend upon the ability of the authority to provide debt products at interest rates which are lower than comparable products currently available to them.

Once established, the authority might be able to issue long-term loan tenors. Experience in Scandinavia and New Zealand shows, however, that in the early years of operation the authority may have a narrower capacity, as it builds its presence in the bond markets. During this period it may be more prudent to issue a series of benchmark bond issuances and ask participating councils to borrow on related terms.

The authority would develop a suite of policies to govern access to lending and provide a framework for a loan request acceptance process. This would incorporate components of the credit approval processes used by commercial banks and other
public sector financing agencies. It would include, for example, definitions of qualifying purposes, requirements on acceptable ranges for financial metrics, and criteria for the satisfaction on borrowers’ internal corporate risk management policies and governance.

Although the authority would not involve itself directly in councils’ internal budgetary and planning processes, the provision of finance will be conditional upon evidence of long-term forecasts and of the capacity to service and repay the debt. A core function of the authority is undertaking these assessments.

Participating councils would be required to provide the authority with details of their financial standing, including but not limited to their audited financial statements, and to inform the authority of any material changes arising during the financial year. The authority’s credit committee would be charged with reviewing this information and approving all loans.

### Loan approval – the Queensland experience

In order to borrow funds from the Queensland Treasury Corporation (QTC), councils must provide:

- a completed borrowings application checklist signed by the Mayor and Chief Executive Officer - in signing the checklist, the Mayor and CEO acknowledge that they are satisfied and have verified that the financial projections contained within the forecast model are the realistic intention of council and that all loan funds will be applied to lawful, capital purposes and that a native title risk assessment has been conducted on any relevant land
- copy of the adopted Debt Policy for the financial year in which borrowings are sought
- completed QTC financial forecast model that contains proposed borrowings amounts and associated repayments (in MS Excel) and supplied on disc
- schedule of capital works projects
- copy of any other information deemed relevant to the application

It is anticipated that these processes and application requirements will be rigorous and fit for purpose, but while stringent could become standard form and consistent over time. Councils would benefit from this standardised approach and would not face the costs of engaging with commercial banks and responding to their individual - and often different - credit processes.

### (ii) Fund raising

In theory, it would be possible (subject to legislative and regulatory approvals) for councils to raise funds through bonds individually (or in groups). However, while some of the largest councils in Australia may find it cost effective to raise their own bonds, very few councils are likely to want to or be able to borrow the amounts that make such bond issues economic. With the exception of PPP bond financing, we are not aware of any councils who have done so in the past.

Fund raising is the area of activity where the national financing authority can demonstrate the benefits of aggregation, and can achieve more than councils would be able to achieve by themselves.

The function of the authority would be to raise funds on behalf of councils. It would bundle smaller debt requirements into larger bond issuances, pooling the needs of the sector and creating a consolidated creditworthiness that would be stronger than the creditworthiness of its component parts. It would build a presence in the bond market and be authorised through its corporate constitution, in accordance with laws and regulations, to issue debt securities into the capital markets. Over time, as the authority develops its range of products builds its presence in the
market, it may be able to support new forms of fund raising such as Tax Increment Financing.

Funds raised would be held by the entity for the purpose of lending operations, maintaining liquidity through reserves or other treasury instruments, and operating expenses. It is anticipated that the authority would aim to minimise the amount of capital it holds before on-lending, to avoid retaining significant unneeded funds, but this will ultimately depend on the commercial arrangements for the preferred model. This will require liaison between participating councils to plan ahead for borrowing needs and enable borrowing requirements to be matched with fund raising activities.

Given that the bond market in Australia has historically been relatively limited, it is anticipated that the national financing authority would create a new class of highly rated bonds targeted at banks, insurance companies and super funds. In doing so, it would contribute to the development of a deeper and more liquid capital market for local infrastructure investments, and create the much-needed avenues for institutional financiers to invest in council projects.

Fund raising – the New Zealand experience

The New Zealand Local Government Funding Agency provides a recent example of a collective local government vehicle delivering on its core function of procuring finance for its members.

In its first ten months of operation, the agency has gone to the market on eight separate occasions, offering securities with maturities ranging from April 2015 to March 2019.

In total, the volume offered has been NZ$1,460m. The total bid volume was NZ$6,247, meaning that issuances had an average cover ratio of 4.3 times.

The credit quality of Local Government Funding Agency bonds has emerged much more quickly than was expected.

The Local Government Funding Agency aims to reduce its margin over New Zealand Government bonds (NZGBs) to 50 basis points. As the graph below shows, progress in meeting this target has been extremely strong – from a margin over NZGBs of 113 basis points at the inaugural tender, the 2015 issue has narrowed to around 56 over NZGBs (as at 5 December 2012).

The graph below shows that while the LGFA bonds do not provide as good value as national government bonds (NZGBs), they consistently track at a premium to those issued by a single council, even the largest council in the country, Auckland.
Achieving good results in the market enables the agency to pass on competitive prices to member councils. After the sixth tender in August 2012, the Chief Executive, Philip Combe, estimated that “AA rated councils are now saving approximately 30 basis points and unrated councils approximately 40 basis points in interest cost by borrowing from the Local Government Funding Agency”.

The effectiveness of fund raising activities will be a function of the supply and demand market dynamics driven by factors such as credit quality, term, pricing and market activity. Consequently, it is critical that the preferred model is a sound commercial proposition for the target pool of investors.

To achieve the best result in fund raising activities, the national financing authority must aim to achieve the strongest possible credit rating. A strong rating is essential to achieve the confidence of investors to empower the authority to issue instruments with attractive terms and enable the benefits to be passed on to participating councils.

Achieving a strong credit rating – the New Zealand experience

In September and December 2011, Standard & Poor’s and Fitch both assigned the New Zealand Local Government Funding Agency a preliminary domestic currency rating of AA+ and the outlook on these ratings is stable.

This rating is the same as the New Zealand Government, and the Local Government Funding Agency is the only entity in New Zealand other than the government to achieve such a strong rating.

According to Standard & Poor’s, the strong rating was assigned because of the authority’s strengths:

- "extremely high" likelihood of extraordinary support from the government
- single-purpose focus in lending to New Zealand's local government sector
- sound aggregate credit quality
- good liquidity position.

Standard & Poor's stated that “the ratings on New Zealand's Local Government Funding Agency (LGFA) reflect our view of the entity's "extremely high" likelihood of extraordinary support from the New Zealand Government, arising from the LGFA's "integral" links to the New Zealand Government, combined with its "very important" role under our government related entity (GRE) criteria. The ratings on LGFA also reflect the organisation's strong stand-alone credit profile, arising from its sole role of providing debt finance to the New Zealand local and regional government (LRG) sector, the sound aggregate credit quality of that sector, and LGFA's prudent liquidity policies. These strengths are moderated by the
organisation's wholesale funding profile and our expectation that risk-weighted capitalisation will progressively decline from initially strong levels as lending increases against a backdrop of a small capital base.¹

The rating that is likely to be assigned will be a function primarily of the authority's "stand alone" credit quality, the likelihood of government intervention, and the credit rating of the supporting government (refer to Appendix E for more detail on this process).

(iii) Supporting liquidity and credit quality

As far as we are aware, no collective local government agency in the world has ever defaulted, nor has any participating council in respect of borrowing from such an agency.

Indeed, in its assessment of options for the New Zealand authority, the New Zealand Treasury noted that even if a council were to default, it would most likely be because of a temporary lack of liquidity rather than insolvency. This is because of their strong powers to levy rates and enforce these if necessary with charges over property.⁹

Adequate liquidity arrangements would nonetheless be required to satisfy the concerns of investors around the ability of the authority to meet its liabilities in the short-term. For example, the authority would need to retain cash amounts appropriate to the amount of its assets held at any time and the risks of the loans that are funded.

<table>
<thead>
<tr>
<th>Liquidity arrangements - examples from South Australia and beyond</th>
</tr>
</thead>
<tbody>
<tr>
<td>• South Australia: In order to cover seasonal shortfalls in funding the Local Government Finance Authority has access to short term borrowing arrangements with the South Australian Government Financing Authority (SAFA).</td>
</tr>
<tr>
<td>• New Zealand: The New Zealand Debt Management Office (DMO) has provided an initial NZ$500m liquidity facility to the local government funding agency. This is anticipated to grow to NZ$1bn in FY15.</td>
</tr>
<tr>
<td>• Canada: The Act establishing the Municipal Finance Authority of British Columbia requires the establishment of a Debt Reserve Fund. The fund accumulates through the withholding of 1% of the principal borrowed on each loan request, which is repaid once the obligation has been repaid by the municipality.</td>
</tr>
<tr>
<td>• Sweden: Kommuninvest maintains a liquidity reserve of between 20-40% of the lending and 50 percent of outstanding lending bids. As an approved monetary policy counterparty to the Swedish Riksbank, Kommuninvest is granted access to the Riksbank's short-term credit facilities.</td>
</tr>
</tbody>
</table>

It is anticipated that the national financing authority's liabilities will in the first instance be secured by debentures, providing a charge over council general revenues. As such, the credit quality of securities is likely to be extremely strong.

While the national financing authority would gain significant financial strength from its strong asset base (loans to local government secured by debentures), evidence from overseas shows that some form of additional credit enhancement is likely to greatly enhance the likelihood of being assigned the best possible credit rating.

Explicit support from higher tiers of government, in the form of risk capital and/or guarantees, are one form of credit enhancement enjoyed by some of the collective vehicles overseas. This credit enhancement makes a profound difference to the ratings agencies and the views of investors.

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¹ New Zealand Treasury, *Regulatory Impact Statement: enhancing local government borrowing options*
As discussed in the evaluation of different options, in the absence of explicit support from the federal or state and territory governments, a mutual or joint and several guarantee provided by members over each other’s liabilities would provide an important alternative enhancement. Importantly in Australia, it could also serve as a “buffer” between the authority and other governments when it comes to securing liabilities.

As precedents in New Zealand, Sweden, Finland, Denmark and elsewhere have demonstrated, a form of joint and several guarantee by members as a first line of recourse can be sufficient in the absence of explicit government guarantees to secure a highly favourable credit rating and achieve good pricing in the market.

Without any form of mutual or government guarantee, individual guarantees from each participating council covering only their own borrowing from the authority would have the disadvantage of focussing the rating agencies and the financial markets on “the weakest link of the chain”.

(iv) Advisory services

Building financial expertise has variously been identified as a priority for local government, where the primary focus is on providing appropriate services to the public, not dealing with the financial markets. Financial markets are complex and dynamic, and they require deep expertise which is generally not present in the local government sector. The lack of expertise is one of the factors contributing to the reluctance of councils to deal with banks and confidently advocate for sustainable debt loads.

The national financing authority could play an important role in addressing the information gap through advice on the processes for accessing financial products. It could become a hub for the transfer of knowledge to councils in the areas of financing, legal matters and general administrative questions. More broadly, the authority has the potential to be a provider of ad hoc advice as part of councils’ internal due diligence on their capital structure. It is anticipated that the national financing authority would offer advisory services on a cost recovery or in-built overhead basis.

In doing so, it would become a counterweight - without vested interest - to voices driving the observed debt aversion.

There are some good examples of this in practice, such as the Local Government Finance Authority of South Australia which is resourced with experienced finance professionals and devotes significant effort to educating the authority’s members around how debt can be used as a resource, rather than a burden. It is anticipated that this message would be communicated nationwide by the national financing authority.

Resourcing the national financing authority with market experts and independent experienced individuals will be necessary not only to service participating councils but to give the market confidence in the entity and ultimately expand the range of willing investors.

Importantly, this advisory role must not replace the responsibility held by every council to prioritise and select infrastructure projects and appropriate procurement models in house.

It is anticipated that the focus of the advisory services provided by the national financing authority would be upon credit assessments, debt management and financial products.

As recommended in *Strong Foundations for Sustainable Local Infrastructure*, there is also a pressing need for an advisory body and guidelines for local government in
respect of procurement models, prioritisation processes and asset management. While the national financing authority may in the future take on these functions too, we suggest that this must not be at the expense of its core role as an advisor on matters related to raising finance in the most efficient way possible.

6. Profitability and operating costs

The national financing authority would be created for the benefit of the community. Its role would be to minimise finance costs for the local government sector and not to make accounting profits. It could be designated as a not for profit entity.

It is anticipated that a portion of any future surplus would be retained in the organisation to build its capital base and subsidise auxiliary services (such as advisory services). Depending on the model, any additional surplus could be returned to shareholders.

The Local Government Finance Authority of South Australia provides a useful precedent. It allocates surplus funds to members in the form of a bonus payment. Since its introduction in 1985, $28m has been distributed, with a further $1.74m to be paid in respect of the year ended 30 June 2012. The bonus payment is apportioned based upon average deposit and loan levels held with the authority during the course of the financial year.

In the absence of the motive of profit, the national financing authority must still be incentivised to keep its cost base as low as possible in order to pass on the largest possible savings to its members. Pooled financing should lead to processing and issuing costs that are considerably lower than if the individual councils were to borrow from the capital markets on their own.

Other operating costs should be kept to a minimum. To this end, they could be benchmarked against comparable entities and performance indicators could be incorporated into annual reporting and management remuneration.

Although long-established, Kommuninvest in Sweden provides an example of how a low cost base can be created and maintained- operating costs are expected to amount to at most 0.08% of the lending volume by 2015.

---

Operating costs and profitability - the New Zealand experience

One of the key objectives of the Local Government Funding Agency is maintaining operational efficiency.

In its first annual report, the agency reports that overheads were contained to NZ$1.4m in the first seven months of operation. This represents annualised overheads of NZ$2.4m, which is well within the performance target of NZ$3m set out in Statement of Intent 2011/12.

Start-up costs were able to be kept to a minimum via an outsourcing agreement with the New Zealand Debt Management Office.

At the end of 2011/12 financial year end the agency had a staff of four.

In its first seven months of operation, the agency recorded a loss of NZ$4.2m. Excluding pre-establishment expenses (NZ$3.8m), its operating loss was NZ$400,000.

The entity should have the capacity to provide a physical presence in each jurisdiction in which members are located. It may, for example, have a head office and branch structure. An on-the-ground presence is considered essential for adequately servicing members, particularly delivering the credit assessment and advisory roles.

The entity would employ suitably skilled and experienced personnel. In doing so, there may be opportunities for other bodies to provide support (at least initially) to the authority. Appropriate providers of support might be state governments, treasury corporations including the Australian Office of Financial Management (AOFM), and other public sector financing agencies such as the Export Finance & Insurance Corporation. In New Zealand,
The bulk of the Local Government Funding Agency's operational activities are outsourced to the New Zealand Debt Management Office (DMO), which is responsible for central government funding. As well as expertise in capital markets and liquidity management, the DMO execute the Local Government Funding Agency's funding and investing functions.
Appendix B
Options and evaluation

Options

11 options for a potential national financing authority for local government in Australia are evaluated in this section.

10 of the 11 options meet all the “core” functional requirements set out above with respect to fund raising and lending to councils. They are distinct by virtue of different permutations of factors of ownership, the providers of any credit enhancement and the nature of any credit enhancement.

The final model (Option 8) is a “pass-through model”, and as such does not meet all the “core” prerequisites previously identified. This option would involve the establishment of a vehicle to act as a financial intermediary or arranger of debt for participating councils requiring finance for specific projects or programs. It would react in response to demand and not have a regular presence in the bond market.

<table>
<thead>
<tr>
<th>Explicit credit support by the Commonwealth or states/territories for capital raising</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<tr>
<td>2</td>
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<tr>
<td>3</td>
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<tr>
<td>4</td>
</tr>
<tr>
<td>5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No explicit credit support by the Commonwealth or states/territories for capital raising</th>
</tr>
</thead>
<tbody>
<tr>
<td>6a</td>
</tr>
<tr>
<td>6b</td>
</tr>
<tr>
<td>6c</td>
</tr>
<tr>
<td>7a</td>
</tr>
<tr>
<td>7b</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>“Pass-through” model</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
</tr>
</tbody>
</table>

The options are described in more detail in the evaluation section below, and - where relevant - appropriate precedents are referenced. The descriptions below are relatively high level, the main intention being to outline the differentiating factors between the options for the purpose of the application of the evaluation criteria.
<table>
<thead>
<tr>
<th>Comparison of options</th>
<th>Establishment/ ownership</th>
<th>Guarantee</th>
<th>Capital contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CW</td>
<td>S/T</td>
<td>LG</td>
</tr>
<tr>
<td>Explicit credit support by the Commonwealth or states/territories for capital raising</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Prescribed Commonwealth agency, with a Commonwealth guarantee over the agency’s obligations</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Entity established by the states and territories, with a guarantee provided by the states and territories over the agency’s obligations</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>3</td>
<td>Entity established by a group of councils, with a Commonwealth guarantee over the agency’s obligations</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>4</td>
<td>Entity established by a group of councils, with a guarantee provided by the states and territories over the agency’s obligations</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>5</td>
<td>Entity established by a group of councils with a capital contribution from the Commonwealth and/or states/territories as a collateral against default</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>No explicit credit support by the Commonwealth or states/territories for capital raising</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6a</td>
<td>Entity established by a group of councils with a capital contribution from participating councils as a collateral against default</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6b</td>
<td>Entity established by a group of councils with a capital contribution from participating councils and an uncapped mutual obligation to support repayment of debt</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>6c</td>
<td>Entity established by a group of councils with a capital contribution from participating councils and a capped mutual obligation to support repayment of debt</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>7a</td>
<td>Entity established by a group of councils without any capital contribution but an uncapped mutual obligation to support repayment of all debt</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>7b</td>
<td>Entity established by a group of councils without any capital contribution but a capped mutual obligation to support repayment of all debt</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>“Pass-through” model</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Entity established by the Commonwealth and/or states/territories as a financial intermediary to collect demand for specific-purpose borrowing and issue securities to match exactly these needs</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

Department of Regional Australia, Local Government, Arts & Sport
National financing authority for local government

Ernst & Young | 44
Evaluation criteria

While many of the concepts and practical administration considerations are common across all the identified options, there are important structural and ultimately commercial differences. The role of the evaluation criteria is to provide a basis for differentiating between the options.

The following evaluation criteria are used in the evaluation of options for a national financing authority. The criteria address the key success factors around purpose and function, impacts on other governments, market credibility and participation rates.

<table>
<thead>
<tr>
<th>Purpose and function</th>
</tr>
</thead>
<tbody>
<tr>
<td>i  Capable of reducing the costs of debt finance.</td>
</tr>
<tr>
<td>ii Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt</td>
</tr>
<tr>
<td>and the transition to long-run sustainable financial management in the local government sector.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Impacts on other governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>iii Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</td>
</tr>
<tr>
<td>iv  Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</td>
</tr>
<tr>
<td>v   Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Market credibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>vi  Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Participation rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>vii Capable of achieving a broad base of participation across the local government sector.</td>
</tr>
</tbody>
</table>
The evaluation criteria play an important role and it is critical that they are appropriate. The criteria identified are considered appropriate because they:

- are closely aligned with the purpose and objectives of a national financing authority as set out in Chapter 1 and Appendix A
- recognise the concept could significantly change the relationships between the local, state and territory, and federal tiers of government
- recognise the complex challenges inherent in implementing new financing arrangements.

The criteria have been drafted on the basis that this study aims to identify the model which is best for local government, while acknowledging that maintaining and increasing the stock of local government infrastructure is the underlying problem. Consequently, the criteria may not represent the specific priorities of the Commonwealth or state and territory governments or any other stakeholder group, nor are they intended to represent the views of the local government sector.

In the next stage of planning for a national financing authority, it is recommended that the criteria are further tested with key stakeholders.

**Scoring mechanism**

The table below contains a scale for rating each model against the evaluation criteria. As noted above, the options are evaluated on the extent to which they could satisfy each criterion.

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Does not satisfy the criterion</td>
</tr>
<tr>
<td>1</td>
<td>Likely to achieve outcomes which satisfy the criterion to a minimal extent</td>
</tr>
<tr>
<td>2</td>
<td>Likely to achieve outcomes which satisfy the criterion to a limited extent</td>
</tr>
<tr>
<td>3</td>
<td>Likely to achieve outcomes which satisfy the criterion to a large extent</td>
</tr>
</tbody>
</table>

**Options evaluation**

Appendix A articulates some of the features and considerations that are considered to be core prerequisites to enable the national financing authority to serve its purpose. The features outlined in Appendix A would apply to each option except for Option 8.

The evaluation set out below uses the criteria identified above to indicate the extent to which the specific features and processes of each option would encourage uptake, bring in investment, interact with the Commonwealth and states/territory governments, and be legally feasible.
Option 1

| 1 | Prescribed Commonwealth agency, with a Commonwealth guarantee over the agency’s obligations |

### Description

This option would involve the establishment by the Commonwealth of a collective financing vehicle for local government with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Commonwealth agency**
  
The authority would be established by the Australian Government as a prescribed statutory corporation under legislation. The authority would operate at arms-length to government to ensure independence and commerciality.

  Under this model, it is anticipated that the Commonwealth would provide seed funding to meet the costs associated with establishing the authority. The funding could be time-limited and cease once the authority is in a position to cover its own costs.

- **Commonwealth credit enhancement**
  
The authority's obligations to third parties would be guaranteed by the Commonwealth. Under the legislation establishing the entity, the Commonwealth would guarantee the due payment of any money that becomes payable by the authority to a counterparty.

  Under this model, the Commonwealth may also provide credit enhancement in the form of liquidity capital, through - for example - a liquidity reserve fund or by providing access to central government short-term credit facilities.

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**KBN Kommunalbanken (Norway)**

KBN Kommunalbanken (KBN) was established by an Act of Parliament in 1926 as a state administrative body with the purpose of providing low-cost finance to the Norwegian local government sector. It is wholly owned by the Royal Ministry of Local Government and Regional Development on behalf of the Kingdom of Norway.

The agency benefits from a maintenance obligation from the central government, which underlines its owner's commitment to KBN as a government agency and the importance it places on KBN as Norway's main provider of low-cost finance to the local government sector.
Export Finance and Insurance Corporation (Australia)

The Export Finance and Insurance Corporation (EFIC) was established in 1991 under the Export Finance and Insurance Corporation Act 1991 (Cth) as a statutory corporation wholly owned by the Commonwealth of Australia.

EFIC’s role is to facilitate the inward flow of investment for the purpose of facilitating the export trade of Australian goods and services. It does this by mitigating private sector risk by acting as guarantor over financing arrangements between third party lenders and exporters, or by direct lending where a bank is unwilling to do so. EFIC is one of only two entities that are explicitly guaranteed by the Commonwealth of Australia, the other being the Reserve Bank of Australia.

Green Investment Bank (UK)

The Green Investment Bank was established in 2012 to accelerate private sector investment in green infrastructure assets. It will work to a “double bottom line” of i) achieving significant green impact and ii) making financial returns, and will operate independently and at arm’s length from government. It will receive initial capitalisation of GBP 3bn by the government until 2015, at which point the agency’s borrowing powers will become effective.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose and function</td>
<td>Capable of reducing the costs of debt finance.</td>
<td>3</td>
</tr>
<tr>
<td>i</td>
<td>Achieves criterion to a large extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Potential to reduce the cost of debt finance to its minimum point (assuming sufficient participation and issuance).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>An explicit guarantee from the Commonwealth implies a very low risk of default on obligations.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>It is noted that the membership may be asked to pay a fee to compensate the guarantor for the guarantee.</td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>While the agency could provide attractive debt pricing, an educative function and advisory services, it does not build relationships between councils and a collective bond with a debt provider. This is a complex dynamic but precedent overseas and feedback to date suggests it is an important cultural consideration. These relationships could build momentum and support for promoting a culture of sustainable borrowing. It may be perceived only as a mechanism for ‘cheap debt’.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>As noted in criterion vii, there are risks to a high participation rate and clearly a positive impact on the sustainable use of debt requires a high level of take-up.</td>
<td></td>
</tr>
<tr>
<td>Impacts on other governments</td>
<td>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</td>
<td>1</td>
</tr>
<tr>
<td>iii</td>
<td>Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A new agency is likely to require enabling legislation. While there is precedent for these processes, for example establishing Infrastructure Australia, they are complex. Establishing new legislation requires extensive management and resources, and presents risks to creating the entity as designed.</td>
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</tr>
<tr>
<td></td>
<td>State or territory legislation (or regulations) may also need to be amended to:</td>
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<tr>
<td></td>
<td>authorise councils to borrow from a federal agency</td>
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</tr>
<tr>
<td></td>
<td>amend restrictions such as limits on borrowing or requirements such as reporting.</td>
<td></td>
</tr>
<tr>
<td>iv</td>
<td>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The Commonwealth would be entering an administrative area which currently it has no role. The impacts are likely to be far reaching including direct engagement in policy frameworks for borrowing and financial management.</td>
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<tr>
<td></td>
<td>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</td>
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<td>---</td>
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<td></td>
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<tr>
<td></td>
<td>The Commonwealth’s financial position would be impacted by the:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► value of debt securities issued by the agency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► providing funding for the agency (to the extent not fully recovered from the membership).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>In considering the extent to which these impacts are manageable, the value of debt issued has the most material impact but at current levels would be small compared with total balance sheet liabilities. Consequently, the volume of council borrowing would need to increase substantially to become material to the Commonwealth’s credit rating.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Furthermore, while the provision of funds for the agency would clearly involve a cost for the Commonwealth, in the long-term it would represent good value as the new authority would help reduce local government’s future reliance on higher tiers of government for financial assistance.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>For states and territories, the impact may be material in those jurisdictions which directly support borrowing by councils. Those obligations would in effect be transferred to the Commonwealth.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Overall, this criterion is achieved to a large extent because the impacts on long-run financial position are likely to be manageable.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Market credibility</td>
<td></td>
</tr>
<tr>
<td>vi</td>
<td>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a large extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>This option is likely to achieve an acceptable level of financing risk at an early point (assuming sufficient participation) primarily because an explicit guarantee could attract sufficient appetite to deliver target volumes of finance.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Participation rates</td>
<td></td>
</tr>
<tr>
<td>vii</td>
<td>Capable of achieving a broad base of participation across the local government sector.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a minimal extent because there are material risks to a high participation rate.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Notwithstanding the attractive pricing likely to be achieved, this option may not create among councils a strong incentive to act collectively and build critical mass.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>From a cultural perspective, this option could be seen as a ‘top down’ Commonwealth initiative which creates a new layer of regulation where it had not existed previously.</td>
<td></td>
</tr>
</tbody>
</table>
Option 2

| 2 | Entity established by the states and territories, with a guarantee provided by the states and territories over the agency’s obligations |

Description

This option would involve the establishment by the states and territories of a collective financing vehicle for local government with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Agency of the states and territories**
  
The authority would be established collectively by participating state and territory governments as a statutory corporation under legislation. The authority would operate at arms-length to government to ensure independence and commerciality.

  Under this model, it is anticipated that the states and territories would provide seed funding to meet the costs associated with establishing the authority. The funding could be time-limited and cease once the authority is in a position to cover its own costs.

- **State/territory government credit enhancement**
  
The authority's obligations to third parties would be guaranteed by state and territory governments. Under the different state and territory legislative instruments establishing the entity, each jurisdiction would be responsible for the due payment of any money that becomes payable by the authority to a counterparty in respect of a default by a council within that jurisdiction.

  Under this model, the states and territories may also provide credit enhancement in the form of liquidity capital, through – for example – contributions to a liquidity reserve fund.

**Local Government Finance Authority of South Australia (Australia)**

The Local Government Finance Authority (LGFA) of South Australia was established in 1984 as a statutory authority, under the Local Government Finance Authority Act. All local authorities in the state are automatically members of the LGFA, but use of the authority for investment and loans is entirely voluntary. In accordance with the act, all the liabilities of the authority (including monies accepted on deposit from the local authorities) are guaranteed by the Treasurer of South Australia.

**Queensland Investment Corporation (Australia)**

Queensland Investment Corporation (QIC) was established in 1991 by the Queensland Government to manage its long-term investments. QIC Limited is a government-owned...
corporation (GOC) constituted under the Queensland Investment Corporation Act 1991 (Qld) (QIC Act). QIC is regulated by state government legislation pertaining to GOCs. Under the act establishing QIC, the Treasurer of Queensland is empowered to guarantee the payment of any moneys payable by, or the discharge of any liability of, the corporation.

### Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose and function</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td><strong>Capable of reducing the costs of debt finance.</strong></td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>► Achieves criterion to a large extent because this model is likely to align the cost of debt finance with that achieved by the states and territories (assuming sufficient participation is achieved).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► An explicit guarantee from the states and territories implies a low risk of default on obligations.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► It is noted that the membership may be asked to pay a fee to compensate the guarantor for the guarantee.</td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td><strong>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</strong></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► While the agency could provide attractive debt pricing, an educative function and advisory services, it does not build relationships between councils and a collective bond with a debt provider. This is a complex dynamic but precedent overseas and feedback to date suggests it is an important cultural consideration. These relationships could build momentum and support for promoting a culture of sustainable borrowing. It may be perceived only as a mechanism for ‘cheap debt’.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► As noted in criterion vii, there are risks to a high participation rate and clearly a positive impact on the sustainable use of debt requires a high level of take-up.</td>
<td></td>
</tr>
<tr>
<td>Impacts on other governments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii</td>
<td><strong>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</strong></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Establishing a new entity would require a range of legislative amendments (though probably not new legislation as jurisdictions have powers to issue instruments to raise funds and to extend guarantees).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The combined amount of legislative change would be resource-intensive and presents risks to achieving the entity as designed.</td>
<td></td>
</tr>
<tr>
<td>iv</td>
<td><strong>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</strong></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Some jurisdictions would become much more closely involved with the sector as a result of extending direct credit support for local government borrowing. This creates material impacts, such as resourcing, particularly in jurisdictions which currently adopt a ‘hands-off’ approach to council financing.</td>
<td></td>
</tr>
<tr>
<td>v</td>
<td><strong>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</strong></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a minimal extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The states and territories’ financial position would be impacted differently depending on their current relationships with local government. The impacts are:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► including the value of debt securities issued by the entity and used by councils - from an accounting perspective, this could be a significant change because council borrowing is not on-balance sheet (although it typically is for credit rating purposes)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► funding liquidity in the agency to the extent not fully passed onto the membership.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The materiality of these impacts are likely to differ based on the extent to which each jurisdiction currently lends to local government or directly supports council borrowing. The potential for an increasing rate of borrowing could materially change the financial position and credit rating assessment for some jurisdictions, noting their smaller balance sheets and revenue-raising powers compared with the Commonwealth.</td>
<td></td>
</tr>
<tr>
<td>Market credibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>vi</td>
<td><strong>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</strong></td>
<td>3</td>
</tr>
</tbody>
</table>
Achieves this criterion to a large extent because this option is likely to achieve an acceptable level of financing risk at an early point (assuming sufficient participation). This is primarily because of the direct credit support from the states and territories and the experience of their debt agencies in the market.

<table>
<thead>
<tr>
<th>Participation rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>vii</td>
</tr>
<tr>
<td>Capable of achieving a broad base of participation across the local government sector.</td>
</tr>
<tr>
<td>► Achieves this criterion to a limited extent.</td>
</tr>
<tr>
<td>► Some jurisdictions provide their councils with access to facilities which benefit from state support or guarantee, and they are well patronised. However, at a national level, there are risks to a high rate of participation because this option may not create among councils a strong incentive to act collectively and build a critical mass.</td>
</tr>
</tbody>
</table>
Option 3

Entity established by a group of councils, with a Commonwealth guarantee over the agency’s obligations

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Commonwealth credit enhancement**
  
  The Commonwealth would guarantee the due payment of any money that becomes payable by the authority to a counterparty.

  Under this model, the Commonwealth may also provide credit enhancement in the form of liquidity capital, through – for example – a liquidity reserve fund or by providing access to central government short-term credit facilities.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
</table>
| Purpose and function | **Capable of reducing the costs of debt finance**  
  ▶ Achieves criterion to a large extent because this model could reduce the cost of debt finance to its minimum point (assuming sufficient participation and issuance).  
  ▶ An explicit guarantee from the Commonwealth implies a very low risk of default on obligations.  
  ▶ It is noted that the membership may be asked to pay a fee to compensate the guarantor for the guarantee. | 3     |
|           | **Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.**  
  ▶ Achieves this criterion to a limited extent.  
  ▶ This option is an entity established by councils to service the sector. However, its success in the finance market does not rely on collective action by a core of councils to pave the way for others. As a result it is less likely to be a catalyst for building momentum and support for promoting a culture of sustainable borrowing. It may be perceived only as a mechanism for ‘cheap debt’. | 2     |
| Impacts on other governments | **Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.** | 1     |
Achieves this criterion to a minimal extent because:
- implementing a guarantee from the Commonwealth is likely to require amended or new legislation
- state and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s mandate with the legal framework of each jurisdiction.

**Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.**

Achieves this criterion to a minimal extent because this option would bring the Commonwealth into a new role and relationship with the local government sector. At a minimum, the provision of a guarantee would require a reporting and review function regarding residual liabilities.

**Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.**

The Commonwealth’s financial position would be impacted by the value of debt securities issued by the new entity. They may be treated as debts and consolidated for reporting purposes.
- However, the current size of borrowing in the local government sector is not material compared with the Commonwealth’s total liabilities and the volume of council borrowing would need to increase substantially to become material to the Commonwealth’s credit rating.
- For states and territories, the impact would be material in those jurisdictions which directly support borrowing by councils. Those obligations would in effect be transferred to the Commonwealth.
- Overall, this criterion is achieved to a large extent because the impacts on long-run financial position are likely to be manageable.

**Market credibility**

Achieves this criterion to a large extent because this option is likely to achieve an acceptable level of financing risk (assuming sufficient participation) given the strength of Commonwealth support.

**Participation rates**

Achieves this criterion to a minimal extent because this option presents material risks to a high participation rate. As noted in criterion ii, because credit enhancement is provided by the Commonwealth, this model may not create a strong sense of ownership and does not create a strong incentive for councils to act collectively (and in doing so, examine their use of debt). This option may be therefore used opportunistically only.
Option 4

Entity established by a group of councils, with a guarantee provided by the states and territories over the agency's obligations

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **State/ territory government credit enhancement**

  The authority's obligations to third parties would be guaranteed by state and territory governments. Each jurisdiction would be responsible for the due payment of any money that becomes payable by the authority to a counterparty in respect of a default by a council within that jurisdiction.

  Under this model, the states and territories may also provide credit enhancement in the form of liquidity capital, through – for example – contributions to a liquidity reserve fund.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
</table>
| i         | **Capable of reducing the costs of debt finance.**  
  ▶ Achieves criterion to a large extent because this model is likely to align the cost of debt finance with that achieved by the states and territories (assuming sufficient participation is achieved).  
  ▶ An explicit guarantee from the states and territories implies a low risk of default on obligations.  
  ▶ It is noted that the membership may be asked to pay a fee to compensate the guarantor for the guarantee. | 3 |
| ii        | **Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.**  
  ▶ Achieves this criterion to a limited extent only.  
  ▶ This option is an entity established by councils to service the sector. However, its success in the finance market does not rely on collective action by a core of councils to pave the way for others. As a result it is less likely to be a catalyst for building momentum and support for promoting a culture of sustainable borrowing. It may be perceived only as a mechanism for state-provided 'cheap debt'. | 2 |
Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.

- Achieves this criterion to a minimal extent because:
  - Agreeing and implementing the terms of a guarantee in similar form consistently across all jurisdictions is likely to be challenging.
  - State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction.

Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.

- Achieves this criterion to a minimal extent only.
- Some jurisdictions would become much more closely involved with the sector as a result of extending direct credit support for local government borrowing. This creates material impacts such as resourcing particularly in jurisdictions which currently adopt a ‘hands off’ approach to council financing.

Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.

- Achieves this criterion to a minimal extent only.
- The states and territories' financial position would be impacted differently depending on their current relationships with local government. The impacts are:
  - including the value of debt securities issued by the entity and used by councils - from an accounting perspective, this could be a significant change because council borrowing is not on-balance sheet (although it typically is for credit rating purposes)
  - funding liquidity in the agency to the extent not fully passed onto the membership.
- The materiality of these impacts are likely to differ based on the extent to which each jurisdiction currently lends to local government or directly supports council borrowing. The potential for an increasing rate of borrowing could materially change the financial position and credit rating assessment for some jurisdictions, noting their smaller balance sheets and revenue-raising powers compared with the Commonwealth.

Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.

- Achieves this criterion to a large extent because this option is likely to achieve an acceptable level of financing risk at an early point (assuming sufficient participation). This is primarily because of the direct credit support from the states and territories.

Capable of achieving a broad base of participation across the local government sector.

- Achieves this criterion to a limited extent only.
- Some jurisdictions provide their councils with access to facilities which benefit from state support or guarantee, and they are well patronised. However, at a national level, there are risks to a high rate of participation: credit enhancement is provided by the states and territories so this option may not create a strong sense of ownership and does not create a strong incentive for councils to act collectively (and in doing so, examine their use of debt).
### Option 5

| 5 | Entity established by a group of councils with a capital contribution from the Commonwealth and/or states/territories as a collateral against default |

#### Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Capital contribution by the Commonwealth and/or states/territories**
  
  Participating jurisdictions would contribute funding to the authority which would be retained within the organisation for as collateral against default.
  
  Capitalisation of the authority would serve to fund establishment costs, cover any net losses in the early years and meet capital adequacy requirements. As the size of the authority’s loan book grows, so would the capital needed to meet the capital adequacy requirements. It is anticipated that in future years this will be funded by retained surpluses in the authority and so it is not expected that jurisdictions would periodically be required to contribute additional capital.

- **No mutual obligation**
  
  Member councils would not be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle’s financial liabilities.

- **No guarantee provided by the Commonwealth, states or territories**
  
  The Commonwealth and state/territory governments would not be bound to support the repayment of the debts of the entity by means of a guarantee over the vehicle’s financial liabilities.

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#### Local Government Funding Agency (New Zealand)

The Local Government Funding Agency (LGFA) was established by the Local Government Borrowing Act 2011 and was incorporated on 1 December 2011. The LGFA is owned by a group of councils and the New Zealand Government. It is a Council Controlled Organisation (CCO) operating under the Local Government Act 2002.

The LGFA’s primary purpose is to provide more efficient finance costs and diversified financing sources (including foreign currency) for New Zealand local authorities. The New Zealand Government’s Debt Management Office (DMO) executes funding and investing functions (on instructions from LGFA) and has provided an initial NZ$500m liquidity facility (to rise to NZ$1bn).
### Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purpose and function</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| i | Capable of reducing the costs of debt finance.  
 ► Achieves this criterion to a minimal extent only.  
 ► This option has relatively less security for investors compared with other options because it does not have an explicit guarantee, or recourse to the membership for additional collateral to support debt pricing, and contributions from other tiers of government may be “under-sized” relative to actual borrowing. | 1 |
| ii | Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.  
 ► Achieves this criterion to a limited extent.  
 ► This option is an entity established by councils to service the sector. However, its ability to attract interest in its products may largely be derived from risk capital contributions from other tiers of government and not collective action by councils. As a result it is less likely to be a catalyst for building momentum and support for promoting a culture of sustainable borrowing. | 2 |
| **Impacts on other governments** | | |
| iii | Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.  
 ► Achieves this criterion to a limited extent.  
 ► State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction, but while these impacts are significant they are likely to be manageable.  
 ► Capital contributions could be provided as untied grants and within existing powers. However, the process is complicated by a “chicken and egg” problem: the size of contribution(s) is proportional to the membership; but membership is likely to reflect a perception of the entity’s pricing power, which in turn is a function of the contribution(s). | 2 |
| iv | Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.  
 ► Achieves this criterion to a limited extent.  
 ► The impact on existing roles would differ significantly across the jurisdictions. In those jurisdictions where local government borrowing is directly facilitated or supported, this role would recede and this would materially change the relationship between the tiers of government, particularly where the state and local sectors work closely on borrowing. These changes would be less obvious in other jurisdictions where councils mostly use commercial banks. | 2 |
| v | Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.  
 ► Achieves this criterion to a large extent because this option could avoid material adverse impacts on all jurisdictions’ long-run position. It arguably offers significant improvements in jurisdictions which directly support or guarantee local government borrowing.  
 ► The capital contribution(s) in this model are unlikely to be material to long-run position. | 3 |
| **Market credibility** | | |
| vi | Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.  
 ► Achieves this criterion to a limited extent.  
 ► Without an explicit guarantee from other tiers of government or equivalent from the membership, a new entity could be expected to face greater challenges gaining the confidence of investors, and this could impact on its ability to raise target volumes of finance. | 2 |
| **Participation rates** | | |
| vii | Capable of achieving a broad base of participation across the local government sector.  
 ► Achieves this criterion to a minimal extent because this option contains material risks to high rates of participation. There could be a perception – until proven otherwise - that this option provides minimum security for investors to achieve a level of pricing to induce critical mass and savings. | 1 |
Option 6a

| 6a | Entity established by a group of councils with a capital contribution from participating councils as a collateral against default. |

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Capital contribution by participating councils**
  
  To join the vehicle, councils would be required to provide a minimum amount of capital which could for example be proportional to average rates revenue. Each member’s capital contribution would be retained within the organisation for the duration of their membership as collateral against default.

  Capitalisation of the authority would serve to fund establishment costs, cover any net losses in the early years and meet capital adequacy requirements. As the size of the authority’s loan book grows, so would the capital needed to meet the capital adequacy requirements. It is anticipated that in future years this will be funded by retained surpluses in the authority and so it is not expected that members would periodically be required to contribute additional capital.

- **No mutual obligation**
  
  Member councils would not be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle’s financial liabilities.

- **No explicit credit enhancement from the Commonwealth, states or territories**
  
  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
</table>
| Purpose and function | **Capable of reducing the costs of debt finance.**  
- Achieves this criterion to a minimal extent only.  
- This option has relatively less security for investors compared with other options because it does not have an explicit guarantee, or recourse to the membership to support the entity’s financial obligations. | 1 |
| | **Capable of positively affecting the culture of debt aversion, supporting the sustainable use** | 3 |
of debt and the transition to long-run sustainable financial management in the local government sector.

- Achieves this criterion to a large extent.
- This option is an entity established by councils to service the sector. Councils would be required to make a contribution to the entity and as such have ‘skin in the game’. The sense of ownership created could be a catalyst for building momentum and support for promoting a culture of sustainable borrowing.

### Impacts on other governments

<table>
<thead>
<tr>
<th>Impact</th>
<th>Achieves this criterion</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>iii</td>
<td>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</td>
<td>2</td>
</tr>
<tr>
<td>iv</td>
<td>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</td>
<td>2</td>
</tr>
<tr>
<td>v</td>
<td>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</td>
<td>3</td>
</tr>
</tbody>
</table>

### Market credibility

<table>
<thead>
<tr>
<th>Credibility</th>
<th>Achieves this criterion</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>vi</td>
<td>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</td>
<td>2</td>
</tr>
</tbody>
</table>

### Participation rates

<table>
<thead>
<tr>
<th>Participation</th>
<th>Achieves this criterion</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>vii</td>
<td>Capable of achieving a broad base of participation across the local government sector.</td>
<td>1</td>
</tr>
</tbody>
</table>
Option 6b

| 6b | Entity established by a group of councils with a capital contribution from participating councils and an uncapped mutual obligation to support repayment of debt. |

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Capital contribution by participating councils**

  To join the vehicle, councils would be required to provide a minimum amount of capital which could for example be proportional to average rates revenue. Each member’s capital contribution would be retained within the organisation for the duration of their membership as collateral against default.

  Capitalisation of the authority would serve to fund establishment costs, cover any net losses in the early years and meet capital adequacy requirements. As the size of the authority's loan book grows, so would the capital needed to meet the capital adequacy requirements. It is anticipated that in future years this will be funded by retained surpluses in the authority and so it is not expected that members would periodically be required to contribute additional capital.

- **Uncapped mutual obligation**

  Member councils would agree to be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle's financial liabilities, which would be called upon only if the collateral and liquidity reserves are insufficient. Each participant's obligation could be calculated relative to its operating revenue.

- **No explicit credit enhancement from the Commonwealth, states or territories**

  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

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**Municipal Finance Authority (MFA) of British Columbia (Canada)**

The Municipal Finance Authority of British Columbia (MFA) was created in 1970 to contribute to the financial well-being of local governments throughout British Columbia.
Long-term debt requirements of local governments (5 to 30 years) must be borrowed through the MFA. All borrowings must be within each municipality’s individual borrowing power, which stipulates that only 25% of sustainable revenue may be allocated to debt servicing costs (principal and interest).

Long-term financing needs are met through placing of debentures in capital markets - normally 10 year bonds to accommodate average borrowing terms requested by clients and the preferences of investors. Short-term funding needs have been fulfilled through a $500m Commercial Paper Program.

Local governments within each regional district are joint and severally liable for each others’ long-term debt borrowings through the MFA. When a municipality passes a borrowing bylaw and presents it to its regional district for the purpose of issuing security, all municipalities in the region must vote on their acceptance of the borrowing. Approval of the bylaw binds each municipality with joint and several obligations.

### Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purpose and function</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Capable of reducing the costs of debt finance.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a limited extent only.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The security undertakings in this option could (assuming sufficient participation) lead to pricing which is equivalent to issuance in highly-rated states.</td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a large extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► This option is an entity established by the sector to service it. More importantly, it requires the sector to take collective action on sufficient scale to achieve favourable pricing and terms, and in this respect, provides the sector with an opportunity to largely control its own borrowing costs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► Individual members would have a direct stake in the performance of other members. The sense of ownership created could be a catalyst for promoting a culture of sustainable borrowing.</td>
<td></td>
</tr>
<tr>
<td><strong>Impacts on other governments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii</td>
<td>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction, but while these impacts may be material they are likely to be manageable.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► There may be a requirement to address the implications of providing a financial guarantee in the form of an uncapped mutual obligation.</td>
<td></td>
</tr>
<tr>
<td>iv</td>
<td>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The local government sector would assume the primary role for supporting its own collective borrowing vehicle.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► The impact on existing roles would differ significantly across the jurisdictions. In those jurisdictions where local government borrowing is directly facilitated or supported, this role would recede (assuming sufficient participation) and this may materially change the relationship between the tiers of government. These changes would be less obvious in other jurisdictions where councils mostly use commercial banks.</td>
<td></td>
</tr>
<tr>
<td>v</td>
<td>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>► Achieves this criterion to a large extent because this option could avoid material adverse impacts on all jurisdictions’ long-run position. It arguably offers significant improvements in jurisdictions which directly support or guarantee local government borrowing.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► However, it is noted that in a scenario of uneven take-up across jurisdictions, an</td>
<td></td>
</tr>
<tr>
<td>vi</td>
<td>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</td>
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<tr>
<td>----</td>
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<tr>
<td></td>
<td>► Achieves this criterion to a limited extent.</td>
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<tr>
<td></td>
<td>► Without an explicit guarantee from other tiers of government, a new entity could be expected to face greater challenges gaining the confidence of investors, and this could impact on its ability to raise target volumes of finance. Credibility could be built over time with a track record to support the underlying credit fundamentals of the sector.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>► However, this option includes an uncapped obligation for members to mutually support obligations. As noted, this feature could be expected to support pricing. It would still be incumbent on the entity to demonstrate the mechanics of this undertaking.</td>
<td></td>
</tr>
</tbody>
</table>

| vii | Capable of achieving a broad base of participation across the local government sector. |
|     | ► Achieves this criterion to a minimal extent because this option contains material risks to high rates of participation. The key risk relates to acceptance of an uncapped mutual obligation (and to a lesser extent, a capital contribution) and specifically the perceptions within individual councils of the implications for financial management. |
Option 6c

6c Entity established by a group of councils with a capital contribution from participating councils and a capped mutual obligation to support repayment of debt.

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Capital contribution by participating councils**
  
  To join the vehicle, councils would be required to provide a minimum amount of capital which could for example be proportional to average rates revenue. Each member’s capital contribution would be retained within the organisation for the duration of their membership as collateral against default.

  Capitalisation of the authority would serve to fund establishment costs, cover any net losses in the early years and meet capital adequacy requirements. As the size of the authority's loan book grows, so would the capital needed to meet the capital adequacy requirements. It is anticipated that in future years this will be funded by retained surpluses in the authority and so it is not expected that members would periodically be required to contribute additional capital.

- **Capped mutual obligation**

  Member councils would agree to be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle's financial liabilities, which would be called upon only if the collateral and liquidity reserves are insufficient. Each participant's obligation, including the upper limit (or cap), could be calculated relative to its operating revenue.

- **No explicit credit enhancement from the Commonwealth, states or territories**

  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
</table>
| Purpose and function | Capable of reducing the costs of debt finance.  
  ▶ Achieves this criterion to a limited extent.  
  ▶ The security undertakings in this option could (assuming sufficient participation) lead to   | 2     |
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ii</strong></td>
<td><strong>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</strong>&lt;br&gt;► Achieves this criterion to a large extent.&lt;br&gt;► This option is an entity established by the sector to service it. More importantly, it requires the sector to take collective action on sufficient scale to achieve favourable pricing and terms, and in this respect, provides the sector with an opportunity to largely control its own borrowing costs.&lt;br&gt;► Individual members would have a direct stake in the performance of other members. The sense of ownership created could be a catalyst for promoting a culture of sustainable borrowing.</td>
</tr>
<tr>
<td></td>
<td>3</td>
</tr>
<tr>
<td><strong>iii</strong></td>
<td><strong>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</strong>&lt;br&gt;► Achieves this criterion to a limited extent.&lt;br&gt;► State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction, but while these impacts may be material they are likely to be manageable.&lt;br&gt;► There may be a requirement to address the implications of providing a financial guarantee with regard to the mutual obligation.</td>
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<tr>
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<td>2</td>
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<tr>
<td><strong>iv</strong></td>
<td><strong>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</strong>&lt;br&gt;► Achieves this criterion to a limited extent.&lt;br&gt;► The local government sector would assume the primary role for supporting its own collective borrowing vehicle.&lt;br&gt;► The impact on existing roles would differ significantly across the jurisdictions. In those jurisdictions where local government borrowing is directly facilitated or supported, this role would recede (assuming sufficient participation) and this would materially change the relationship between the tiers of government. These changes would be less obvious in other jurisdictions where councils mostly use commercial banks.</td>
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<tr>
<td><strong>v</strong></td>
<td><strong>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</strong>&lt;br&gt;► Achieves this criterion to a large extent because this option could avoid material adverse impacts on all jurisdictions’ long-run position. It arguably offers significant improvements in jurisdictions which directly support or guarantee local government borrowing.</td>
</tr>
<tr>
<td></td>
<td>3</td>
</tr>
<tr>
<td><strong>vi</strong></td>
<td><strong>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</strong>&lt;br&gt;► Achieves this criterion to a limited extent.&lt;br&gt;► Without an explicit guarantee from other tiers of government, a new entity could be expected to face greater challenges gaining the confidence of investors, and this could impact on its ability to raise target volumes of finance. Credibility could be built over time with a track record to support the underlying credit fundamentals of the sector.&lt;br&gt;► Demonstrating the mechanics of the mutual obligation in this option would be a key challenge to establishing the credibility of this approach.</td>
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<tr>
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<td>2</td>
</tr>
<tr>
<td><strong>vii</strong></td>
<td><strong>Capable of achieving a broad base of participation across the local government sector.</strong>&lt;br&gt;► Achieves this criterion to a limited extent.&lt;br&gt;► While there are risks to high rates of participation, this option arguably offers an optimal balance between security and pricing, extent of mutual obligation, and extent of capital contribution.&lt;br&gt;► A capped mutual obligation could be perceived as a more manageable commitment compared with an uncapped obligation.</td>
</tr>
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<td></td>
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</tr>
</tbody>
</table>
Option 7a

| 7a | Entity established by a group of councils without any capital contribution but an uncapped mutual obligation to support repayment of all debt |

Description

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Uncapped mutual obligation**
  
  Member councils would agree to be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle's financial liabilities, which would be called upon only if the collateral and liquidity reserves are insufficient. Each participant's obligation could be calculated relative to its operating revenue.

- **No explicit credit enhancement from the Commonwealth, states or territories**
  
  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

Municipality Finance Plc (Finland)

Municipality Finance Plc (MuniFin), established in 2001, is incorporated as a financing institution under the Finnish Act on Credit Institutions and is supervised by the Finnish Financial Supervision. It is 53% owned by municipalities, 16% by the government, and 31% by the local government pensions fund.

MuniFin enjoys a guarantee provided by the Municipal Guarantee Board (MGB). 328 Finnish municipalities are members of MGB (over 99% of the population) and its only function is to guarantee MuniFin’s debt obligations. The member municipalities are jointly liable on a pro rata basis for MGB’s commitments. If one member fails to meet its obligations, then all other members must make up the shortfall.

Kommuninvest (Sweden)

Kommuninvest was founded by nine municipalities and a county council in 1986, and now has close to 300 municipalities and county council members, more than 85% of the total. Its objective is to provide competitive loans and other financial services for its members.

All members of the Kommuninvest Cooperative Society signs a joint and several guarantee covering all commitments of the agency.
KommuneKredit (Denmark)

KommuneKredit was established in 1899 by a special Act as an association (membership organisation) under Danish law, with the objective of securing cost-efficient financing for local government clients. Membership is voluntary, but currently all Danish municipalities are members.

Members of KommuneKredit are directly, jointly and severally liable for all of KommuneKredit’s obligations.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose and function</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Capable of reducing the costs of debt finance.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The security undertakings in this option could (assuming sufficient participation) lead to pricing which is equivalent to issuance in highly-rated states. This is likely to be the case without capital contributions from the membership, though to a lesser extent than options 6a, b and c.</td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a large extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>This option is an entity established by the sector to service it. More importantly, it requires the sector to take collective action on sufficient scale to achieve favourable pricing and terms, and in this respect, provides the sector with an opportunity to largely control its own borrowing costs. Individual members would have a direct stake in the performance of other members. The sense of ownership created could be a catalyst for promoting a culture of sustainable borrowing.</td>
<td></td>
</tr>
<tr>
<td>Impacts on other governments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>iii</td>
<td>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction, but while these impacts may be material they are likely to be manageable.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>There may be a requirement to address the implications of providing a financial guarantee in the form of an uncapped mutual obligation.</td>
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</tr>
<tr>
<td>iv</td>
<td>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The local government sector would assume the primary role for supporting its own collective borrowing vehicle.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The impact on existing roles would differ significantly across the jurisdictions. In those jurisdictions where local government borrowing is directly facilitated or supported, this role would recede (assuming sufficient participation) and this would materially change the relationship between the tiers of government. These changes would be less obvious in other jurisdictions where councils mostly use commercial banks.</td>
<td></td>
</tr>
<tr>
<td>v</td>
<td>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a large extent because this option could avoid material adverse impacts on all jurisdictions’ long-run position. It arguably offers significant improvements in jurisdictions which directly support or guarantee local government borrowing.</td>
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</tr>
<tr>
<td></td>
<td>However, it is noted that in a scenario of uneven take-up across jurisdictions, an uncapped obligation could lead to a concentration of risk in particular jurisdictions, which could be adverse.</td>
<td></td>
</tr>
<tr>
<td>Market credibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>vi</td>
<td>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Achieves this criterion to a minimal extent. Without an explicit guarantee from other</td>
<td></td>
</tr>
</tbody>
</table>
tiers of government, a new entity could be expected to face greater challenges gaining the confidence of investors, and this could impact on its ability to raise target volumes of finance.

- Without a capital contribution, the entity would need to focus on the mechanics of the mutual obligation in this option and demonstrating its robustness would be a key challenge to establishing credibility. It could be perceived as less tangible security compared the combination of a capital contribution and a mutual obligation.

<table>
<thead>
<tr>
<th>Participation rates</th>
<th>Capable of achieving a broad base of participation across the local government sector.</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>vii</td>
<td>Achieves this criterion to a minimal extent because of the risks in this option to high rates of participation. The key risk relates to acceptance of an uncapped mutual obligation and specifically the perceptions within individual councils of the implications for financial management.</td>
<td>---</td>
</tr>
</tbody>
</table>
**Option 7b**

| 7b  | Entity established by a group of councils without any capital contribution but a capped mutual obligation to support repayment of all debt |

**Description**

This option would involve the establishment by a group of councils of a collective financing vehicle with the objective of issuing debt securities to the capital markets and on-lending the funds to members. The differentiating factors are:

- **Capped mutual obligation**

  Member councils would agree to be bound to support the repayment of the debts of the entity by means of a joint and several guarantee over the vehicle's financial liabilities, which would be called upon only if the collateral and liquidity reserves are insufficient. Each participant's obligation, including the upper limit (or cap), could be calculated relative to its operating revenue.

- **No explicit credit enhancement from the Commonwealth, states or territories**

  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

**Evaluation**

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purpose and function</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>i</td>
<td>Capable of reducing the costs of debt finance.</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>▶ Achieves this criterion to a limited extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▶ The security undertakings in this option could (assuming sufficient participation) lead to pricing which is equivalent to issuance in highly-rated states. This is likely to be the case without capital contributions from the membership, though to a lesser extent than options 6a, b and c.</td>
<td></td>
</tr>
<tr>
<td>ii</td>
<td>Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>▶ Achieves this criterion to a large extent.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▶ This option is an entity established by the sector to service it. More importantly, it requires the sector to take collective action on sufficient scale to achieve favourable pricing and terms, and in this respect, provides the sector with an opportunity to largely control its own borrowing costs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>▶ Individual members would have a direct stake in the performance of other members. The sense of ownership created could be a catalyst for promoting a culture of sustainable borrowing.</td>
<td></td>
</tr>
</tbody>
</table>
### Impacts on other governments

<table>
<thead>
<tr>
<th></th>
<th>Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
</tr>
<tr>
<td></td>
<td>State and territory legislation and regulation is likely to require amendment to authorise use by councils and harmonisation of the entity’s procedures and requirements with those of each jurisdiction, but while these impacts may be material they are likely to be manageable.</td>
</tr>
<tr>
<td></td>
<td>There may be a requirement to address the implications of providing a financial guarantee with regard to the mutual obligation.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
</tr>
<tr>
<td></td>
<td>The local government sector would assume the primary role for supporting its own collective borrowing vehicle.</td>
</tr>
<tr>
<td></td>
<td>The impact on existing roles would differ significantly across the jurisdictions. In those jurisdictions where local government borrowing is directly facilitated or supported, this role would recede (assuming sufficient participation) and this would materially change the relationship between the tiers of government. These changes would be less obvious in other jurisdictions where councils mostly use commercial banks.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Achieves this criterion to a large extent because this option could avoid material adverse impacts on all jurisdictions’ long-run position. It arguably offers significant improvements in jurisdictions which directly support or guarantee local government borrowing.</td>
</tr>
</tbody>
</table>

### Market credibility

<table>
<thead>
<tr>
<th></th>
<th>Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Achieves this criterion to a minimal extent only.</td>
</tr>
<tr>
<td></td>
<td>Without an explicit guarantee from other tiers of government, a new entity could be expected to face greater challenges gaining the confidence of investors, and this could impact on its ability to raise target volumes of finance.</td>
</tr>
<tr>
<td></td>
<td>Without a capital contribution, the entity would need to focus on the mechanics of the mutual obligation in this option and demonstrating its’ robustness would be a key challenge to establishing credibility. It could be perceived as less tangible security compared the combination of a capital contribution and a mutual obligation.</td>
</tr>
</tbody>
</table>

### Participation rates

<table>
<thead>
<tr>
<th></th>
<th>Capable of achieving a broad base of participation across the local government sector.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Achieves this criterion to a limited extent.</td>
</tr>
<tr>
<td></td>
<td>The risks in this option to high rates of participation are similar to those noted in other options 6 and 7. However, this option could result in higher participation given that it does not require a capital contribution and it caps the mutual obligation, which could be perceived as a more manageable commitment compared with an uncapped obligation.</td>
</tr>
</tbody>
</table>
Option 8

Entity established by the Commonwealth and/or states/territories as a financial intermediary to collect demand for specific-purpose borrowing and issue securities to match exactly these needs.

Description

This option would involve the establishment by the Commonwealth and/or states/territories of a vehicle with the objective of procuring finance for councils or groups of councils. The differentiating factors are:

- **Non-lending**
  
  The authority's main purpose would be as a financial intermediary or arranger of debt for participating councils requiring finance for specific projects or programs. It would react in response to demand and not have a regular presence in the bond market.

- **No explicit credit enhancement from the Commonwealth, states or territories**
  
  It is anticipated that there would be no explicit credit enhancement or funding support from the Commonwealth, states or territories.

The Housing Finance Corporation (UK)

The Housing Finance Corporation (THFC) is an independent, specialist, not-for-profit organisation that makes loans to Registered Social Landlords, which are organisations, such as Housing Associations, that provide affordable housing to tenants throughout the United Kingdom.

THFC funds itself through the issue of bonds to private investors and by borrowing from banks. It therefore acts as an aggregating financial intermediary, so diversifying risk for those who make funds available to THFC and reducing the cost and standardising the loan terms for those RSLs that borrow from us.

Evaluation

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Basis of evaluation</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purpose and function</td>
<td>Capable of reducing the costs of debt finance.</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Does not achieve this criterion.</td>
<td></td>
</tr>
</tbody>
</table>
|   | ▶ This option could deliver competitively priced debt from commercial lenders but this is unlikely to be an improvement on the status quo.  
   | ▶ The entity would match its fund raising activities directly to council loans and therefore participating councils would not be able to drawdown loans instantly, as loan amounts and tenors must accumulate to allow the authority to execute matching funding.  
   | ▶ Although the authority may be able to operate at a lower cost base, it may not have the same ability to lower finance costs as some of the collective options. This is because its irregular bond issuances would be of varying credit quality, would prevent it from building up a presence in the markets, and the authority would lack substantial capitalisation or credit enhancement. |
|---|---|
| ii | Capable of positively affecting the culture of debt aversion, supporting the sustainable use of debt and the transition to long-run sustainable financial management in the local government sector.  
   | ▶ Achieves this criterion to a minimal extent only.  
   | ▶ This option could induce some demand from councils contemplating borrowing but does not provide a broader framework or set of incentives for the sector to examine its use of debt and sustainable borrowing. |
|   |   |
| Impacts on other governments |   |
| iii | Manageable upfront, and ongoing, impacts on the existing legislative and regulatory frameworks in the states and territories.  
   | ▶ Achieves this criterion to a large extent.  
   | ▶ This option does not make substantive structural changes to legislation or regulation. |
| iv | Manageable upfront, and ongoing, impacts on the existing relationships between the tiers of government.  
   | ▶ Achieves this criterion to a large extent.  
   | ▶ This option does not make substantive changes to the relationships between the tiers of government. |
| v | Manageable upfront, and ongoing, impacts on the long-run financial position of the Commonwealth, states and territories.  
   | ▶ Achieves this criterion to a large extent.  
   | ▶ This option would not be expected to alter the allocation of liabilities in respect of borrowing or their volumes. |
| Market credibility |   |
| vi | Capable of achieving an acceptable level of financing risk by attracting local (and international) debt market investors.  
   | ▶ Achieves this criterion to a minimal extent only.  
   | ▶ This option could be credible as an intermediary but not as a means of attracting financing into the sector more broadly.  
   | ▶ The authority would act in response to demand, and so would not have a regular presence in the market. It would not necessarily be rated, but the bonds issued would be, and this rating would in each case depend upon the creditworthiness of the council or councils participating in the issuance. |
| Participation rates |   |
| vii | Capable of achieving a broad base of participation across the local government sector.  
   | ▶ Achieves this criterion to a minimal extent only.  
   | ▶ This option is likely to suit a smaller number of larger councils with large-scale projects. |
Evaluation summary

Based upon the evaluation above, the scores of each option can be summarised as follows.

<table>
<thead>
<tr>
<th>Option</th>
<th>1 CW agency, CW guarantee</th>
<th>2 S/T agency, S/T guarantee</th>
<th>3 LG entity, CW guarantee</th>
<th>4 LG entity S/T guarantee</th>
<th>5 LG entity, CW or S/T capital contribution</th>
<th>6a LG entity, LG capital contribution</th>
<th>6b LG entity, LG capital contribution, uncapped mutual obligation</th>
<th>6c LG entity, LG capital contribution, capped mutual obligation</th>
<th>7a LG entity, uncapped mutual obligation</th>
<th>7b LG entity, capped mutual obligation</th>
<th>8 CW or S/T entity, financial intermediary</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>i</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>3</td>
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<td>1</td>
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The evaluation suggests several models are closely ranked. This outcome largely reflects the broad similarities among the commercial characteristics and structure of the options. However, the evaluation process suggests that marginal differences in the credit support structures and the proxy to councils could have a significant impact on stakeholders and processes. The evaluation focussed on testing those impacts.

Option 6c scores the highest and it is recommended for further investigation.
Appendix C
Financial modelling

Financial benefits of establishing a national financing authority

Results

Estimates of the size of the financial benefits of establishing a national financing authority are provided in the tables below. It is important to note that the estimates are indicative only. They have been generated through a high level modelling exercise and reflect a set of assumptions about current and future use and pricing of debt across the local government sector.

Estimates of savings have been made on a jurisdiction by jurisdiction basis because each has different incumbent arrangements for local government borrowing, and consequently represents a different baseline.

Table 1 below shows an estimate of the interest costs which could be avoided by councils, as a proportion of their current costs, through a national financing authority. That is, in each jurisdiction, councils using the authority could reduce the interest paid on every dollar of debt by between 7% - 17%.

Some jurisdictions, particularly Queensland, could benefit to a larger extent, which is a function of the difference between the assumptions about their current costs of debt finance and an estimate of debt pricing achieved by a national financing authority.

Table 1 – Interest costs avoided as a proportion of current costs

Table 2 below shows an estimate of the cumulative interest costs which could be avoided over a 20 year period by using a national financing authority. That is, across all jurisdictions, councils using the authority could save approximately $431m in nominal interest costs over a 20 year period.
Table 2 - Cumulative interest costs avoided

Table 3 below shows an estimate of the cumulative saving in interest costs which could be achieved as debt is progressively sourced through a national financing authority and not through existing arrangements. As noted, approximately $431m could be saved over 20 years assuming 65% of all debt used by local government is sourced from the authority. This estimate increases to $663m if it is assumed that 100% of debt is provided by the authority.

Table 3 – cumulative interest costs avoided with an increasing proportion of debt sourced from a national financing authority

The estimates of savings in the tables above are limited to interest expenses. It is important to note that the estimates of savings do not include:

- the transaction costs of obtaining funds from commercial lenders. These costs would be material in aggregate but are difficult to quantify. Transaction costs avoided could include both the arrangement and upfront fees typical of commercial borrowings and the administration costs incurred by public sector bodies who lend to councils.
the avoided costs of credit support in those jurisdictions which explicitly support local government borrowing. These costs are also difficult to quantify but it is important to recognise that a national financial authority for local government could result in a more efficient semi-government financing structure in Australia because the credit risk associated with local government could be transparently priced in the market.

To the extent a monetary value is applied to these categories of cost, the overall estimate of savings - for local, state and territory governments - would increase.

### Case study – conceptualising the financial benefits of a national financing authority

A large scale waste-to-energy facility, capable of processing almost 1,000,000 tonnes of waste, is proposed to be located in a major regional city. The facility has the potential to generate significant economic growth in the region through the creation of employment opportunities, diversification of industries in the region and environmental and financial sustainability by harnessing the waste from five surrounding local government areas to produce usable products.

The sponsoring council has developed a business case and a preferred procurement method. The project requires a capital investment exceeding $300 million, a portion of which is expected from the private sector, but council will need to raise debt finance to fund the balance. In this scenario, the value of a national financing authority could be:

- avoiding the need for council to approach the commercial market to source debt. A funding parcel of this size, and for a novel asset, would suggest an intensive competitive process
- achieving a cost of debt cost which is approximately 10% cheaper than commercial providers. This saving would lessen the impact of the borrowing on council's projected and forecast cash flows, and reduces the level of financial risk created by the project. The size of the impact of new debt on cash flows will be material to council’s decision to pursue the project
- avoiding the need to secure the lending against the new facility. Commercial lenders may require, as security, rights over the asset, which could inhibit the sponsor council’s flexibility in future regarding ownership and management of the facility.

### Modelling method, assumptions and inputs

The purpose of the modelling is to estimate the size of savings which could arise from shifting a majority of local government borrowing to a national financing authority. As noted above, the primary financial benefit of a collective model is cheaper debt derived from scale and structured credit enhancement. The debt pricing which would be achieved by the preferred model can at this point only be estimated with a low level of confidence. However, a set of assumptions have been made to facilitate a calculation. The basis for these assumptions, and source of them, is in Table 4 below.

The modelling estimates the savings on debt repayments which may be achieved in each jurisdiction if the majority of local government borrowing (65%) was sourced from a highly-rated collective model. The estimates of saving also rely on assumptions about the proportion of total debt by tenor in each jurisdiction: for simplicity, it is assumed there is medium term borrowing (10 years) and long term borrowing (20 years), noting more interest is paid over longer loan tenors.

The estimate of savings is calculated as the interest expense in the baseline scenario less the interest expense in the national financing authority scenario. Interest expense is calculated using, for each jurisdiction and for the assumed volume of medium and long term debt, an amortising profile with semi-annual principal and interest payments.

In the national financing authority scenario, two interest rates are used for all jurisdictions: one for medium term debt and the second for long term debt.
In reality, different repayment profiles are used in the local government sector, including interest-only and sculpted repayment profiles. However, insufficient information is available to make an assessment of their frequency of use.

Table 4: modelling inputs

<table>
<thead>
<tr>
<th>Input categories</th>
<th>Inputs used</th>
<th>Source of inputs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume of debt</td>
<td>The debt requirement modelled approximates total debt outstanding across the sector. The aggregate used is $11.135bn. The breakdown by jurisdiction is: NSW 3,155m, NT 11m, QLD 5,836m, SA 721m, TAS 66m, VIC 702m, WA 644m. It is assumed that a minimum of 65% of the debt requirement in each jurisdiction would be sourced from the national financing authority. (An authority is unlikely to achieve pricing benefits without this volume of debt.)</td>
<td>NSW: DLG response to questionnaire, QLD: DLG response to questionnaire, WA: WATC Annual Report 2012, NT, SA, TAS, VIC: ABS catalogue 5512, for 2010/11</td>
</tr>
<tr>
<td>Term of debt</td>
<td>Two tenors have been used in the modelling: ► Medium term debt, which fully amortises over 10 years ► Long term debt, which fully amortises over 20 years</td>
<td>Information received from councils suggests that tenor tends to be between 10 and 20 years.</td>
</tr>
<tr>
<td>Pricing of debt</td>
<td>Two interest rates are assumed for each jurisdiction: ► a rate for medium term debt ► a rate for long term debt. Both rates are priced from the reference rates listed in the next column. The medium and long term rates used in each jurisdiction are listed below.</td>
<td>Reference rates: NSW, VIC: BBSW 90 day swap (AFMA, 12 Dec), QLD: QTC 5.75% coupon bond maturing 22/7/24 (Thomson Reuters, 12 Dec), WA: WATC 6.00% coupon bond maturing 16/10/23 (Thomson Reuters, 12 Dec), SA: SAFA 5.00% coupon bond maturing 20/5/21 (Thomson Reuters, 12 Dec 2012), TAS and NT: assume SA benchmark as no issuance beyond April 2015. An implicit assumption here is that all borrowing in a jurisdiction is sourced from either the commercial market or through a public sector agency. In practice, several states use a combination of both.</td>
</tr>
<tr>
<td></td>
<td>Medium</td>
<td>Long</td>
</tr>
<tr>
<td>NSW</td>
<td>4.260%</td>
<td>4.360%</td>
</tr>
<tr>
<td>NT</td>
<td>4.377%</td>
<td>4.477%</td>
</tr>
<tr>
<td>QLD</td>
<td>4.663%</td>
<td>4.763%</td>
</tr>
<tr>
<td>SA</td>
<td>4.377%</td>
<td>4.477%</td>
</tr>
<tr>
<td>TAS</td>
<td>4.477%</td>
<td>4.577%</td>
</tr>
<tr>
<td>VIC</td>
<td>4.260%</td>
<td>4.360%</td>
</tr>
<tr>
<td>WA</td>
<td>4.240%</td>
<td>4.340%</td>
</tr>
</tbody>
</table>

In most states, issuance does not go out to 20 years, and information on the pricing of commercial debt by tenor was anecdotal only. Consequently, the modelling is conservative on the assumed costs of longer term debt.

For the national financing authority scenario, the medium and long term rates are equivalent for all jurisdictions: ► medium term assumes 70 basis points over the 10-year Commonwealth bond rate ► long term assumes 80 basis points over the 10-year Commonwealth bond rate. The reference rate for the national financing authority scenario is the 5.50% coupon bond maturing April 2023 (RBA 12 Dec 2012). The margins over the reference rate assume an AAA-rated security and as noted earlier this outcome would ultimately be a function of the commercial arrangements in place to support an authority. The margins assumed are considered reasonable because they are...
<table>
<thead>
<tr>
<th>Input categories</th>
<th>Inputs used</th>
<th>Source of inputs</th>
</tr>
</thead>
</table>

- Pricing and credit quality

It is not possible to know precisely how the market would price instruments issued by the national financing authority. Yields, margins and spreads are determined by a range of variables including timing, size of issuance and liquidity, term, credit rating, and economic and market conditions.

Especially when market conditions are difficult, local government bonds have the potential to be very attractive to investors. At a minimum, the tax-raising powers of local government represent a stable and regular revenue-raising capacity to provide liquidity and ultimately security over repayments. In the historically rare events of distress, this is backed by the implicit support from other tiers of government enjoyed by the sector.

In the current macroeconomic environment, banks and other financial institutions are likely to systematically review their capital allocation to different segments and ensure that capital is preferentially allocated to segments that meet their requirements in terms of risk and return. Indeed, the introduction of APRA regulations implementing the Basel III recommendations around the quality of assets held by Australian authorised deposit-taking institutions (ADIs) presents something of a “window of opportunity”. The market has an appetite for low-risk investments, and the national financing authority could have the ability to provide them. Domestic investors, particularly banks, hold approximately 60 per cent of semi-government bonds outstanding. Anecdotal evidence gathered during the consultation suggests debt issued by a national financial authority would be similarly attractive.

The aim of the authority is to provide councils with the same opportunities that the Commonwealth, states and territories currently enjoy in terms of access to the institutional investment markets. Figure 2: Commonwealth Government, state government and corporate bond yields demonstrates that there is a clear pricing advantage a) between federal government and state government bond yields and b) between corporate and government bond yields. The national financing authority presents an opportunity to move into this space and provide further segmentation of issuance of government debt.

Figure 2: Commonwealth Government, state government and corporate bond yields (source: Reuters)

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It is difficult at this point in time to estimate the relative pricing of local government bonds with state government bonds, it is anticipated that they would be competitive or comparable (and the New Zealand experience provides a good indication that this is a reasonable expectation).

The appeal of securities issued by the national financing authority is likely to spread to international investors as well as domestic. Almost 80% of Australian Government issue, and about half of all semi-Government issue, are owned by foreigners.\textsuperscript{11}

\textsuperscript{11} Bank of New Zealand, Interest Rate Research, 13 February 2012.
## Appendix D
Local government financing vehicles overseas

The table below provides details about what are considered to be the most relevant precedents of local government collective financing vehicles overseas.

<table>
<thead>
<tr>
<th>Name</th>
<th>New Zealand Local Government Funding Agency Ltd</th>
<th>Kommuninvest Sverige AB</th>
<th>Municipality Finance PLC</th>
<th>KommuneKredit</th>
<th>KBN Kommunalbanken</th>
<th>Municipal Finance Authority of British Columbia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership</td>
<td>Member councils (88%) and the NZ Government (12%)</td>
<td>Subsidiary of Kommuninvest Cooperative Society (KCS) - owned by member councils.</td>
<td>Finnish Government (16%), councils (53%) and local government pension fund (31%).</td>
<td>Members (100%)</td>
<td>Norwegian Government (100%)</td>
<td>Non-share capital</td>
</tr>
<tr>
<td>Rating (Moody's/S&amp;P/Fitch)</td>
<td>-/AA+/AA</td>
<td>Aaa/AAA/-</td>
<td>Aaa/AAA/-</td>
<td>Aaa/AAA/-</td>
<td>Aaa/AAA/-</td>
<td>Aaa/AAA/AAA</td>
</tr>
<tr>
<td>Lending remit</td>
<td>Member councils</td>
<td>Member councils or entities guaranteed by member councils</td>
<td>Finnish councils and public housing entities</td>
<td>Danish councils or entities guaranteed by councils</td>
<td>Councils or companies in the local government sector</td>
<td>Regional districts, member municipalities, regional hospital districts</td>
</tr>
<tr>
<td>Guarantee Structure</td>
<td>Joint and several guarantee from local and regional governments</td>
<td>Members of KCS sign a guarantee to be a member of Kommuninvest.</td>
<td>Municipalities on a joint pro-rata basis through Municipal Guarantee Board</td>
<td>Joint and several guarantee from all local and regional governments</td>
<td>Letter of support from Norwegian Government</td>
<td>Joint and several guarantee from municipalities</td>
</tr>
<tr>
<td>Liquidity Policies</td>
<td>Hold liquid assets equivalent to at least 10% of LRG assets. Access to a liquidity line from New Zealand's DMO initially NZ$500m increasing to NZ$1bn over 4 years. Portfolio repo-eligible</td>
<td>Primary liquidity reserves of at least 4% of total assets (currently 4% or SEK9bn) and a total liquidity reserve equal to a minimum 24% of the balance sheet ready to be sold (highly liquid prefunding of SEK45bn)</td>
<td>Carry sufficient liquidity to carry on normal operations absent of new funding. Liquidity portfolio invested in liquid instruments (EUR5bn equivalent to 44% share of lending) and committed bank lines of EUR140m.</td>
<td>Funding should at all times exceed lending. Ability to keep 25% of lending as prefunding. Currently stands at 17%</td>
<td>Available liquidity should equal 100% of net cash requirements for 12 months.</td>
<td>Debt service reserve fund and sinking fund of C$1.5bn, 180% of next 12 months debt service cover. Additional C$200m on demand back stop facility and 2 C$250m CP back-up lines</td>
</tr>
<tr>
<td>Market share</td>
<td>Forecast 30% by 2014</td>
<td>40%</td>
<td>-50%</td>
<td>&gt;90%</td>
<td>47%</td>
<td>Not known</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th><strong>Lending activities</strong></th>
<th>At 30 June 2012, 14 out of the 18 participating local authorities borrowed a total of $819m</th>
<th>Lending on 30 June 2012 amounted to SEK 187.9b</th>
<th>As at 30 June 2012, total loans amounted to €14,680m</th>
<th>In the first half of 2012, total gross lending was DKK 19,284 and total net lending was DKK 8,644</th>
<th>In the first three quarters of 2012, KBN paid out NOK 23.2b in new loan disbursements. Total loan growth during this period was NOK 8.7m (4.2%), below their target of 6%</th>
<th>Loan balance in 2011 was C$4.8b</th>
</tr>
</thead>
</table>
| **Fundraising activities** | At the final bond tender for 2012 (12 December 2012), LGFA's bond outstandings increased to over $1.5b | In total, SEK 64b was raised in long-term debt instruments during the first six months of 2012. During this period, a total of SEK 25b in long-term borrowings matured | Total funding acquisition for January-June 2012 amounted to €4,930m. Total amount of funding to June 2012 grew to €22,820m. In 2011, raised more than 99% of its funds outside of Finland | In 2011, total funding amounted to DKK 62.6b. In 2011, the following were issued:  
- Debt securities: DKK 11.1b  
- Adjustable rate loans: DKK 7.4  
- Structured bonds: DKK 1.3b  
- Traditional bonds: DKK 593m  
- Non-callable bonds: DKK 1.8b. Estimated long-term funding budget for 2012 was €4b | New borrowings for the first three quarters of 2012 amounted to NOK 93m. KBN completed its USD benchmark program for 2012 with three issuances totaling USD 4b. | In 2011, MFA issued a 5-year C$515m debenture that provided a yield to investors of 3.029%, which was the largest in size and set a record as the lowest yield |
Appendix E
Credit rating process

The role and importance of the credit rating

Obtaining a rating from a reputable credit rating agency or agencies is an important part of building market confidence and achieving the lowest possible pricing for securities issued to the market. A poor credit rating leads to the likelihood of higher finance costs due to the perceived risk of default.

Credit rating agencies assess an entity’s risk profile to enable investors to make decisions on the ability of the entity to meet its obligations. This involves quantitative risk analysis, including comparing financial ratios with chosen benchmarks, and qualitative analysis, which focuses on the management character, legal, political and economic environment in which it operates.

Rating methodology for government-related entities

It is anticipated that the local government financing authority would be rated by the major agencies as a government-related entity.

The methodologies used by the major ratings agencies for rating government-related entities are similar in substance with some minor variances. Credit ratings are therefore generally, but not always, consistent.

The approach to rating government-related entities generally involves the consideration of their credit quality as falling between the inclusive bounds formed by:

- the entity’s stand-alone credit rating, which represents the entity’s credit quality in the absence of extraordinary support or burden, and
- the government's rating, which is a function of the government's ability to support (or, in a negative scenario, its need to avail itself of the resources of) the entity.

The proximity of the final assigned rating to either of these ratings is a function of the perceived likelihood of sufficient and timely extraordinary government intervention in support of the entity meeting its financial obligations, and the default dependency between the two entities.

In circumstances where the government will likely extend timely extraordinary support, the rating of the entity tends to be close to, and move in tandem with, that of the government. Conversely where the entity’s importance to government is low and the two entities are not closely linked, likelihood of government support is low and the entity rating will bear closer resemblance to its stand-alone credit rating.

Final assessments will always be a function of issuer- and issue-specific attributes as well as assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodologies and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect credit judgment.

Determining the likelihood of sufficient and timely extraordinary government intervention

Ratings agencies have different methods of assessing the likelihood of sufficient and timely extraordinary government intervention. Two such approaches are explained below.

(1) Standard & Poor’s

To determine the likelihood of sufficient and timely extraordinary government intervention, Standard & Poor’s assesses two factors: the importance of the entity’s role to the
government and the strength and durability of the link between an entity and the government.

- **The importance of the entity’s role to the government**
  
The importance of the entity’s role to the government is based upon the severity of the effect that a default of the entity would have on government or the local economy, in the absence of government intervention. An entity may be important to the government either because it implements a key national policy, provides an important public service, or because it affects the proper functioning of an important economic sector.

  Quantitative indicators include the number of employees, the entity’s revenues as a percentage of the country's GDP, its share in national exports, its share in the production of energy for the country, or its share in national deposits for a bank also point to the entity’s importance to government.

- **The strength and durability of the link between an entity and the government**
  
The strength and durability of the link between an entity and the government is based upon the degree to which the government drives the entity’s strategy, operations and by its level of supervision. Analytical considerations include the percentage of ownership of the entity, the existence of a partial or ultimate government guarantee of the entity’s obligations, and reputational risk to the government should the entity default.

  An opinion on the government's general propensity to intervene in the entity’s sector in a credit supportive and timely manner is assessed including a view of the government's current willingness to support a particular entity, its track record of past interventions, its degree of involvement in the day-to-day operations of its entities, but also the cultural and political aspects related to the government’s intervention and its administrative capacity to provide timely support.

  In governments where there is a high propensity to intervene, it is generally assessed that the link between the government and its entities is stronger than for governments with a low propensity to intervene. If there is doubt regarding the willingness and/or capacity of the government to provide timely support for policy reasons, weak administrative capacity, or past practices, the link between the government and its entity is generally considered to be low, even if the entity has a critical role.

  The two factors are used to form an assessment of the likelihood of sufficient and timely extraordinary government intervention as follows:
Moody's assesses the likelihood of sufficient and timely extraordinary government intervention through their 'support scorecard' and consider the institutional framework (which includes legal requirements or barriers, government policy stance, degree of oversight, reputation risk and moral hazard), historical behaviour, and individual characteristics such as political relationships, strategic role and debt structure.

Moody's estimates the default dependency between the two entities based on the following factors:

- **Intergovernmental fiscal arrangements**
  Does the entity rely on fiscal transfers from higher levels of government? Substantial transfers increase likelihood that the entity's and governments revenues are highly correlated.

- **The degree to which own-source revenue bases overlap**
  Does the entity rely on similar own-source revenues as government (e.g. taxes, fees)? If so, adverse economic conditions would most likely impact both parties similarly.

- **The economic relationship between the two**
  Is the entity insulated from economic shocks impacting on the government? Does the entity perform strongly throughout the business cycle?

Based upon these questions, an entity is matched to one of a number of scenarios in a “dependence scorecard” as follows:
Other considerations

The following considerations, which may be relevant to the national financing authority, are also taken into account by rating agencies when assessing government-related agencies.

Where an entity has links to more than one government

Agencies analyse both the nature of the link between the entity and each single government, as well as the relationships between the different governments. If one government has a prominent link to the entity and appears likely to fully support the entity, its rating will generally apply. If government support is provided by all governments on the basis of their respective share, the lowest rating would generally apply. If “joint and several” support is expected, the entity's rating could be higher than their stand-alone credit rating. Conversely if slow decision making or asymmetries in interests could weaken support to the entity, it may reduce the likelihood of obtaining a strong rating.

Extraordinary government intervention may impair an entity's rating

While in most cases the likelihood of extraordinary government intervention enhances an entity's rating above its stand-alone credit rating, in a few instances government intervention is detrimental. An entity rating below its stand-alone credit rating may reflect the expectation of extraordinary negative intervention from the government, for instance through a tendency to increase taxes and dividends, to require the entity to provide subsidies, or to restrict the entity's flexibility in some other way in a period in which government faces fiscal or external stress.

Rating an entity above the rating on its government

Whilst generally a rarity, an entity may be rated above the government if the entity's ability to service its debt is superior to that of the government and that, ultimately, if the government defaults on its foreign currency debt, there is a measurable likelihood that the entity will not default. For this to happen, the first condition is that the entity's stand-alone credit rating will exceed the government's foreign currency rating. The second condition is that the government's willingness and ability to impair the entity's credit standing in periods of stress should be limited.
Rating an entity's junior obligations

Governments may not necessarily support entities in a manner that equally benefits all security holders. Indeed, supporting the entity's higher-ranking obligations may be to the detriment of lower-ranking, and specifically subordinated and/or deferrable, obligations, as contemplated by the terms of their respective issuances. Therefore, as for any other entity, specific obligations issued by an entity might be rated differently from its issuer credit rating. Hybrid capital or other subordinated obligations may be rated below the issuer credit rating or senior obligations if it is anticipated that intervention could be less beneficial (and possibly negative) than for other obligations.

Rating an entity's subsidiaries

When rating a subsidiary of an entity, the subsidiary's relationships with both its parent entity and the government are analysed. Generally a subsidiary will carry a lower rating than its parent, as the importance of the entity to government is lower and the link is more indirect. As such, extraordinary support by government is less likely. But in circumstances where the subsidiary may have a prominent role and links with government, it may be rated in the same manner as an entity and hold a higher rating than its parent.

Sources

- Moody's Investors Service, Global Credit Research, The Application of Joint Default Analysis to Regional and Local Governments
- Moody's Investors Service, Global Credit Research, The Application of Joint Default Analysis to Government related Issuers
- Standard & Poor's, Global Credit Portal, Rating Government-Related Entities: Methodology and Assumptions
Status and limitations

We would like to acknowledge the assistance and support provided by the Department of Regional Australia, Local Government, Arts & Sport. In particular, the Department assisted in providing access to the Inter-jurisdictional Working Group on Local Government, which consists of representatives of all state and territory governments, the Commonwealth and the Australian Local Government Association. Through this group we were able to access the preliminary views of key governmental stakeholders, and we would like to express our gratitude to the members of the group for their cooperation.

We note, however, that due to time constraints, we were only able to consult with the group during the initial stages of the study. Although we have attempted to take the groups’ views into account as much as possible, we have not been able to test our findings with its members or engage them in the evaluation of options.

We also consulted with other stakeholders including the Commonwealth Treasury, state treasuries, local government representative organisations, councils, financiers and ratings agencies.

We emphasise that the findings and recommendations in this study are preliminary. We would strongly recommend further consultation and refinement of the analysis.

Confidence in the recommended option is based solely upon a high level evaluation of a long list of options against the identified criteria. We have relied on our own knowledge and on the input received from stakeholders. We may not have considered all relevant options or issues. The analysis has not been subject to legal advice.

In particular, the financial modelling we have performed is high level and would need to be developed further. We have relied upon the inputs and assumptions provided to us and other assumptions discussed with the Department. The model has been developed in good faith and in the belief that the information provided to us was not false or misleading. We have not audited or reviewed any of the inputs or assumptions provided to us.