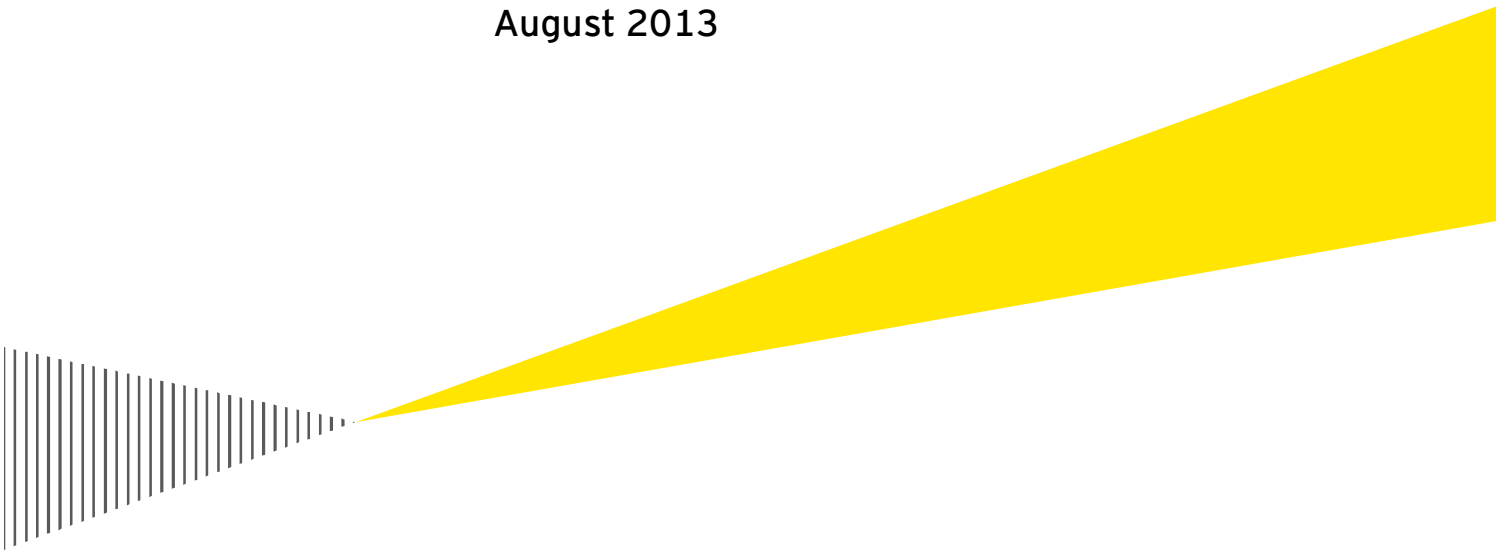
Infrastructure financing solutions for Australia's capital cities

Council of Capital City Lord Mayors

August 2013



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Executive summary: Infrastructure financing solutions for Australia's capital cities

Key findings

- Australia's capital city councils are in a uniquely strong position to move towards a more favourable debt load and make better use of available or alternative sources of finance for their identified capital investment needs.
- There is not a unanimous view within the group of capital city councils in respect to the immediate need for borrowing.
- For those cities that are already able to borrow via state government borrowing agencies, this is likely to remain the cheapest form of borrowing available in the short and medium term.
- For those cities that do not have access to state government loans, directly sourced bank debt is likely to provide the most suitable and cost-effective form of debt finance for most small and medium requirements.
- For those cities with larger borrowing requirements, significant savings are likely to be achievable through issuing a public bond into the Australian market.
- Councils may be able to achieve favourable outcomes if they were to enter into collective borrowing arrangements with other councils.
- Were a future Commonwealth Government to consider tax concessional arrangements for lenders, and capital city borrowing was to qualify, this could further reduce costs for borrowing councils.

Debt has a role in the delivery of infrastructure in Australia's capital cities

Borrowing always comes with risks and costs. These costs include not just interest payments but transaction costs, complex processes and due diligence requirements. The decision to borrow must always be made on a needs basis, supported by a robust analysis of the capacity to service and repay the debt.

But the key attribute of debt is that it can allow the smoothing of payments for new investment over time and enable the cost of infrastructure to be shared with future generations who will enjoy the benefit of the asset. The risks and costs must therefore be weighed up against the upside of being able to deliver or bring forward key infrastructure priorities, which might not otherwise have been possible.

Despite this potential upside, within the local government sector as a whole, borrowing is underutilised as a means of reducing the large and growing backlog of priority projects and programs.

Capital city councils, more than most, have the capacity to arrest this trend. Financial analysis indicates that capital city councils have low borrowing levels and a high portion of own-sourced revenues – together indicating a strong ability to repay debt. Compared with other councils, they have strong rates bases, significant commercial incomes, advanced asset and financial management capabilities, and projects with greater capacity to generate commercial revenues.

Each city is different in terms of size and financial profile, and therefore has different capital requirements (some requiring no borrowing at all). But these characteristics mean that – on paper – Australia's capital cities are in a uniquely strong position to move towards a more balanced debt load and make better use of available or alternative sources of finance, should the capital need be identified. This is because the types of project they deliver and the mix of revenues they receive represent robust credit fundamentals and provide a basis for engaging advantageously with the financial markets.

The challenge for capital city councils is to ensure that they operate with an optimal capital structure, thus enabling infrastructure investments with lumpy cost profiles to go ahead and be brought forward. An optimal capital structure means a debt load that can comfortably be carried – both in a financial sense and in the eyes of stakeholders and the community.

To achieve the most favourable debt load, in some circumstances there is likely to be a strong case for moving away from conventional borrowing strategies.

Moving towards an optimal capital structure should include consideration of alternative sources of debt

Although not explored in detail in this report, we believe that councils would be able to achieve favourable outcomes if they were to enter into collective borrowing arrangements with other councils. This would give the market the opportunity to provide a lower cost of borrowing based upon the combined credit credentials and economies of scale associated with bundling. Although capital cities may be more financially self-sufficient than many other councils, the benefits could still be significant.

However, we recognise that the capital city councils do not currently forecast a role for themselves in collective finance raising, and therefore the findings in this report are based on individual borrowing scenarios.

Many councils (including four of the six capital cities included in this study) are already able to borrow from state government borrowing agencies (directly or, in the case of Adelaide, indirectly through the Local Government Finance Authority of South Australia) and they receive financial advantage from doing so through lower interest rates and arrangement fees that would unlikely be matched in the banking or capital markets sector. For these councils, state-supported finance is likely to remain the cheapest form of borrowing available in the short and medium term.

For those capital city councils that do not have access to state government loans, directly sourced bank debt is likely to provide the most suitable and cost-effective form of debt finance for most small and medium requirements. Banks offer flexibility and simplicity because loan tenor, repayment structures and debt service arrangements can be tailored to the council's forecast cash flows. The application and establishment process is straightforward, with minimal information requirements, and execution risk is low. Pricing varies and fluctuates between banks and over time, but the opportunity to run a competitive process can lead to favourable pricing outcomes for borrowers.

For those councils with larger borrowing requirements, significant savings are likely to be achievable through issuing a public bond into the Australian market. The costs of issuing

bonds can be higher than councils may be used to in securing debt financing and, on this basis, a one-off bond issue of less than $100 million may not be an efficient financing strategy, even if the coupon achieved was comparable to other debt alternatives. For a larger issuance, however, the savings when compared with conventional bank debt can be material over the term of the instrument. Illustrative preliminary analysis indicates that the saving could be around $3 million for a $100 million issuance or $7 million for $200 million issuance over ten years.

Were a future Commonwealth Government to consider tax concessional arrangements for lenders, and capital city borrowing was to qualify, this could further drive down costs for borrowing councils.

There is not a unanimous view within the group of capital city councils in respect to the immediate need for borrowing. Some have indicated they do not forecast any borrowing in the near team. Others have major projects in the pipeline and they are open-minded to new financing strategies.

Any future borrowing activity would need to take regard of the legislative constraints that are placed on local government by state governments. And nothing should take away from each and every council the responsibility for sound financial management and decision-making. Ultimately, decisions about whether to borrow will remain a question for individual councils based upon the relativity of the benefit of the proposed use of funds and the ability to meet the payments associated with it.

Summary evaluation of alternative source of debt

The table below summarises the evaluation of alternative debt solutions.

Table 1 Evaluation summary

Mechanism	Evaluation	
Bank term loans	Bank term loans are considered to be a simple, flexible and cost effective source of finance for local government.	
AUD public bond	AUD bonds have the potential to provide considerable pricing benefits, but involve a greater degree of complexity in going to market when compared with bank term loans.	
US public bond	Overall, the complexity of issuance and the risks of hedging are considered to outweigh the potential pricing benefits of this option.	
US private placement	Overall, the complexity of building relationships with offshore investors and the risks of hedging are likely to outweigh any potential pricing benefits associated with this option.	
AUD private placement	Potential to be complex, with an unknown pricing benefit.	
AUD retail bond	Moderately flexible and complex but unlikely to provide the most attractive pricing and cost benefit.	

1. Introduction

Objective

The Council of Capital City Lord Mayors (CCCLM) comprises the civic leaders of Australia's eight capital cities (including the Chief Minister of the ACT).

Ernst & Young has been engaged by the CCCLM to explore the use of alternative debt solutions for financing local government infrastructure in Australia's capital cities. This report presents our findings and recommendations.

The primary objective of the report is to examine a range of financing mechanisms available to capital city councils in Australia. A secondary, connected, purpose is to identify the links between the infrastructure task faced by the capital cities and the role of borrowing, and to comment on how achieving an optimal capital structure through an alternative debt load might affect their ability to accelerate investment in the most pressing infrastructure priorities.

Capital cities included within the study

The scope for this study covers six of Australia's capital cities: Adelaide, Brisbane, Hobart, Melbourne, Perth and Sydney. As advised by the CCCLM, the specific requirements of the City of Darwin and the ACT Government have not been examined as part of this work; however a number of the findings and recommendations apply to Darwin and Canberra too.

In this report, the word "city" or the name of a particular city refers to the statutory local government area covering the CBD within each city, for example "Adelaide" refers to Adelaide City Council, "Brisbane" to Brisbane City Council, and so on.

Consultation

The report is structured in such a way that it focuses initially on the challenges facing the capital cities, before identifying and evaluating alternative strategies, including a suite of alternative sources of debt. Solutions are identified and evaluated based upon the problem identified, rather than used as a starting point for the analysis.

In light of this, it was considered to be an important step as an opening stage of the review to consult with representatives of each capital city. To this end, in May 2013, Ernst & Young interviewed each member of the CCCLM working group (listed below) with the objective of understanding the infrastructure task facing each capital city and the role of debt finance, and of seeking preliminary views on the key drivers and criteria for evaluating potential solutions.

Adelaide:	Mark Gray
Brisbane:	Scott Stewart
Hobart:	David Spinks
Melbourne:	Mark Stoermer
Perth:	Ian Berry
Sydney:	Bob Wallace

We would like to express our gratitude to the members of the CCCLM working group for their cooperation in this consultation process.

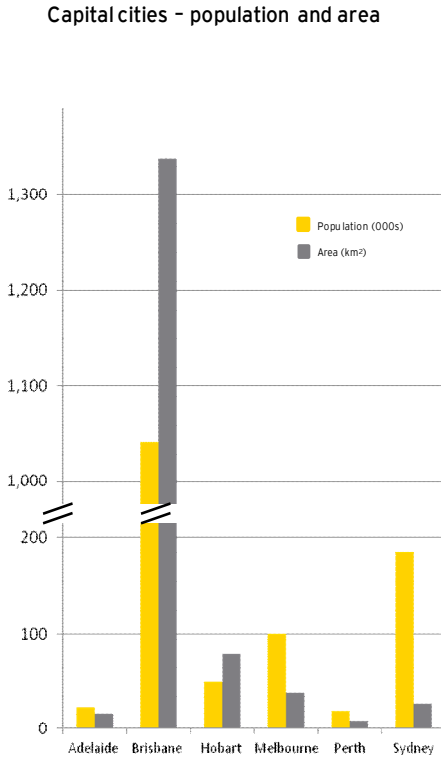
2. Local infrastructure in Australia's capital cities

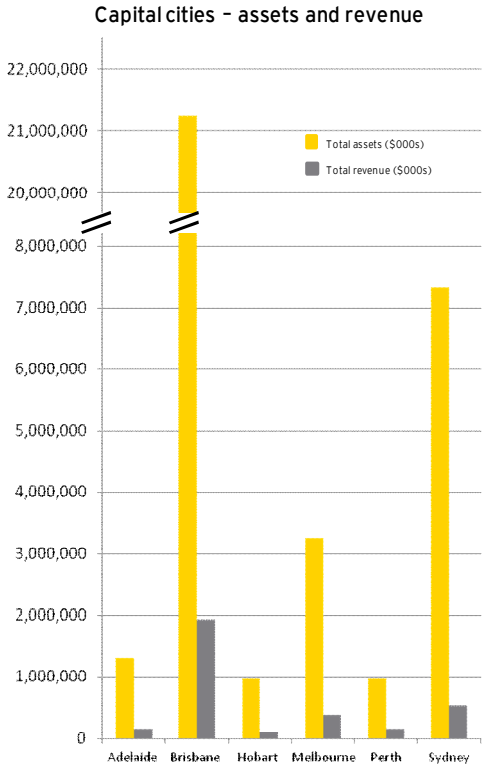
Australia's capital cities

Figure 1: Capital cities included within this study

Australia's capital city councils are all unique. Each one is different in respect to the size and distribution of its population, its social and economic fabric, its politics, governance and its plans for growth. Furthermore, each one is subject to a different set of jurisdiction-specific laws and political environment at the state government level.

Figure 2: Capital cities – a snapshot[1]





[1] Data sourced from most recently available annual report of each city council.

As the graphs above clearly illustrate, by virtue of its size alone, Brisbane stands out within the group of six cities.

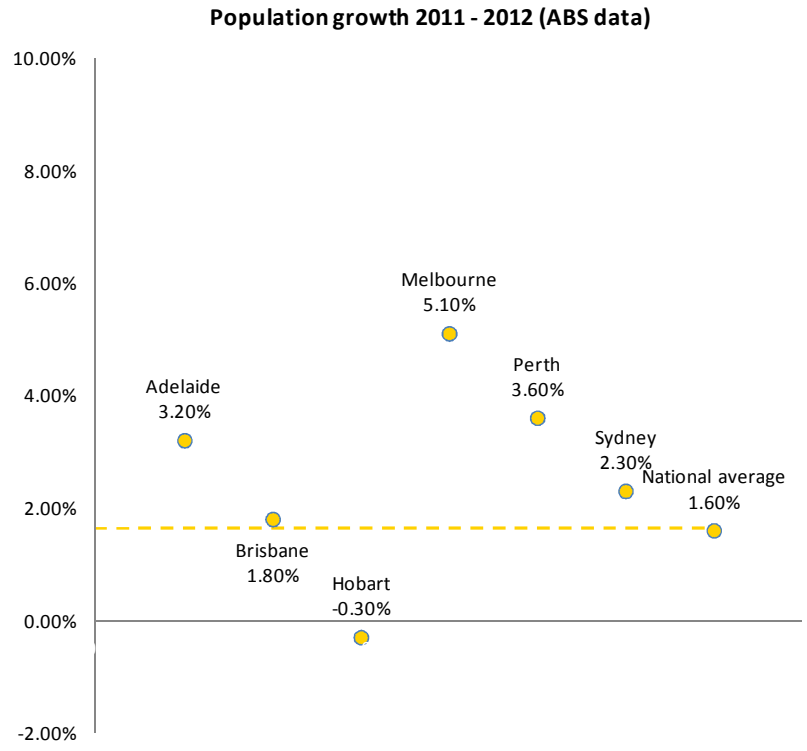
Brisbane City Council famously has a budget comparable with some state governments and is easily the largest council in Australia. The next most populous city council in the group, Sydney, has a population about six times as small. The smallest of the cities, Perth, has a population which represents one fifty-fifth of Brisbane's. The vast differences in population size are reflected in the large differences in total council assets, costs and revenues.

The peculiarities and idiosyncrasies of each capital city – such as the differences in population bases – have arisen as a result of the confluence of multitude of factors – historical, social and political. In analysing the requirements of the capital city councils we have been cognisant of these differences, and respectful of the fact that what works for one city might not work for the others.

And yet despite the clear differences is size and shape, there are some important common factors which bind Australia's capital cities together. These include the following:

- Each capital city is the most populous city in its respective jurisdiction.
- With the exception of Hobart City Council, the capital city councils are growing fast – faster than the national average and some significantly faster.

Figure 3: Population growth in the capital cities



Population growth is anticipated to continue into the future in the capital cities. Brisbane City Council is expected to add 187,000 people (or 17%) by 2031.[2] Adelaide is expected to add 18,000 people (84%), Melbourne 73,000 (67%), and Perth 13,000 (62%).[3]

[2] Brisbane City Council, *Brisbane Long Term Infrastructure Plan 2012-2031*
[3] http://forecast2.id.com.au/default.aspx?id=105&pg=5000; http://forecast2.id.com.au/default.aspx?id=128&pg=5000; http://forecast2.id.com.au/default.aspx?id=284&pg=5000

- Within each state, the capital city is the focus of economic, political and cultural activity. It is where judicial, administrative and legislative duties are performed for the state. It is the main gateway in and out of the state, the seat of government, and the "face" of the state to the outside world.
- The capital cities are gateways not just to the state in which they are located, but to and from the rest of Australia too. For example, 47% of all international business visitors to Australia arrived through Sydney Airport in 2012.[4]
- Each capital city local government area includes a CBD. CBDs are distinctive in that they are the focus of concentrated business and cultural activity and have unique requirements in terms of access and amenity as a result.
- Because of their role as the "face" of - or gateway to - the state, in capital cities there is a greater degree of interface with state governments than might be the case in other councils. Local and state governments have a common interest in investing in the CBD, something which can present both challenges and opportunities for the infrastructure task.

The infrastructure task for capital cities

As with every local government in the country, the infrastructure provided and maintained by the capital city councils plays a very important role for the community it serves. It provides access to welfare, education, transport, sport and recreation, and serves key environmental functions such as waste collection and disposal.

And being a capital city brings some extra responsibilities, challenges and pressures when it comes to the infrastructure task – mainly driven by the unique role outlined above – that are not faced by other councils.

On any given week day, for example, 600,000 people travel into Sydney CBD for work, study, shopping and sightseeing.[5] These people do not live in the City of Sydney and they are not City of Sydney ratepayers (although their employers may be). But they are users of council infrastructure.

Partly as a consequence of this role, capital city councils have in many cases evolved in such a way that they now possess a greater degree of responsibility for assets and services that are in other places the responsibility of higher tiers of government. Capital cities, more than any other type of council, have moved well beyond the traditional focus on the three "Rs" of rates, roads and rubbish. That model has long been outgrown as Australia's major cities have established themselves in the global marketplace. By way of example, Brisbane City Council runs a major public transport system.

This can, however, result in an interface or overlap with the role and activities of state governments. In Adelaide CBD, for example, the South Australia Government is investing in a new hospital, upgrading the convention centre, the Adelaide Oval and the city's transport infrastructure. The interface with this kind of state government activity can create not only practical issues (such as traffic management) but also a risk of contradictory priorities for a single geographic area.

Furthermore, the projects delivered by the capital cities are amongst the biggest projects in local government. While the transport projects delivered by Brisbane City Council are not the norm across the local government sector as a whole, each of the six cities has been or is involved in projects whose size is above average within the jurisdiction in which it is located.

For the coming period, each city has its own pipeline of investments, which include:

[4] http://now.nsw.gov.au/Data-Sources.html
[5] http://www.cityofsydney.nsw.gov.au/learn/youve-gotta-love-this-city

- Public transport projects: light rail in Sydney CBD and the Perth City Link.
- Road projects: Kingsford Smith Drive upgrade in Brisbane.
- Urban renewal and regeneration: the upgrade of Victoria Square and Rundle Mall in Adelaide, reinvigoration of the CBD and surrounds pursuant to the *Inner City Action Plan* in Hobart, renewal of Arden-Macaulay in Melbourne, and regeneration of Green Square in Sydney.
- Housing: the Key City Worker Housing project in Perth and completion of the 'Ergo Apartments' affordable housing development in Adelaide.
- Various library, stormwater, drainage, waste, and other capital programs, plus significant asset renewal and maintenance backlogs.

The conclusion to be drawn from the consultation undertaken, and from other sources such as publicly-released plans and budgets, is that the extent of the infrastructure task in Australian capital cities is significant and not getting any smaller. This is evidenced by indicators such as high demand for assets, maintenance backlogs and rising renewal costs. In light of this, it is unsurprising that the capital city councils are looking closely at their funding and financing capacity and the optimal way to apply capital to addressing the challenge.

Funding the infrastructure task – revenue sources

There are three core sources of revenue which all Australian councils have the capacity to leverage for the purposes of expenditure on infrastructure and services. These are rates and taxes, sales of goods and services, and government grants. Sales of goods and services includes payments for the issue of licenses and permits, development contributions, and users charges applied for parking, community services, libraries, recreation centres and other council-provided facilities. Together, sales of goods and services and rates are generally known as own-source revenue streams.

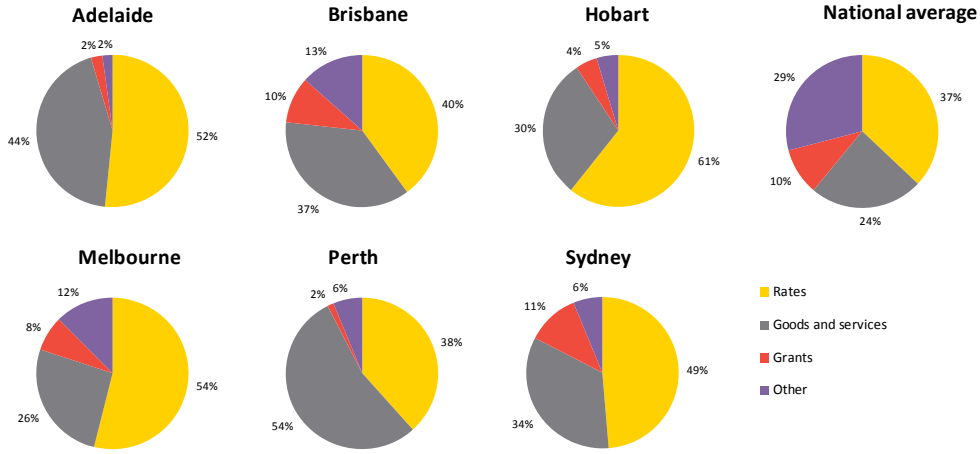
The relative contribution of the different income streams varies considerably from council to council. There is clear statistical evidence of the correlation between the demographic characteristics (including population density and mix of economic activity) of a local government area and the relative amount of own-source revenue that the council raises.

Unsurprisingly, the more urbanised the council, and the more advanced the economic activity within the council area, the greater its ability to raise money from own-source income streams such as taxation (rates) and the sale of goods and services. Equally, it has long been recognised that rural and remote councils have very little capacity to raise their own revenue and are, as a result, heavily dependent upon grants.

When it comes to the six capital cities, it follows that own-source revenues play a significant role in the overall funding mix. As the charts below demonstrate, combined, sales of goods and services and rates make up 96% of revenue in Adelaide, 77% in Brisbane, 91% in Hobart, 80% in Melbourne, 92% in Perth and 83% in Sydney – in all cases well above the national average of 61%.

Similarly, with the exception of Brisbane and Sydney, the contribution of grants income to the overall funding mix is considerably lower than the national average. The grants revenue for Brisbane ($187 million in 2012, or around 10% of total revenue) is higher than normal in the reported period due to the impact of the flood events that were experienced in the city in recent times. Excluding the abnormal receipts from the Natural Disaster Relief and Recovery Arrangements (NDRRA) would reduce the percentage contribution from this area to about 7%.

Figure 4: Capital cities – revenue splits[6]



The high relative contribution made by own-source revenue in Australia's capital cities is driven by two factors:

- **Rates base**

  Capital cities generally have relatively strong rates bases. Rates are a tax levied by councils upon residential and commercial property, based upon the value of land (normally capital improved). In capital cities, demand for land is high because of economic and cultural activity, and this drives land values up. High land values do not automatically mean high rates receipts (because of the way rates are set in the budget process), however it does mean that capital city councils have a higher base than other types of council from which to levy the tax. Rates represent a very secure source of funding as councils can enforce payment by means of a charge over property. They also have the ability to raise the rate at which rates are applied (although this ability is in some cases restricted, notably in New South Wales, where the councils must apply for Ministerial approval to raise rates above a pre-determined level).

- **Commercial assets and activities**

  As a general rule, the local government sector across Australia has relatively few assets which produce commercial returns. But of all types of council, it is the urban centres – and particularly capital cities – that have the greatest ability to buck this trend and engage in commercial infrastructure management, taking advantage of their unique ability to draw upon the purchasing power of a concentrated residential and business catchment areas. For example:

  - All of the capital city councils engage in commercial car park operations. The City of Perth operates 15,000 bays and earned $62.8m in parking fees in 2011-12, 40% of all its revenues combines. The City of Adelaide also has a considerable car park business, operating 6,500 off-street parking pays and 13,000 regulated on-street bays.
  - The City of Melbourne has two wholly-owned commercial subsidiaries: CityWide Service Solutions Pty Ltd (a company established to provide contract services on a competitive basis to local government and other public and private sector clients) and Queen Victoria Market Pty Ltd (a company established to manage and develop the Queen Victoria Market).

Despite the relatively large contribution made by own-source revenue streams to the funding mix in capital cities, there remains a large infrastructure deficit, implying that

[6] Data sourced from latest council annual reports. National average: Ernst & Young, *Strong Foundations for Sustainable Local Infrastructure*.

these revenues – however large – are insufficient to generate significant surpluses for capital city councils. This is because, firstly, they are often based on cost recovery, and not profit-making principles. And secondly, they are not unlimited pools of capital:

- There are caps on rating and development charges (whether in regulation or limited to 'cost recovery' charging only) in some jurisdictions.
- There can often be political imperatives not to raise rates and charges.
- Commercial income such as car parking revenue is (to an extent) limited by competitive forces.

There are two conclusions to this which are relevant to the financing task – and these are explored further below. Firstly, despite enjoying a funding mix in which discretionary revenue streams play a large role, there is a role for alternative sources of funds and finance. Secondly, when it comes to financing, the existence of large own source funding streams means that capital cities will be considered by the market to have stronger credit credentials than other councils that do not have the ability to tap into revenue sources of this type.

Funding the infrastructure task – capacity and capability

It has been widely observed that a key problem facing the local government sector in many areas is a lack of skilled resources required to develop and deliver infrastructure projects on time and on budget.[7] The ability to run a competitive procurement process and achieve efficient pricing is an important example of the link between skills and infrastructure provision.

The capacity of local government in this regard is highly variable by geographic location and type of council. Arguably, the capital cities are generally relatively sophisticated and can attract high quality staff – this is because of their location, status, budget and the perception that they offer career opportunities not available elsewhere in the sector.

Improvements to asset management techniques in recent years is providing councils (both elected members and officers) with a better appreciation of the whole-of-life costs associated with infrastructure.[8] Capital city councils appear to be leading this upward trend. One implication of this, which is relevant to this study, is that there is an ever greater awareness of the implications of unduly low levels of debt upon councils' ability to invest in their assets.

Advanced asset management gives capital cities a greater level of certainty in future planning. However high the level of sophistication, there is always an element of uncertainty in forward planning. Of particular concern to representatives of two of the six capital cities interviewed for this study is the specific uncertainty caused by the prospect of structural reform within the local government sector through the amalgamation of councils.

There are a number of benefits that can potentially be realised by amalgamation in the form of economies of scale and other efficiencies. In previous cases of structural reform, the argument in favour of amalgamation is usually founded upon the desire to harmonise strategic and community planning, improve financial and asset management, and design better approaches to planning and business procedures.

For capital cities, however, there could be significant risks when it comes to amalgamation. These are largely based on the fact that capital city councils are generally strong performers, and amalgamation could lead to them merging with weaker councils. Amalgamation with neighbouring councils in weaker financial positions and with more pressing infrastructure requirements could change the nature of the capital city council's

[7] For example, Ernst & Young, *Strong foundations for sustainable local infrastructure,* 2012
[8] *Ibid*

capabilities - one capital city estimates that in a likely amalgamation scenario, the current jurisdiction might account for 50% of assets in the new larger council, but 90% of the revenues – effectively meaning that the 'old' capital city council would be in a position of subsidising the extended council.

Structural reform could have a significant impact on the financial position of a capital city council and a flow-on implication on its capacity to raise and service debt.

3. The role of debt in Australia's capital cities

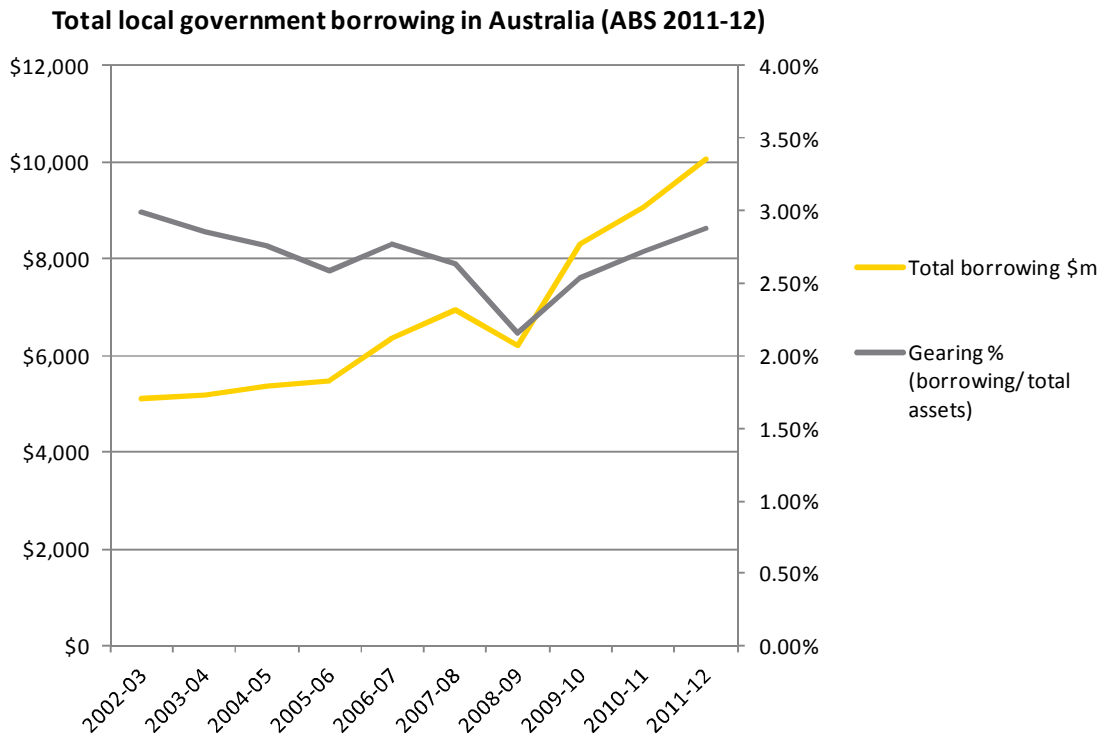
The role of debt in the local government sector

Across the Australian local government sector as a whole, councils tend to adopt a cautious approach to borrowing. There remains a clear reluctance to borrow to pay for infrastructure, and overall levels of debt are low. Ernst & Young's report for the Commonwealth, *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
- a 'cultural' reluctance to borrow based upon an overly negative assessment of the risks and costs involved.

Debt plays a small role in the balance sheet of most Australian councils. ABS data shows that, nationally, debt represents only 2.8% of net assets. Furthermore, interest payments represent 1.4% of total council revenue, evidence that there is greater capacity to service borrowings.

Figure 5: Local government borrowing 2011-12



As the figure above demonstrates, although the overall quantum of borrowing in the sector has grown over the last decade, its role in the overall capital mix (represented by the gearing ratio) has remained at a relatively constant – and low – level.

Whilst gearing levels appear to be low, this is largely a reflection of the fact that much of a council's balance sheet is represented by non-income producing assets. Basic financial gearing ratios using asset value may not necessarily be the most suitable way to analyse the borrowing capacity, especially in light of the diversity of balance sheets across the sector. 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".[9]

In the analysis of capital city debt profiles below, we use debt service coverage ratios as a more suitable indicator of the capacity to borrow.

Notwithstanding the limits of 'blunt' financial ratios, they do provide a useful illustration of the overall debt position taken by councils, and are supported by other more qualitative indicators, such as the following:

- Queensland Treasury Corporation reports that 22 of 73 councils in the state have no outstanding debt at all.[10]
- A third of councils in South Australia 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."[11]

It may be that councils with low (or no) debt 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.

The more likely reason for a low debt position is that, as not-for-profit organisations, councils are generally reluctant to increase the revenue burden on the community, thereby constraining their capacity to increase debt levels further without offsetting savings to service the debt.

The role of debt in Australia's capital cities today

When it comes to the capital city councils, debt plays a different role in each. Within each council, this role is a function of the respective legislative and policy environment, the funding mix, the forward capital program and the attitude towards debt on the part of elected officials.

Of the six cities studied, four of them currently use debt to support infrastructure delivery, whereas two do not have any debt outstanding:[12]

[9] Local Government and Planning Ministers' Council, *Local Government Financial Sustainability - Nationally Consistent Frameworks*, May 2007

[10] While this number appears low, there are other factors at play in Queensland than just a decision to borrow. Many regional local governments are likely to be supported by direct funding from state government to deliver services to their constituency; as a result, there may not need to be a capacity or capability to borrow for some of these councils.

[11] Tasmanian Audit Office, *Report of the Auditor-General, No. 6 of 2011-12: Auditor-General's Report on the Financial Statements of State entities, Volume 4 Part I - Local Government Authorities 2010-11*, November 2011

[12] Based on consultation with the CCCLM working group and on review of publicly-available financial information.

Table 2 The role of debt finance in the six capital cities

City	Role of debt
Adelaide[13]	Forecast debt at the end of 2012-13 is $7.7 million, provided by the South Australia Local Government Financing Authority (LGFA). The 2013-14 budget proposes significant new borrowing of $46.8 million. This will increase total borrowing outstanding at the end of 2013-14 to $55.2 million. The capital requirement identified for the coming year relates to two of the largest projects in the city's history, the $25 million Stage 1 redevelopment of Rundle Mall and $28 million rejuvenation of Victoria Square. With the exception of borrowings relating to these projects, borrowings are assumed to be used for the Property Portfolio and other income-earning assets in line with the Strategic Financial Parameters. Borrowing by Adelaide City Council is undertaken in accordance with council's Treasury Policy. When a borrowing requirement is identified, council has a policy of going to competitive tender, including the LGFA and commercial banks. Historically, the LGFA has always provided the most competitive response and has been selected as the provider of debt.
Brisbane[14]	In common with all Queensland councils, Brisbane City Council borrows exclusively from Queensland Treasury Corporation (QTC). It raises general purpose borrowings from QTC to fund a range of capital projects. Repayments are made quarterly in accordance with the underlying borrowing rate and after adjustment for new borrowings and earlier repayments. Apportionment of the payment between finance costs and debt redemption will vary according to interest rates. Brisbane City Council also raises specific borrowings from QTC to fund a range of projects. Repayments are made in accordance with the arrangements set up for the specific loans, including frequency of loan repayments and new borrowings. Borrowing costs are expensed as finance costs in the Statements of Comprehensive Income when they are incurred. Where borrowing costs can be attributed to a project, the costs are capitalised as part of the qualifying asset. A significant proportion of Brisbane's debt arises from investment in major income generating infrastructure road projects (the type of project that is unique to Brisbane City Council as the largest local government in Australia). Brisbane has committed to making these sizeable investments for the economic benefit of the region and funded these transactions through debt. Without these pronounced infrastructure activities, its debt would be more modest. The fair value of QTC net debt held by Brisbane City Council was $1.8 billion at the end of 2011-12. Net debt (debt less cash on hand) is forecast to be $2.3 billion at the end of 2013-14. According to recently released plans, this is anticipated to be the peak debt load and will be reduced going forward. These debt levels are in part reflective of Brisbane City Council's investment in income generating investments including the Go Between Bridge and Legacy Way toll roads. In this context, the budget for 2013-14 and forward estimates for 2014-15 to 2016-17, forecast borrowings over the next few years to be as follows: 2013-14 $483 million 2014-15 $317 million 2015-16 $126 million Brisbane City Council no longer subscribes to an external credit rating but is rated by QTC as "strong".

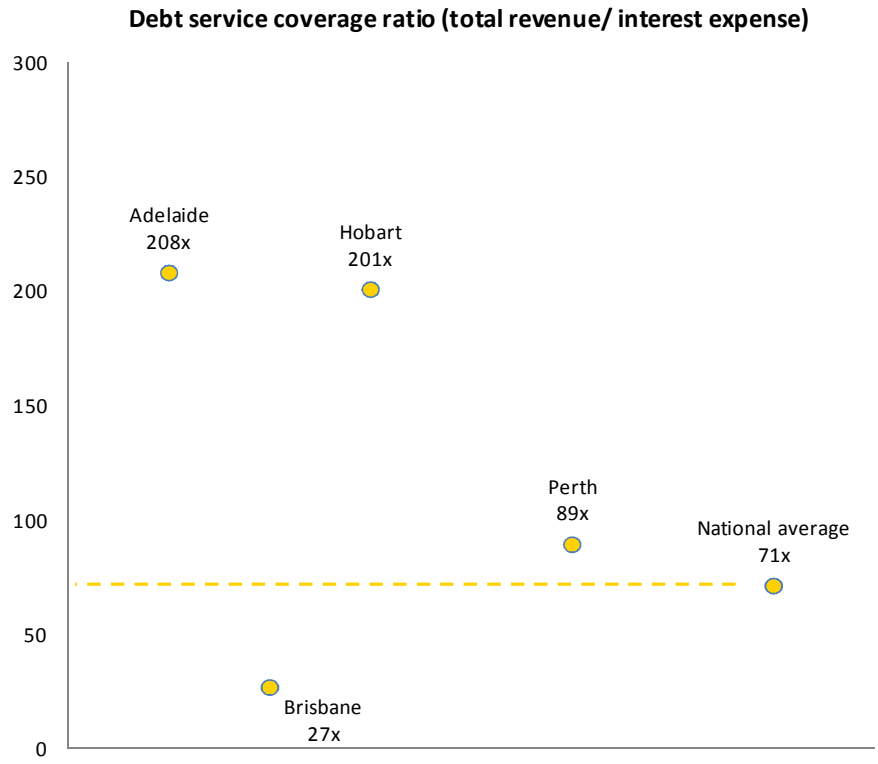
[13] Adelaide City Council, *Business Plan and Budget 2013-2014*
[14] Brisbane City Council, *Annual Report 2011-12 and Annual Plan and Budget 2013-14*

Hobart	At the end of 2012-13, Hobart City Council had six loans outstanding, totalling $14.7 million. This includes a loan of $2.5 million negotiated in June 2013. One of the facilities is with Commonwealth Bank and was taken out in 2006 for a term of 30 years, for the purpose of purchasing land at Porter Hill. The other loans are provided by Tascorp, and have a term of 10 years. In all cases, principal and interest is paid half-yearly and the interest rate is fixed for the term of the loan. When a borrowing requirement is identified, council has a policy of going to competitive tender, including Tascorp and commercial banks. Historically, Tascorp has normally provided the most competitive response and has been selected as the provider of debt, however Commonwealth Bank has been selected in some cases.
Melbourne[15]	The City of Melbourne currently has no borrowings. The *Draft Annual Plan and Budget 2013-14* indicates that no new borrowings will be raised in the forthcoming financial year. The City of Melbourne is rated AAA by Standard & Poors, and has been since March 2001.
Perth[16]	The City of Perth had outstanding borrowings of around $60 million at the end of 2012-2013. This consists of five loans, with maturities ranging from July 2019 to July 2022, including one of $24 million drawn down during 2012-13 to partially fund the construction of the Cathedral Square New Civic Library. All current loans are provided by WATC and are principal and interest with a fixed interest rate. Perth has a borrowing requirement for 2013-2014 of around $0.6 million for car park design. A further $16 million will be borrowed in the subsequent two years for construction work on the car park project. When a borrowing requirement is identified, council has a policy of going to competitive tender, including WATC and commercial banks. Historically, WATC has normally provided the most competitive response and has been selected as the provider of debt.
Sydney[17]	The City of Sydney currently has no borrowings, and has no forecast borrowing requirements for the forthcoming financial year. The City of Sydney does not have an external credit rating but is rated by the New South Wales Government as "strong" with stable outlook.

The graph below demonstrates the current role of debt in the six capital cities. With the exception of Brisbane, each city has a debt service coverage ratio (representing the ability to repay debt) above the national average for all local government in Australia. Melbourne and Sydney do not feature as they currently operate at a zero debt position.

[15] City of Melbourne, *Draft Annual Plan and Budget 2013-14*
[16] City of Perth, *Annual Report 2011/12*
[17] City of Sydney, *Annual Report 2011/12*

Figure 6: The ability of Australia's capital cities to service their current debt profile



In terms of the source of debt used by the capital cities, it is notable that each of the four councils that does borrow has access to finance provide by the state government or a state-backed collective financing vehicle. With the exception of one Hobart City Council loan with the Commonwealth Bank, all debt is sourced through the public sector. On the other hand, the two councils with no current debt – Melbourne and Sydney – do not have access to state government finance. None of the councils use sources of finance other than conventional loans from the state, the LGFA or commercial banks.

Optimising the capital structure

The fundamental challenge faced by Australia's capital city councils is one which is common not just to all local government, but to all public and private sector organisations involved in infrastructure delivery and management. This challenge is that the costs of infrastructure are high and lumpy and growing, and when there are many competing demands on revenues, meeting these costs places significant pressures on the budget.

A suboptimal capital structure, and overlooking alternative sources of capital, makes this challenge even greater. It can prevent infrastructure investments from going ahead when there are not adequate revenues to fund projects with lumpy cost profiles. And the consequence of delay and non-investment is that the infrastructure gap gets bigger – or at the very least, it does not get smaller.

In the context of sound financial management and project planning, the key benefits of optimising the role of debt within the capital structure are that it can:

- enable councils to deliver new infrastructure when it is required and earlier than they otherwise would have been able

- enable the funding and development of 'user pays' or other income-generating infrastructure such as toll roads
- 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.

An unbalanced use of borrowing – represented by excessively low debt and debt service ratios – is having a negative impact on the ability of capital cities to meet their stated infrastructure priorities. An overly pessimistic assessment of the risks of using debt is inconsistent with the market view that they possess what lenders clearly consider to be sound credit fundamentals.

This analysis is consistent with a recent practice note issued as part of the Commonwealth's Local Government Reform Fund (2012), which 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."[18]

There are two broad ways in which councils can seek to optimise their capital structure for the purposes of meeting the infrastructure task.

Firstly, better use should be made of tools and methods for assessing a safe and sustainable role of debt that is commensurate with the council's forward capital program. This is likely to involve optimising the use of the business cases for infrastructure projects. In addition to the net economic benefit of a project, more advanced analysis can be performed on the available funding sources and the accretion to revenue. Potential benefits include bringing forward alternative revenues sources (such as value capture) and using these to support Tax Increment Financing models, recycling assets, investing in maintenance on schedule to reduce future lifecycle costs, and facilitating inward business investment.[19]

Secondly, and relevant to this study, is the better use of alternative sources of finance. Compared with the sector as a whole, Australia's capital city councils are very well placed to move towards an optimal debt load supported by a range of sources.

Capital city councils have strong and predictable own-source revenue streams, and large capital projects, often with strong income-generating capabilities. They are generally better resourced and enjoy the benefit of more sophisticated treasury functions. And their current debt load is relatively low (and in some cases, zero). These credentials would suggest that the capital city councils would be in a strong position to take advantage of market appetite for low-risk lending.

[18] Institute of Public Works Engineering Australia, *Long-term Financial Planning, Practice Note 6*, January 2012
[19] Optimising the use of different revenue streams in support of local government activities is explored in the recent paper: Comrie J, *In Our Hands: Strengthening Local Government Revenue for the 21st Century*, Australian Centre of Excellence for Local Government, University of Technology, Sydney.

Access to alternative sources of debt is simply an enabler for a more balanced capital structure; however the specific sources and types of debt are important because they determine its cost and consequently impact on the amount of indebtedness a council can support. These sources of debt are the subject of the remaining sections of this report.

Constraints and opportunities

The assessment made of alternative capital structures and new sources of finance will be unique to each capital city council. Each city needs to consider a number of council-specific factors associated with its requirement for finance, its ability to service debt, the impact on credit rating or other metrics, optimising the funding mix and community acceptance.

These factors form the basis of the evaluation of alternative sources of debt within this report.

In addition to these, there are some constraints and opportunities which – while not the core focus of the evaluation undertaken – provide important context for any potential move towards an optimal debt load and a more sustainable capital profile. These considerations are summarised below and explored in further details in the appendices.

- **Legislative and policy context (Appendix 1)**

  In modifying their capital structures and making best use of all available financing options, councils need to be cognisant of the policy and legislative environments in which they operate. This includes not only the impact of any restrictions on their activities, but also opportunities presented by emerging policies or new programs or initiatives at other tiers of government.

  Local government is the creature of state and territory governments, each of which impose different constraints and have different policies when it comes to local government financing. The Commonwealth also has a role in setting the policy direction for local government. These are summarised in Appendix 1.

- **Collective borrowing arrangements (Appendix 2)**

  For the purposes of this study, it is assumed that borrowing by capital city councils will continue to be on an individual basis. This is the traditional form of borrowing structure used by Australian councils, whereby terms and conditions are based on negotiation between individual councils and financiers.

  For this reason, and because of the differing requirements in each capital city, the evaluation of alternative financing mechanisms in this study takes as a 'default' position the assumption that a council would borrow on behalf of itself only and not approach the market collectively.

  However, as the local government sector – including capital city councils – move towards an optimal debt load in the future, there are significant benefits that might be gained from collective action. These benefits - which have been demonstrated overseas – include the ability to aggregate smaller borrowing needs to create a larger unit with the required security to enable councils to obtain lower interest rates, while also introducing operational efficiencies and administrative synergies to drive costs down.

  Based on the success of collective borrowing activities overseas, there has been some momentum within Australia to further explore options for similar arrangements for Australian councils. Developments in this area – and the impact for capital city councils – are explored further in Appendix 2.

- **Tax concession finance (Appendix 3)**

Through its control of the tax system, the Commonwealth is able to create incentives to lower the cost of debt for lenders and borrowers, as a means of encouraging inward investment in priority areas, such as infrastructure.

Previous Commonwealth tax-preferred infrastructure schemes have not been entirely successful, and the current Government does not support the provision of direct concessions in the form of lower tax payable of interest receivable. However, the Government has demonstrated an appetite to amend the tax system in other circumstances, and therefore the local government sector should be encouraged to continue to make the case for Commonwealth support – either through making itself eligible for existing schemes or through lobbying for new schemes which are applicable to council-delivered projects.

These arguments are developed further in Appendix 3. In light of the current policy environment, tax concessions for local government financing have not been considered as part of the evaluation of financing mechanisms in this report.

4. Alternative borrowing solutions

Alternative borrowing solutions - overview

Many councils in Australia (including the capital city councils) have in the past operated at very low debt levels. For those that have borrowed, they have typically sought to source debt on an individual basis and have chosen 'conventional' sources such as bank loans and (where available) loans from state government Treasury Corporations. This is because of the ease of arrangement and existing relationships with lenders, a perception of competitive pricing, and – in some cases – low awareness of other sources.

There has been a general lack of uptake of alternative debt products, and – where alternative sources can provide more favourable outcomes – this may have prevented the sector from moving to an optimal debt load.

A range of alternative sources of debt has been identified for evaluation within this report, with the objective of assessing their suitability for further consideration by capital city councils. These are summarised in the table below.

Table 3 Overview of options

Name of option	Description/ overview
1. Bank term loans	A loan provided by a bank or group of banks to raise short or long-term finance. The borrower is required to make periodic interest payments for the life of the loan, at a rate determined on the basis of a reference rate and a specific margin. Loan structures include principal and interest or interest only where the principal is repaid in full at maturity. Bank loans are the traditional form of debt utilised by the local council sector in Australia. The exception is in states where Treasury Corporation or state-supported financing agency loans are either mandatory or available on more attractive terms. Key lenders to the local government sector include the four major domestic banks (ANZ, CBA, NAB and Westpac) and a number of the second tier banks (such as Bendigo and Adelaide Bank).
2. AUD public bond	A debt security which is placed on the Australian open market to raise medium and long-term funds. It is a legal contract sold by the issuer to the investor, promising to repay the holder the face value of the bond plus interest at future dates. Bonds have a specific term and a specific form of interest and principal repayment. The borrower or issuer is typically required to make periodic interest payments (commonly referred to as coupons) for the life of the bond, and at the maturity of the bond the principal is repaid. Bond investors are typically institutional and other large investors such as fund managers, banks and foreign governments. While the Australian bond market is a key source of funding for both the Commonwealth and the state governments, to date, councils in Australia have not raised debt in the AUD public bond market.
3. US public bond	A debt security which is issued to raise medium and long-term funds in the US market. In common with an AUD public bond, the borrower or issuer is typically required to make periodic interest payments for the life of the bond, and at the maturity of the bond the principal is repaid. The US bond market is the largest bond market in the world, with total outstanding debt at December 2012 of approximately US$38 trillion. The US bond market attracts a diverse range of domestic and international issuers, with one of the key difference to the AUD public bond market being

	the well developed local (municipal) bond market.
4. US private placement	Unregistered debt or equity securities that are directly negotiated between an issuer and a limited number of US investors in a private and unregistered transaction. The most common form of US private placement is a long dated debt security similar to a bond. The borrower or issuer is required to make periodic interest payments (coupons) for the life of the private placement and at the maturity of the private placement the principal is repaid. There are approximately 50 active investors in the US private placement markets typically US insurance companies and pension funds seeking medium to long term fixed income to match their liabilities.
5. AUD private placement	Unregistered debt securities that are directly negotiated between an issuer and a limited number of investors in a private and unregistered transaction. The AUD private placement market operates in a similar way to the USPP market, however on a smaller scale and in a less developed market. Issuers are typically Australian corporates, however this market would also be suitable for local councils. The Treasury Corporation of Victoria has previously issued debt in the private placement market. Investors are generally Australian superannuation funds and other institutional investors.
6. AUD retail bond issuance	A simplified AUD public bond which is targeted at the public. The NSW Waratah bonds are an example of an Australian government entity raising debt in the Australian retail bond market. In addition, Australian "treasury" bonds have been tradable on the Australian Stock Exchange ("ASX") since May 2013, which may encourage new government debt being raised from the retail market.

More detail on each option is provided in Appendix 4.

While conventional bank debt (the first option) is neither new nor innovative, it has been included in the analysis as an option for those capital cities that do not currently borrow or do not currently borrow from the commercial banking sector.

We have not examined options which involve the provision of finance by state governments or the Commonwealth – for example the granting of access to Treasury Corporation financing where it is not currently made available to councils. We have taken the view that this would require a significant change of policy, and it is beyond the remit of this study to advocate such a change.

However, we do acknowledge that in light of the legislative constraints described in this report, the availability of some of the mechanisms identified are likely to be dependent upon approval by the state government in some jurisdictions.

Alternative borrowing solutions - criteria

The consultation showed unanimous support for enhancing the ability of the local government sector to access high quality and cost-effective debt finance. Although no council actively seeks to increase its debt levels in the absence of other factors, the accepted reality is that there is a pressing infrastructure task that needs to be met and own-source revenues are often insufficient to fully fund the required investments.

Only one council indicated that it is unlikely to have a requirement for debt financing in the next ten years. All other cities suggested that they are open-minded to investigating alternative borrowing solutions, although it was stressed that any new arrangement would

need to demonstrate significant benefit over existing arrangements for those cities that currently do borrow for infrastructure.

Ultimately, the impetus for alternative financing comes from the need for a large and sustained infrastructure investment program, which will vary from city to city and council to council. The specific financing requirements of a capital city council (as with any other organisation) will always be on a needs basis and subject to the robust development of a forward capital program based upon sustainable financial practices.

If debt can be raised in a way that enables the associated risks to be safely managed and that enables priority projects to go ahead, then it should be regarded as an appropriate contributor to project delivery. What is important is that the benefits and risks of all solutions are adequately assessed to enable each council to make the right decision as to the benefits of borrowing. To the extent debt finance is used, it should be as cost-effective and as efficient as possible.

With this in mind, the analysis in this paper evaluates a number of financing mechanisms on the basis of three criteria. These criteria, which are described below, have been selected based on the priorities identified by the representatives of each capital city council consulted as part of this review. Implicit in the analysis is an assumption that councils are open to borrowing more in the future.

Diversification itself is not a relevant evaluation criterion in the analysis of alternative financing options. For those cities that already hold debt (Adelaide, Brisbane, Hobart and Perth), diversification is an important part of an effective financial risk mitigation strategy, but should not be a significant differentiator between the various alternatives.

The criteria have been drafted on the basis that this review aims to assess solutions which are likely to provide the best outcomes for capital city councils, namely to enable an optimal capital structure which would support higher levels of debt, for the ultimate benefit of providing the desirable level of infrastructure. Consequently, the criteria may not represent the specific priorities of individual councils or other stakeholders, nor are they intended to represent the views of the local government sector as a whole.

Table 4 Evaluation criteria

Criterion	Description
Price and cost	The most important criterion identified by the representatives of the capital cities was price and cost. 'Price' refers to the financial terms associated with a new borrowing solution (i.e. interest payments), and 'costs' refers to other associated payables such as arrangement costs, legal costs, approvals and so on. Taken together, price and cost are crucial as they have a direct and material impact on value for money for rate payers. The ability to service debt has implications for the availability of additional revenue to support any debt increase, and consideration of rate payer equity in setting the term horizon for the additional debt funding required. Any alternative solution would need to reduce the costs of debt finance. This means that the total cost over the life of the facilities or instruments would need to be lower than the total cost of currently available arrangements, including all additional costs in arranging, reporting and managing the facilities or instruments. Importantly, for those cities (Brisbane, Hobart and Perth) that borrow via state government Treasury Corporations, and for Adelaide which borrows via the state government supported financing agency, the task of "beating" current arrangements is challenging. As borrowers, governments have access to the cheapest financing costs available thanks to their high credit quality, and as lenders they do not have the profit motive which compels private sector financiers to levy arrangement and other costs on their clients. For example, in recent situations when Adelaide, Hobart and Perth have identified a borrowing requirement, they have invited bids from private sector financiers (commercial banks), and in only one case has a bank been able to provide an offer that was favourable in price and cost to the terms offered by the state Treasury

	Corporation. In the current policy environment in Queensland, Brisbane borrows directly from QTC without inviting tenders from banks.
Flexibility	Council representatives identified flexibility as an important criterion for evaluating alternative financing. Flexibility generally applies to the ability to specify and tailor the term, tenor, and repayment arrangements of a facility or instrument. Flexibility is important because the ability to match the servicing and repayment profile of debt to projected cash flows can have a profound impact upon budgeting, sustainable financial management and project delivery. Capital city councils deliver projects for which differing loan structures may be appropriate. For example, a shorter term (4-5 years) would be appropriate for some smaller projects, and might have an impact on the appetite to access the most competitive pricing available were council to take the risk on variable rates. Those councils that borrow through state government apparatus benefit from the high degree of flexibility that state lenders can offer as a result of their market access and positioning. The key measure of this criterion is therefore the ability of the mechanism to match or to better the flexibility implicit in current borrowing arrangements.
Simplicity	Simplicity reflects the relative ease of implementation of the mechanism. This includes the administrative burden of setting up the facility or instrument, taking into account any approvals, listing, documentation and disclosure requirements. It also includes a measure of potential community acceptability, and the upfront and ongoing impacts on the existing relationships between the tiers of government, including any legislative change required.

Alternative borrowing solutions - evaluation

To evaluate the alternative debt solutions against the identified criteria, a system of 'green', 'amber' and 'red' ratings has been used, as described in the table below.

A 'red' rating under any individual criterion means that the mechanism will be assessed as 'red' - or unsuitable – overall. Otherwise the overall rating is the rating which has featured most prominently in the evaluation. An overall rating of 'green' or 'amber' implies that the mechanism is likely to be suitable for further consideration by capital city councils.

Table 5 Ratings

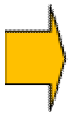
	Description
	'Green' means that the mechanism has high potential to achieve outcomes which satisfy the criterion.
	'Amber' means that the mechanism has moderate potential to achieve outcomes which satisfy the criterion.
	'Red' means that the mechanism has minimal potential to achieve outcomes which satisfy the criterion.

Based upon the criteria and rating system identified above, the evaluation results are presented in the tables below. The detailed evaluation supporting these outcomes is presented in Appendix 4.

Table 6 Evaluation of options

Name of option	Price/ cost	Flexibility	Simplicity	Overall
1. Bank term loans				
2. AUD public bond				
3. US public bond				
4. US private placement				
5. AUD private placement				
6. AUD retail bond issuance				

Table 7 Evaluation summary

Mechanism	Evaluation	
Bank term loans	Bank term loans are considered to be a simple, flexible and cost effective source of finance for local government.	
AUD public bond	AUD bonds have the potential to provide considerable pricing benefits, but involve a greater degree of complexity in going to market when compared with bank term loans.	
US public bond	Overall, the complexity of issuance and the risks of hedging are considered to outweigh the potential pricing benefits of this option.	
US private placement	Overall, the complexity of building relationships with offshore investors and the risks of hedging are likely to outweigh any potential pricing benefits associated with this option.	
AUD private placement	Potential to be complex, with an unknown pricing benefit.	
AUD retail bond	Moderately flexible and complex but unlikely to provide the most attractive pricing and cost benefit.	

Alternative borrowing solutions – preferred options

Based upon this evaluation, two options – bank term loans and AUD public bond – are considered suitable for further consideration by capital city councils – and are discussed

further below. The remaining four options all have characteristics, risks or associated costs that imply that they are not likely to be suitable for use in the short to immediate term.

The underlying financial data for the analysis below is provided in Appendix 5.

- **Bank term loans**

  Of the six financing mechanisms identified, conventional bank loans were assessed to offer favourable outcomes in terms of flexibility and simplicity. Loan tenor, repayment structure and debt service arrangements can be tailored to the council's borrowing and cash flow requirements. The application and establishment process is straightforward, with minimal information requirements, and execution risk is low.

  We have sourced indicative interest rates from two major domestic banks. Indicative rates for a 10 year fixed interest loan has been provided as this is the most common loan request based on feedback both from banks and from the local government sector.

  The rates were provided in the last week of June and first week of July 2013 and are likely to change over time. Although in recent weeks prices have been driven up following the US Federal Bank flagging that the quantitative easing program will be progressively scaled back, banks still have a strong appetite to provide attractive pricing to the local government sector, as the table below demonstrates. This is in part driven by the presence of competition in the market.

  The rates below are provided on the basis that banks consider councils typically to be rated in the S&P A to AA range. While we have not completed a detailed ratings analysis of the capital city councils, the indicative ratings provided by banks provide a useful basis by which pricing can be compared to rated bonds and other mechanisms. In practice, some councils may be rated higher and some may be rated lower.

  The indicative ratings range provided is below typical state government ratings but still remains comfortably in the investment grade credit rating range.

  These estimates are provided on the basis of individual borrowing by councils. It is likely that the rates offered by banks would be more competitive for a group of councils borrowing under a collective arrangement, but that has not been specifically assessed in this report.

Table 8 Bank debt pricing[20]

Borrower	Borrower rating	10 year fixed rate
"Big 4" Bank A	AA	5.70%
	A	5.80%
"Big 4" Bank B	A	5.80%

  Although this pricing may be attractive, for those councils that borrow directly from Treasury Corporation, it is unlikely that commercial banks will be able to compete by providing debt at a lower cost than the state government.

  The table below shows state government bond yield ranges for those jurisdictions which play a role in local government financing (noting that South Australia supports council borrowing indirectly through the Local Government Finance Authority of South Australia).

[20] In our analysis, we have made an assumption based upon engagement with banks that the market participants consider Australian local councils to be typically rated in the S&P A to AA range. Rates are current as at the first week of July 2013.

Table 9 Treasury Corporation bond yields[21]

Borrower	Rating	Tenor	Yield
Western Australia	Aaa	10 years	4.70%
South Australia	Aa1	8 years	4.61%
Queensland	Aa1	10 years	4.89%
Tasmania	AA+	9 years	4.80%

Treasury Corporations may apply additional costs to these rates when lending to councils, but we understand these are not likely to add much to the underlying cost of finance – which is clearly lower than the rates offered by commercial banks.

Ultimately, for those councils that have access to Treasury Corporation loans, they are likely to remain the preferable source of finance going forward. For those that do not have access to state government finance, however, conventional bank debt is likely to be the simplest and most flexible source of debt for most borrowing requirements. While other solutions may provide a pricing advantage, this benefit is often only realised on capital requirements of a certain size (as explored below).

- **AUD public bond**

We have reviewed current bond yields for AUD public bonds with 9-10 year maturities issued by state government Treasury Corporations and eight corporate issuers.

While the observed yields vary significantly for different issuers of a given credit rating, government issuers typically price tighter than corporates due to their perceived higher credit strength. For example, banks typically attract an additional risk premium following the events experienced during the global financial crisis.

We consider that local government would attract pricing that is less favourable than state governments, but more favourable than some corporate issuers. A simple average for a given rating therefore provides a useful indicator of the potential pricing that might be achieved by a capital city council issuer.

Table 10 AUD bond 10 year average pricing

Borrower rating	P.a.
AA	5.07%
A	5.47%

The table below compares this pricing with the bank loan and Treasury Corporation pricing assumptions and demonstrates that there may be merit in councils considering an AUD public bond for debt raising requirements compared to bank term debt. The midpoint margin saving in the analysis suggests potential interest rate savings of approximately 0.50% p.a. compared with conventional bank debt. There is no core pricing benefit when compared with Treasury Corporation loans.

[21] Source: Reuters 27 Jun 2013

Table 11 AUD bond - potential savings

Observed pricing and potential savings	Rating	10 year pricing	Savings vs. Treasury Corp	Savings vs. Bank Debt Funding
Treasury Corporation	AA	4.64%		
	A	4.64%		
Bank Debt Funding	AA	5.70%	-1.06%	
	A	5.80%	-1.16%	
AUD Bond	AA	5.07%	-0.43%	0.63%
	A	5.47%	-0.83%	0.33%

As highlighted in the evaluation, it is important not just to compare the options on the basis of price alone. Issuing bonds involves a number of costs that would not be incurred in conventional bank or Treasury Corporation borrowing. We have assumed these costs to be as follows:

- Arranger fees (upfront): 1.00% – 1.50% of issuance depending on size of issuance
- Credit rating fees (upfront): $150,000
- Legal fees (upfront): $100,000
- Credit rating fees (ongoing): $50,000 a year

As the table below demonstrates, the impact of these costs can be considerable, with the upfront costs alone likely to accommodate for over 4 years' worth of interest savings on a $50 million bond. For a $200 million bond they represent 2.3 years of savings.

Table 12 Indicative fees for AUD bond issuance

(A$ms)	Upfront Fee Components			Total Upfront Fees			Ongoing Fees
AUD Bond Size	Arranger fees	Credit rating fees	Legal fees	Total upfront fees	As % of bond	Approx. years savings	Credit rating fees
50.00	1.50%	0.15	0.10	1.00	2.00%	4.2	0.05
100.00	1.25%	0.15	0.10	1.50	1.50%	3.1	0.05
200.00	1.00%	0.15	0.10	2.25	1.13%	2.3	0.05

Including the upfront and ongoing costs of arrangement and issuance enables a more reliable comparison to be made between issuing a public bond and drawing a conventional loan from a commercial bank.

The figures below provide an indicative illustration of the potential benefit of an AUD public bond when compared with a bank loan. We have assessed issuances of $50 million, $100 million and $200 million, and interest has been assumed to be fixed over a 10 year term. The underlying data is presented in Table 22 in Appendix 5.

Figure 7 Potential savings - bond vs bank – cumulative $

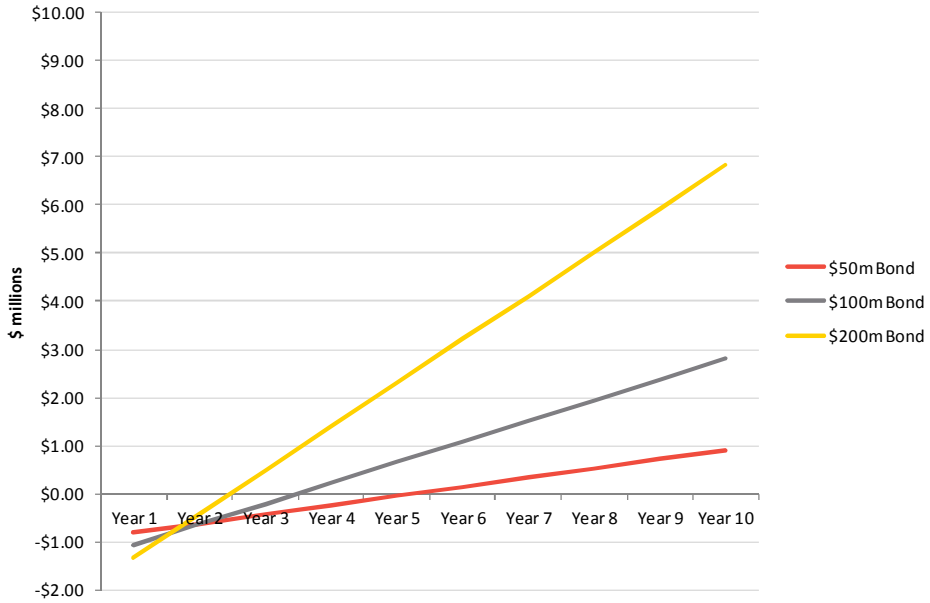
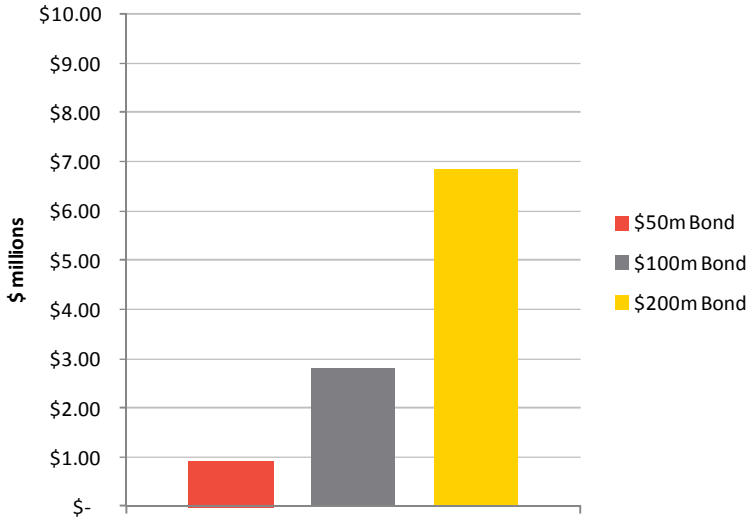


Figure 8 Potential savings - bond vs bank - $ total

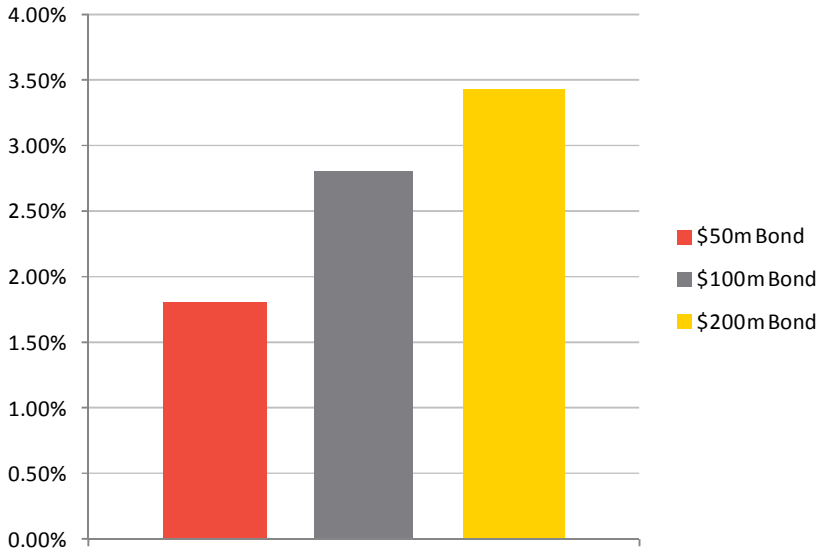


The figures above show that, despite early "losses" as interest rate savings are eroded by upfront costs of issuance and arrangement, over the term of an instrument there is considerable scope for savings.

The quantum of savings is of course dependent on the overall size of the issuance. While the "losses" are smaller in early years with a smaller issuance, the associated savings in the outer years are greater. Overall, indicative savings of $0.9 million, $2.8 million and $6.9 million are possible on issuances of $50 million, $100 million and $200 million respectively.

The figure below assesses these savings as a percentage of the quantum of the issuance, and demonstrates that the relative savings are larger, the larger the underlying issuance. Overall savings as a percentage of the issuance are 1.80%, 2.80% and 3.42% for issuances of$50 million, $100 million and $200 million respectively.

Figure 9 Potential savings - bond vs bank - total as % of loan



The difference in relative savings is driven by the fact that some of the costs in issuing bonds are fixed and not relative to the size of the issuance. Larger issuances therefore have a greater ability to "absorb" these costs over the term.

For this reason, it is generally observed that the cost effectiveness of issuing bonds diminishes significantly with smaller issuances. For example, a council considering issuing a bond with an overall value of $50 million would need to consider the overall saving of 1.80% in light of the risks, complexities and alternative strategies – noting that the cost of subsequent issuances would be lower as a result of the issuer's ability to leverage previous establishment costs.

As with bank loans, the analysis above has considered individual borrowing only. As discussed elsewhere in this report, there are precedents in other countries for local government bodies issuing bonds through a collective authority and achieving highly advantageous pricing on the back of their combined credit credentials. While this is beyond the scope of the analysis in this report, it should be an important consideration of any council wishing to further investigate the merits of issuing a public bond.

Alternative borrowing solutions – summary of findings

Based upon the analysis above, the key findings are as follows:

- For those councils with access to **state government Treasury Corporation loans**, these are likely to remain the cheapest form of borrowing available in the short and medium term.
- For those councils that do not have access to state government Treasury Corporation loans, **conventional bank debt** is likely to provide the most flexible and cost-effective form of debt finance for small and medium borrowing requirements.
- For those councils with larger borrowing requirements, significant savings might be achieved through issuing **a public bond** into the Australian market. Although bond issuance involves an element of cost and complexity, the relative saving for a large issue when compared with conventional bank debt can be material over the term of the instrument.
- Although not specifically modelled in this report, we believe that councils would be able to achieve a more favourable outcome from alternative borrowing solutions if

they were to enter into a **collective arrangements** with other councils, and give the market the opportunity to provide a lower cost of borrowing based upon the combined credit credentials and economies of scale associated with bundling.

- Although not specifically modelled in this report, any **tax concessional arrangements** for lenders in the future could drive down costs for borrowing councils and drive a more favourable outcome from alternative borrowing solutions that qualify for the concession.
- Any future borrowing activity would need to take regard of the **legislative constraints** that are placed on local government by state governments.
- We do not consider that **US public bonds**, **US private placements**, **AUD private placements** or **AUD retail bond issuances** are suitable borrowing solutions for Australia's capital city councils at the current time.

Appendix 1 Legislative and policy context

State governments are the implicit financial supporters of all local government entities and each one has legislated in respect of what councils can and cannot do with regards to raising funds and finance. The ability of the capital city councils to modify their capital structures and make use of alternative borrowing mechanisms is defined by these legislative constraints and considerations.

Furthermore, the Commonwealth has a policy interest in local government financing activities. It has a leading role to play in encouraging the local government sector to manage its own future, in contributing to local and regional economic prosperity, and in using its unique status to bring together diversified stakeholders and provide support and direction for policy intervention.

The table below summarises some of the legislative and policy considerations at state and Commonwealth level that have an impact upon the financing activities of councils in Australia.

Table 13: Legislative and policy context for local government borrowing

Jurisdiction	Legislative/ policy context
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 councils. ▸ 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*.
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 (DLG) 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.
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. Treasury uses two KPIs when assessing borrowing requests: net interest cost to revenue and net interest bearing debt to revenue. ▸ 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 than10 % and a net debt (gross debt less cash assets) to operating revenue ratio of less than 60%.

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. ▸ Following the announcement by the Minister for Local Government in March 2012 of the establishment of the Independent Local Government Review Panel, the DLG TCorp's work to include a financial sustainability and benchmarking assessment of all 152 NSW Councils. ▸ Based on the individual council assessments and at the request of the Independent Review Panel, TCorp have prepared a report into the financial sustainability of the NSW local government sector, *Financial Sustainability of the New South Wales Local Government Sector*.
The Commonwealth	The Commonwealth Government has articulated its vision for strong and sustainable Australia, including a desire to encourage the local government sector to manage its own future and contribute to local and regional economic prosperity and community wellbeing. ▸ ***Strong Foundations for Sustainable Local Infrastructure*** In 2012, the Commonwealth Government commissioned Ernst & Young to undertake a broad review of funding, financing and delivery of local infrastructure. The resulting report *Strong Foundations for Sustainable Local Infrastructure*, included 13 recommendations and a focus on the suboptimal use of debt financing within the local government sector. ▸ ***National Financing Authority for Local Government - Options assessment*** Building on recommendation 3 of *Strong Foundations for Sustainable Local Infrastructure*, the Commonwealth engaged Ernst & Young to undertake further work on feasible models for debt in the local government sector. The resulting report recommends further work on a collective financing vehicle. ▸ **Referendum on the constitutional recognition of local government** The Commonwealth has announced that at the time of the 2013 federal election there will also be a referendum on the constitutional recognition of local government. Were the "Yes" campaign to be successful, it is not anticipated that constitutional recognition will have a significant impact on the role of debt in local government, especially as the Commonwealth has stated its unwillingness to provide financial support (for example through explicit credit enhancement) to the local government financing effort. ▸ **The Opposition** The Coalition is committed to asking the Office of Financial Management to examine an Infrastructure Partnership Bonds Scheme. Private infrastructure operators and state and local governments will be eligible for concessional treatment.

Appendix 2 Collective borrowing arrangements

Individual councils have not always been able to achieve the best value for money from private financial markets (including commercial banks) in the past – and this is largely because the typical size of the capital requirement of a council is relatively small. Most Australian councils (outside of South East Queensland) are small entities and as such have less influence in the capital markets than, say, state governments or large corporations.

While this is not usually a significant issue for those councils that are able to access borrowing from a state government central borrowing authority, it means that those councils that do issue debt externally do so in a fragmented way and typically in relatively small quantities. For example, minimum bond issuance requirements (generally considered to be around $100 - $200 million) are almost always beyond the needs or capacity of the vast majority of Australian councils.

If councils were able to aggregate their individual borrowing needs into a communal buying power and a larger unit, they would be able to gain access to lower cost borrowings, while also introducing operational efficiencies and administrative synergies to drive costs down. Acting as a group also provides standardisation of lending terms, transparency of process, economies of scale and the ability to access new markets which may provide competitive pricing and funding diversification.

To achieve some of these benefits of scale, the simplest strategy would be to approach the market as an informal group in order to convince lenders of the merit of offering the most competitive rates as a means of securing the business of a number of borrowers. While councils in Australia have in the past come together to tender for services in this way, there is no history of doing to so as a means of obtaining lending proposals. A group of councils in Victoria has, however, recently collectively approached the commercial banks through the Municipal Association of Victoria (MAV) for proposals for loans to fund their Defined Benefit Plan liabilities.[22]

At the other end of the spectrum would be a move towards a more formal arrangement, whereby councils would create a new financing entity to build a presence in the bond markets, issue debt securities to raise funds and provide targeted debt products to its members at cost-effective interest rates and with flexible terms.

As precedents of local government financing agencies from overseas (such as in Sweden, Finland and Canada) have shown, aggregating the smaller borrowing needs of participating councils through such an entity can create the required scale and security arrangements to gain a strong credit rating, thus enabling councils to gain access to lower cost borrowings.

The New Zealand Local Government Funding Agency (NZLGFA) provides a recent example. The NZLGFA was established by the *Local Government Borrowing Act 2011* and was incorporated on 1 December 2011. The NZLGFA 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*.

As the table below illustrates, at the end of June 2013, the agency had gone to the market on 24 separate occasions, offering securities with maturities ranging from April 2015 to March 2019. In total, the volume offered was NZ$2,190 million. The total bid volume was NZ$8,927 million, meaning that issuances had an average cover ratio of 4.1 times.

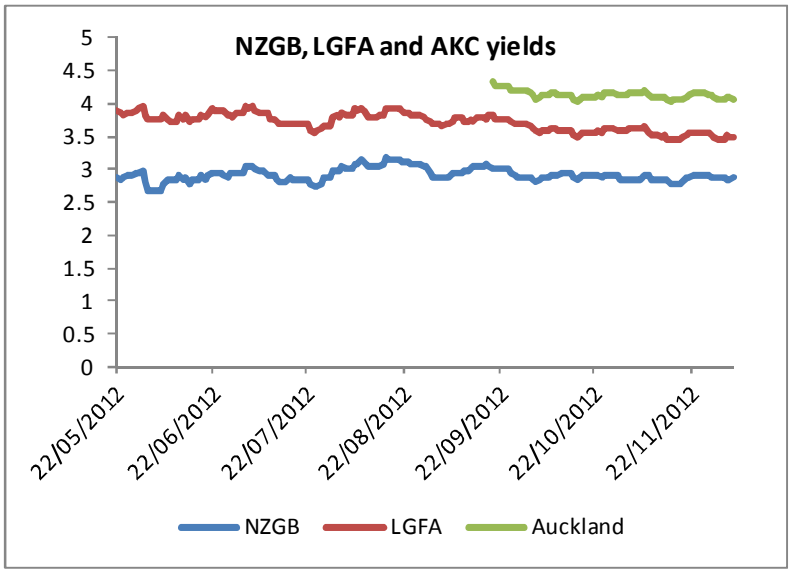
[22] http://www.governmentnews.com.au/2013/06/18/article/Lender-tender-for-Vic-councils-superannuation-funding-gap/ABNVUVYKGQ

Table 14 NZLGFA Bonds - tender results history

Tender Date	Maturity Date	Tender No	Volume Offered (Millions)	Volume Bid (Millions)	Volume Accepted (Millions)	Over/Under Allocation (Millions)	Wtd. Avg. Successful Yield %	Range of Accepted Bids %	Wtd. Avg. Unsuccessful Yield %	Range of Unsuccessful Bids %
15 May 2013	15 March 2019	12	$15	$21	$15	$0	3.799	3.730 - 3.830	3.840	3.840 - 3.840
15 May 2013	15 December 2017	12	$10	$15	$10	$0	3.610	3.600 - 3.620	3.630	3.630 - 3.630
15 May 2013	15 May 2021	12	$215	$611	$215	$0	4.115	4.050 - 4.140	4.219	4.150 - 4.310
10 April 2013	15 March 2019	11	$155	$734	$165	$10	3.789	3.705 - 3.840	3.867	3.845 - 3.900
10 April 2013	15 April 2015	11	$10	$50	$0	-$10	0.000	0.000 - 0.000	3.157	3.110 - 3.200
20 February 2013	15 March 2019	10	$205	$746	$205	$0	4.256	4.170 - 4.285	4.327	4.290 - 4.400
20 February 2013	15 December 2017	10	$45	$176	$45	$0	3.986	3.850 - 4.010	4.027	4.010 - 4.050
12 December 2012	15 March 2019	9	$45	$179	$45	$0	3.950	3.950 - 3.950	4.004	3.960 - 4.030
12 December 2012	15 December 2017	9	$30	$148	$30	$0	3.590	3.590 - 3.590	3.646	3.590 - 3.680
7 November 2012	15 December 2017	8	$50	$270	$50	$0	3.600	3.600 - 3.600	3.724	3.670 - 3.830
7 November 2012	15 March 2019	8	$80	$378	$80	$0	3.983	3.980 - 3.990	4.065	3.990 - 4.160
3 October 2012	15 March 2019	7	$180	$596	$180	$0	3.915	3.870 - 3.940	3.968	3.940 - 4.020
3 October 2012	15 December 2017	7	$95	$326	$95	$0	3.583	3.560 - 3.600	3.640	3.600 - 3.730
22 August 2012	15 March 2019	6	$75	$245	$75	$0	4.234	4.190 - 4.260	4.317	4.260 - 4.380
11 July 2012	15 March 2019	5	$135	$503	$135	$0	4.100	4.090 - 4.100	4.135	4.110 - 4.300
11 July 2012	15 April 2015	5	$10	$43	$10	$0	3.230	3.230 - 3.230	3.306	3.280 - 3.340
6 June 2012	15 March 2019	4	$75	$418	$75	$0	4.080	4.080 - 4.080	4.162	4.090 - 4.230
6 June 2012	15 December 2017	4	$55	$334	$55	$0	3.740	3.740 - 3.740	3.861	3.780 - 4.000
2 May 2012	15 December 2017	3	$120	$798	$120	$0	4.234	4.220 - 4.240	4.264	4.240 - 4.350
2 May 2012	15 April 2015	3	$20	$57	$20	$0	3.427	3.360 - 3.460	3.501	3.460 - 3.560
21 March 2012	15 December 2017	2	$180	$765	$180	$0	4.910	4.890 - 4.930	4.984	4.930 - 5.050
21 March 2012	15 April 2015	2	$85	$194	$85	$0	4.008	3.960 - 4.050	4.100	4.050 - 4.150
15 February 2012	15 April 2015	1	$50	$216	$50	$0	3.670	3.650 - 3.690	3.922	3.740 - 4.130
15 February 2012	15 December 2017	1	$250	$1,104	$250	$0	4.607	4.330 - 4.660	4.797	4.670 - 5.090

The graph below shows that while the NZLGFA 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. In this case, there is a clear and demonstrable pricing benefit from acting as a group compared with individually.

Figure 10: NZLGFA yields versus New Zealand Government and Auckland City Council



In light of the success of collective financing agencies overseas (the Danish agency – KommuneKredit – has been operational since 1898), the Commonwealth has recently commissioned work investigating the case for establishing a similar agency in Australia,

aligned with the objective of enabling councils to access cost-effective loans while promoting a culture of sustainable use of debt within the sector.[23]

Preliminary analysis undertaken as part of the exercise found that in each jurisdiction, councils using the authority could reduce the interest paid on every dollar of debt by between 7% – 17%. Across all jurisdictions, councils using the authority could save approximately $431 million in nominal interest costs over a 20 year period.

While the establishment of a national financing authority in Australia is unlikely to be imminent, and thus is not explicitly included in the analysis in this report, it would be something that the capital city councils could benefit from were it to be progressed.

Membership and participation in any future agency would of course be voluntary for councils and each capital city would each need to assess the benefits of participation. Importantly, in evaluating the benefits and costs of any future collective financing activities, councils would need to bear in mind that a guarantee structure may be required to provide lenders with the required security over the collectively issued facilities or instruments.

In the absence of a Commonwealth or state government guarantee, a guarantee would be provided by each member of the consortium of borrowing councils and would be a reflection of their several or joint and several liability. Several liability is where the parties are liable for only their respective obligations, whereas joint and several liability is where each party is liable up to the full amount of the relevant obligation.

A joint and several collective borrowing structure for local councils would likely improve the overall credit quality and result in funding efficiencies. However, it would also change the risk profile for councils as they would be guaranteeing the debt of other entities.

[23] Ernst & Young, *National Financing Authority for Local Government - Options assessment*, 2013

Appendix 3 Tax concession finance

The Commonwealth has an ability – unique among tiers of government in Australia – to put the tax system to use as a means of creating incentives to lower the cost of debt for lenders and borrowers, thereby encouraging inward investment in priority areas, such as infrastructure. This is known as tax concession finance, and the most common form is providing income tax exemption (full or partial) on interest paid on debt instruments to lenders. The concession for the lender provides an incentive to pass the benefit through to the borrower in the form of lower lending rates.

The cost of such concessions is notionally borne by the Commonwealth through lower tax receipts (in addition to administrative costs accruing to the ATO). Provided that these costs are not shifted to the borrower (such as a council via adjusted distributions to state governments or funding for local governments in other ways), the effective cost of debt for the borrower can be significantly lower than would otherwise be the case.

It has been widely observed that one of the main reasons for the success of the development of the municipal bond market in the USA is the fact that coupon payments on municipal bonds are often exempt from federal and state taxes. This has made this form of investment relatively attractive in the eyes of investors, increasing demand for tax beneficial investments and therefore pushing the cost of debt down. As a result, the ability of local governments to raise significant amounts of finance on the municipal bond markets has been strong.

The history of tax concession finance in Australia

Tax concession finance for infrastructure has been trialled in Australia. However, two previous Commonwealth-supported schemes, Develop Australia Bonds (DAB), and the Infrastructure Borrowings Tax Offset Scheme (IBTOS) – described in the table below – resulted in significant issues and both schemes were withdrawn.

Table 15 Tax concession finance - Australian precedents

Scheme	Description/ overview
"Develop Australia Bonds"	The name "Develop Australia Bonds" was the marketing term used for infrastructure borrowings authorised under the D*evelopment Allowance Authority Act*. The concession operated by making the interest payments of the borrower non-deductible for tax purposes, whilst the interest income was exempt in the hands of the lender (i.e. effectively the benefit of the interest deduction was transferred to the lender). Between 1992 and 1996, projects supported by the *Development Allowance Authority Act* accounted for a total of $29 billion. In 1996, an assessment by the Government revealed that tax minimisation provisions were being exploited and the taxation benefits were principally being accessed by high marginal tax rate individual investors. The Government concluded that the transfer of tax benefits as originally intended under the legislation is not working as most of the benefits were being captured by financiers and tax planners. The program was replaced in 1997 by the Infrastructure Borrowings Tax Offset Scheme which was capped at $75 million per year.
The Infrastructure Borrowings Tax Offset Scheme	The Infrastructure Borrowings Tax Offset Scheme provided Australian Government support for infrastructure investment in Australia. Legislation giving effect to the scheme was contained in Division 396, Land Transport Facilities, of the *Income Tax Assessment Act* 1997. The Tax Office and the Department of Transport and Regional Services jointly administered

	the scheme. The scheme provided a tax rebate for approved infrastructure projects to resident infrastructure lenders. In return, the borrower was able to access lower finance costs and forwent tax deductions on interest payments associated with the loan. Limited to large scale land transport projects, the last to take advantage of it was Transurban Group's CityLink tollway in Melbourne. However, as with the previous scheme, the program was mainly used by promoters to develop hybrid tax-advantaged debt securities for high net worth individual investors, which was not the intended purpose of the Government. The program was phased out in 2004.

The Opposition's "Infrastructure Partnership Bonds Scheme"

The current Commonwealth Opposition has committed to investigating the establishment of an "Infrastructure Partnership Bonds Scheme", outlined in the table below, which has some similar characteristics to precedent programs.

Table 16 The Opposition's proposed "Infrastructure Partnership Bonds Scheme"

Scheme	Description/ overview
"Infrastructure Partnership Bonds Scheme"	The Coalition is committed to asking the Office of Financial Management to examine an Infrastructure Partnership Bonds Scheme. Private infrastructure operators and state and local governments will be eligible for concessional treatment. 10 year infrastructure bonds will receive concessional tax treatment in the form of a tax rebate. The assessable interest income generated from the bonds will attract a 10 per cent tax rebate irrespective of the tax status or rate of the taxpayer. The form and structure of the scheme has not been confirmed, but it is proposed that it would only apply to projects that: ▸ qualify as a national priority under Infrastructure Australia's pipeline of infrastructure projects ▸ have been subject to a public cost-benefit analysis ▸ generate sufficient returns such that the debt can be serviced by the revenues generated by levies or charges that relate directly to the project.

For local government, the scheme proposed by the Opposition has considerable potential as a means of lowering the cost of finance for income-generating projects. The biggest impediment would appear to be that the scheme is to be restricted to "national priority" projects under Infrastructure Australia's pipeline.

The *Infrastructure Australia Act* 2008 defines "nationally significant infrastructure" as including transport infrastructure, energy infrastructure, communications infrastructure and water infrastructure "in which investment or further investment will materially improve national productivity". It is telling that, not a single project on Infrastructure Australia's most recent (2012) *Priority List* is a local government sponsored project.[24]

In order to meet the requirements identified by the Opposition's proposed scheme, it is likely that either

- councils would need to make a concerted effort to bring forward larger projects (for example through collective procurement and delivery of infrastructure), or

[24] Infrastructure Australia, *Progress and Action: June 2012 Report to the Council of Australian Governments*, June 2012

- the *Infrastructure Australia Act*'s definition of "nationally significant infrastructure" would need to be amended so that typical local government projects might be included.

Given the uncertainty as to the details of the scheme at present, it would be prudent for the capital city councils to monitor its development and, if it materialises, to work closely with the Coalition to ensure that local government is well placed to take advantage of the benefits it might bring.

Should a future government chose to develop tax concession finance through an infrastructure bond scheme, then a national financing authority (explored in Appendix 2) could provide the necessary governance structures and oversight to mitigate some of the risks.

The Labor Government

Our engagement with the current Labor Government has indicated that it does not support tax concession financing through the use of tax exemptions or concessions for bonds. Tax preferred infrastructure bonds are not supported by the Infrastructure Finance Working Group, established by the Government to examine such issues.[25]

The Government's reluctance to re-introduce tax-preferred infrastructure bonds is based on the following factors:

- The Government does not perceive a "market failure" in respect of access to finance, as councils currently have readily available debt from either the commercial banking sector or – in some jurisdictions – state government loans.
- As explored above, previous infrastructure bond schemes have proven hard to administer and have resulted in unintended consequences.
- There is perception that grant funding is a more transparent and less complex means of providing financial support to councils.

However, despite not supporting tax-preferred bond financing, the current Government has demonstrated a willingness to use the tax system to incentivise investment in infrastructure through other means.

The *Tax Laws Amendment (2013 Measures No. 2) Bill* 2013 recently passed through both house of Parliament. The legislation creates a new tax loss incentive aimed at encouraging private sector investment in nationally significant infrastructure. It does this by allowing the value of carry forward losses to be uplift by the 10-year government bond rate, and the losses from the continuity of ownership test (COT) and the same business test (SBT) to be exempted. The new incentives are designed to preserve the economic value of early-stage tax losses throughout an infrastructure project, and will provide much needed certainty to investors with respect to the recoupment of such losses.

Once again, the scheme is applicable to nationally significant infrastructure only and infrastructure which involves private sector investment. While this may essentially rule out the majority of local government projects, capital city councils may be able to benefit from the scheme dependent on the size and nature of investments in their pipelines.

Making the case

The recent legislation has shown that there is some appetite on the part of the Government to use the tax system as a means of encouraging investment in infrastructure. The challenge for local government is to build a strong case for inclusion within such schemes.

Firstly, local government should be encouraged to assess the eligibility of their projects (current or future) for existing schemes. In light of the emphasis on "national priorities" and

[25] Infrastructure Finance Working Group, *Infrastructure Finance and Funding Reform*, April 2012

large projects, capital cities are perhaps best placed of any councils to do this, on account of the size of their infrastructure projects. However, there is clearly some way to go before the Commonwealth considers council-delivered infrastructure as a class to be nationally significant. We would therefore recommend dialogue with the Commonwealth (potentially through Infrastructure Australia) to reconsider the assessment of local government projects within the national priority pipeline. We would also recommend that serious consideration be given to the aggregation of infrastructure programs across multiple councils. Not only can this drive significant cost savings and efficiencies, it could also give projects the required scale to be considered "nationally significant".

Secondly, local government should be encouraged to lobby for new tax-based measures that are either specifically targeted at local government, or are structured in such a way that local government will be able to participate at current levels of activity.

While being respectful of the current policy position against direct financial support for local government borrowing, a strong case could be made to the Commonwealth for using the tax system to lower the cost of borrowing for councils as a means of efficiently financing the infrastructure task.

Such as case would need to strongly demonstrate a legitimate market inefficiency as the basis of a convincing case for government intervention. It would need to articulate the benefits – namely that tax concessions for lenders can bring down costs of borrowers and ultimately enable marginal projects to go ahead that otherwise would not have.

The judgment made on these factors would then provide a basis to look at some design options and estimate the costs to revenue (which can be evaluated relative to gains) and examine practical issues such as eligibility, scheme design, scale, and implementation.

Ultimately, the Commonwealth would need to consider carefully tax concessional mechanisms as part of its broader policies on tax reform. Precedents from overseas have clearly shown, however, that tax concessions can provide a significant incentive for the market to lower financing costs that drive flow-through pricing benefits for the borrower. For those capital city councils for whom the price of debt-raising can make the difference between a project being fully funded or not, the case for tax concession financing is compelling.

Appendix 4 Alternative financing mechanisms

In this section, the suite of alternative forms of debt finance which are likely to be available to councils in Australia are explored. The options are:

1. Bank term loans
2. AUD public bond
3. US public bond
4. US private placement
5. AUD private placement
6. AUD retail bond issuance.

For each option, this chapter provides firstly a description of the mechanism (including typical market requirements and associated costs) followed by an evaluation against the criteria identified.

We have not examined options which involve the provision of finance by state governments or the Commonwealth – for example the granting of access to Treasury Corporation financing where it is not currently made available to councils. We have taken the view that this would require a significant change of policy, and it is beyond the remit of this study to advocate such a change.

However, we do acknowledge that in light of the legislative constraints described earlier, the availability of some of the mechanisms identified are likely to be dependent upon approval by the state government in some jurisdictions.

The default assumption for the analysis in this section is a council borrowing individually, although where relevant, considerations are identified which would have an impact on the analysis should a group of councils seek to raise finance on a collective basis.

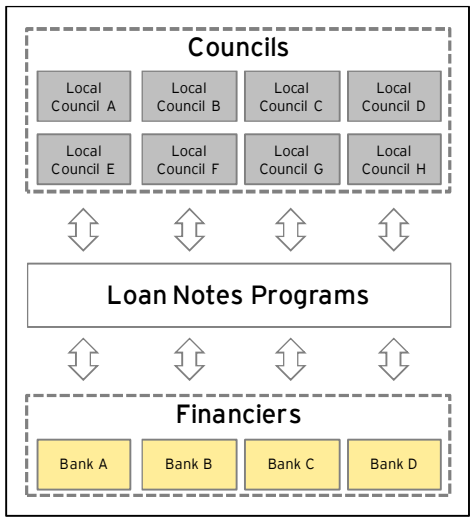
To evaluate the alternative financing mechanisms against the identified criteria, a system of 'green', 'amber' and 'red' ratings has been used, as described in the table below.

Table 17 Ratings

	Description
	'Green' means that the mechanism has high potential to achieve outcomes which satisfy the criterion.
	'Amber' means that the mechanism has moderate potential to achieve outcomes which satisfy the criterion.
	'Red' means that the mechanism has minimal potential to achieve outcomes which satisfy the criterion.

A 'red' rating under any individual criterion means that the mechanism will be assessed as 'red' overall. Otherwise the overall rating is the rating which has featured most prominently in the evaluation.

1. Bank term loans	
Description	
Overview	A bank term loan is a loan provided by a bank or group of banks to an entity (corporate or governmental) to raise short and long-term funds. The borrower is required to make periodic interest payments for the life of the loan, at a rate determined on the basis of a reference rate and a specific margin. The level of the margin is determined on current market and industry trends and the risk profile of the specific borrower (or project for project-specific loans). The interest rate for the term of the debt may be variable or fixed. Principal repayments can either be made according to a specified amortisation schedule or at the maturity of the loan. Bank loans are the traditional form of debt utilised by the local council sector in Australia. The exception is in states where Treasury Corporation or state-supported financing agency loans are either mandatory or available on more attractive terms, such as in Queensland, Tasmania and Western Australia. Key lenders to the local government sector include the four major domestic banks (ANZ, CBA, NAB and Westpac) and a number of the second tier banks (such as Bendigo and Adelaide Bank).
Lending structures	There are three primary bank debt structures: ► A bilateral loan is a loan agreement between one borrower and one lender. Most bank debt funding provided to councils in Australia is on a bilateral basis. ► A syndicated loan is a loan agreement between one borrower and multiple lenders, with common terms and conditions and pricing. The loan is structured, arranged and administered by one or more banks known as arrangers. ► An alternate to bilateral and syndicated structures, is the club structure whereby the borrower and its lenders agree to one central document detailing terms and conditions, whilst side agreements with each lender details facility types, limits and price. Bank loans may be secured or unsecured, but loans to councils in Australia are typically provided on a secured basis (i.e. mortgage over rates) to the extent possible under the respective jurisdictional laws.
Typical market requirements	Typical loan size: No minimum Typical tenor: 1 – 20 years Rating required: No Legal opinion required: Yes Debt listing: No Road show required: No Financial covenants: Typically none Upfront fees: Typically none Lender relationship: Yes
Establishment process	Terms and conditions are based on negotiation between the lender and the bank(s). It is typical for a borrower to tender to a number of banks to obtain the most competitive possible solution in respect of price, tenor and term.
Costs	There are typically three components to the cost of bank term loans: ► The market interest rate used to price the loan which is referred to as the base rate (e.g. the Bank Bill Swap Bid Rate (BBSY)). ► The margin over the market rate that is applied to reflect the creditworthiness of the borrower and/or the transaction being contemplated.

	► Commercial banks do not typically charge establishment fees for loans to councils. For fixed rate loans, which are common for the local government sector, the fixed rate provided by the bank represents a combination of the market interest rate and the margin. Fixed rate loans currently are around 5.70% to 5.90% for a 10 year tenor (based on quotes from two domestic banks provided in the last week of June and first week of July 2013).
Current market conditions	The Australian bank market currently has strong appetite and liquidity to provide finance to the local government sector. Appetite varies from bank to bank and over time depending on the regulatory capital positions of the lender and the ability to cross-sell ancillary business. This illustrates the potential benefits of undertaking a competitive tender process. The Australian domestic banks typically consider local councils to be rated in the A to AA range. Debt amounts greater than $200m will typically require a syndicate of banks. Changes in banking regulations – in particular the introduction of Basel III – have negatively impacted the availability of longer tenor bank loans. Whilst banks can provide long term commitments of up to 15 to 20 years, they are reluctant to provide a fixed rate facility beyond 10 years. Given the changes in banking market dynamics, the availability of long term debt may continue to contract to 10 years or less.
Advantages	► Simple and cost effective ► No credit rating required ► Historically attractive fixed interest rates ► Flexible maturities ► High success of execution ► Low complexity ► Low cost of arranging ► Prepayment is normally permitted
Disadvantages	► Concentration of financing source ► Early redemption costs for fixed rate loans ► Changing bank regulatory environment may reduce availability of long term financing and increase price ► Floating rates mean exposure to other market rates.
Options for councils to act on a collective basis	A collective bank term loan may be structured as follows:  Banks and councils sign up to a single loan agreement (the "Loan Notes Program") which contains the key terms and conditions. Councils continue to borrow on an individual basis but via a centralised funding platform. This agreement replaces the existing bilateral documentation thereby centralising and standardising the financing process.

	Once established, local councils submit a request for funding which would be received by a centralised administrator who would then seek bids from the panel of banks. The banks bid based on price, tenor and quantum with the administrator awarding the transaction to a bank based on the most favourable terms received. This proposed structure would bring standardisation of lending offers, ease of access, administrative savings, transparency of process and competitive pricing.	
Evaluation		
Price/ cost	In most jurisdictions apart from Victoria and New South Wales, the commercial banks have struggled to play a significant role in local government finance in recent years as they are unable to compete with state Treasury Corporations. All the main banks, however, appear to have a strong appetite and sufficient liquidity to provide finance to the local government sector at competitive rates. Indicative rates for a 10 year fixed rate, principal and interest loan are provided in the table below, based on our engagement with two domestic banks. These quotes were current as at [DATE] and are likely to change over time and across different lenders. This range was provided on a general and indicative basis only however it provides a useful reference point for comparing pricing and costs. Market participants consider Australian local councils to be typically rated in the S&P A to AA range. It is important to note that market dynamics are volatile and current bank pricing has increased materially since mid June 2013 following the US Federal Bank flagging that the quantitative easing program will be progressively scaled back.	
Flexibility	Bank loans are considered to be the most flexible lending structure available for local councils. Loan tenor, repayment structures and fixed or variable interest rates can generally be tailored to the council's borrowing and cash flow requirements. Loans can be interest only or principal and interest, and there is generally no minimum size. We note that banks can provide long term commitments, say 15 to 20 years, but are becoming more reluctant to provide fixed rate facilities beyond 10 years. For longer terms, say 15 years, it is likely that a fixed rate will be provided for the first 10 years with a price reset in year 10. This makes it harder to price bank debt beyond 10 years. When entering into an arrangement with a commercial bank, borrowers generally have some ability to renegotiate terms during the loan tenor, noting that fixed rate bank loans often include break costs for early repayment. The low cost of refinancing also provides flexibility where circumstances change.	
Simplicity	Bank loans are viewed to be the most simplistic lending structure available for local councils. The application and establishment process is straightforward, with minimal information requirements. Arrangement typically only requires the involvement of a single bank, and execution risk is low.	
Overall evaluation	Bank term loans are considered to be a simple, flexible and cost effective source of finance for local government.	

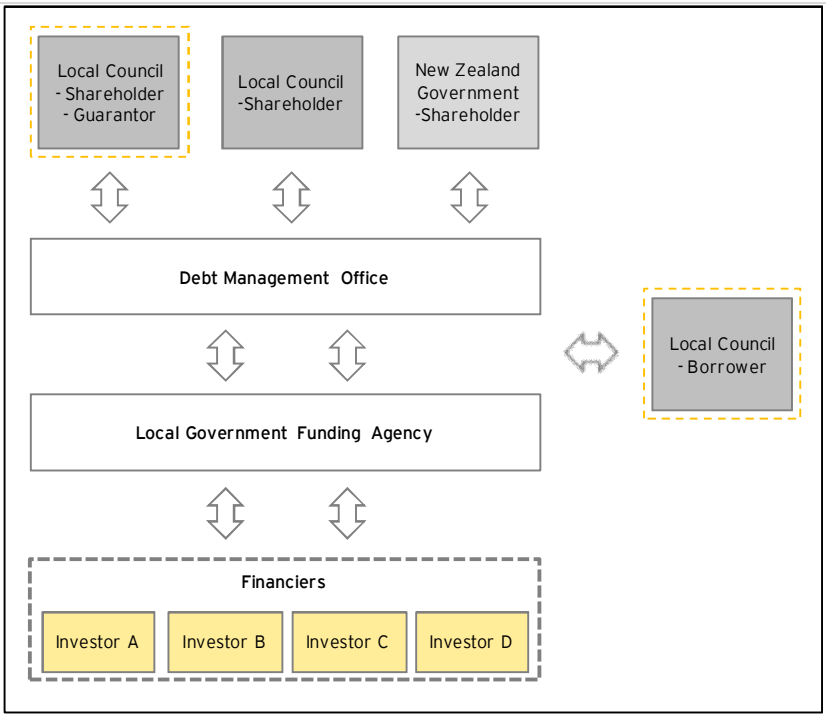
Borrower	Borrower rating	10 year fixed rate
"Big 4" Bank A	AA	5.70%
	A	5.80%
"Big 4" Bank B	A	5.80%

2. AUD public bond	
Overview	An AUD public bond is a debt security which is placed by an entity (corporate or governmental) on the Australian open market to raise medium and long-term funds. It is a legal contract sold by the issuer to the investor, promising to repay the holder the face value of the bond plus interest at future dates. Bonds have a specific term and a specific form of interest and principal repayment. The borrower or issuer is typically required to make periodic interest payments (commonly referred to as coupons) for the life of the bond, and at the maturity of the bond the principal is repaid. Bond investors are typically institutional and other large investors such as fund managers, banks and foreign governments. The bond market in Australia is made up of a diverse range of issuers including: ► The Commonwealth Government: issues bonds commonly referred to as "treasuries". ► State governments: issue bonds commonly referred to as "semis". ► Domestic and foreign corporations: issue bonds collectively referred to as "credit". ► Foreign governments and supranationals: issue bonds commonly called "sovereign" and "supranational". While the Australian bond market is a key source of funding for both the Commonwealth and the state governments, to date, councils in Australia have not raised debt in the AUD public bond market. However, there is considerable international precedent for local government bond issuances including "municipal bonds" in the USA, Auckland City Council in New Zealand and more recently the New Zealand Local Government Funding Agency which issues bonds on behalf of the local councils.
Lending structures	Whilst there are a range of different types of bond structures issued by corporates, government bonds typically take the following form: ► Fixed rate bonds: have a coupon that remains constant throughout the life of the bond. ► Floating rate notes: have a variable coupon that is linked to a base rate. AUD bonds can either be secured or unsecured, however treasuries and semis are typically unsecured.
Typical market requirements	Typical loan size: $200m minimum Typical tenor: 1 – 10 years Rating required: At least one Legal opinion required: Yes Debt listing: Yes Road show required: Recommended Financial covenants: Typically none Upfront fees: None Lender relationship: None
Establishment process	A bond issuance typically requires the engagement of an arranger or bank as an under writer / lead manager who will coordinate the process. In the case of Australian "treasuries" and "semis" these bonds are typically coordinated by the Australian Office of Financial Management ("AOFM") in the case of the Commonwealth or the respective Treasury Corporation in the case of state governments. The preparation of bond offering memorandum and other documentation is required.

<table>
<tr><td></td><td>Issuers must obtain at least one credit rating from an external credit rating agency (such as Standard & Poor's, Moody's or Fitch).
Marketing of bond is generally required to generate investor appetite.</td></tr>
<tr><td>Costs</td><td>In the case of corporate issuances, an arranging fee of 1.00-1.50%, dependent on size, is typically payable to an arranger or bank. In the case of Australian "treasuries" and "semis," no arrangement fees are payable given the arranging role is completed in house by AOFM or the Treasury Corporation.
Other costs include legal fees and credit rating agency fees. No establishment fees are required to be paid.</td></tr>
<tr><td>Current market conditions</td><td>Recent public bond issuances in Australia include the following:
<table>
<tr><td>Type</td><td>Treasury</td><td>Semi</td><td>Credit</td></tr>
<tr><td>Issuer</td><td>Australian Commonwealth Government</td><td>Treasury Corporation of NSW</td><td>BHP Billiton</td></tr>
<tr><td>Date</td><td>Jun-13</td><td>Apr-13</td><td>Oct-12</td></tr>
<tr><td>Amount</td><td>$700m</td><td>Not disclosed</td><td>$1,000m</td></tr>
<tr><td>Yield (as at 27 June 2013)</td><td>2.64%</td><td>3.15%</td><td>3.96%</td></tr>
<tr><td>Term</td><td>4 years</td><td>3 years</td><td>5 years</td></tr>
</table>
As at June 2012, the total of all treasury and semi bonds on issue was approximately $445bn, with a net issuance of $43bn treasuries and $34bn semis in the prior financial year.[26]
Strong investor appetite exists for infrastructure and other investment grade bonds with many issuances being oversubscribed, enabling higher volumes and lower pricing than initially proposed by issuers.
Pricing is competitive with global bond and domestic loan markets as a result of institutional investors seeking to diversify their portfolios away from equities.
Tenors of one to 10+ years are available, with investor preference for five to seven years.</td></tr>
<tr><td>Advantages</td><td>► Diversification of funding source
► Liquidity and price</td></tr>
<tr><td>Disadvantages</td><td>► Issuers must have a credit rating
► Minimum transaction size of A$200M, typically driven by upfront costs.
► Early termination fees in the case of repayment prior to maturity</td></tr>
<tr><td>Options for councils to act on a collective basis</td><td>An AUD public bond could be issued by either an individual council or collectively. Owing to the minimum quantum of a typical bond issuance compared with the typical quantum of debt required by an individual council, collective issuance has a number of advantages.
To this end, the Commonwealth has recently commissioned research into establishing a collective borrowing authority for councils in Australia, which would issue bonds on behalf of its members.[27] This research looks at options for establishing such an entity and makes recommendations as to a preferred model.
In New Zealand, the recently-established New Zealand Local Government Funding Agency (LGFA) provides an example of a potential collective borrowing structure which could be utilised to issue bonds on a collective basis:</td></tr>
</table>

[26] AFMA, *2012 Australian Financial Markets Report*

[27] Ernst & Young, *National Financing Authority for Local Government - Options assessment*, 2013



There are three levels of participation for local councils in the NZGFA: borrower-shareholders, borrower-guarantors and borrowers. The LGFA is 20% owned by the Crown with the balance owned by 30 New Zealand councils.

A joint and several guarantee applies to councils that borrow in excess of NZ$20m. In the event of default, guaranteeing councils are required to pay a proportion of the amount owing, based on a council's rates income calculated as a percentage of the aggregate rates income of all guaranteeing councils

The LGFA has access to a NZ$500 m liquidity line from the New Zealand Government Debt Management Office (DMO), for liquidity purposes in a stress scenario. The DMO is also responsible for the majority of LGFA's operational activities.

Evaluation

Price/ cost

The Australian public bond market offers tight pricing compared with traditional bank debt. Pricing data is provided in Appendix 5, and summarised in the table below.

Borrower rating	10 year average pricing
AA	5.07%
A	5.47%

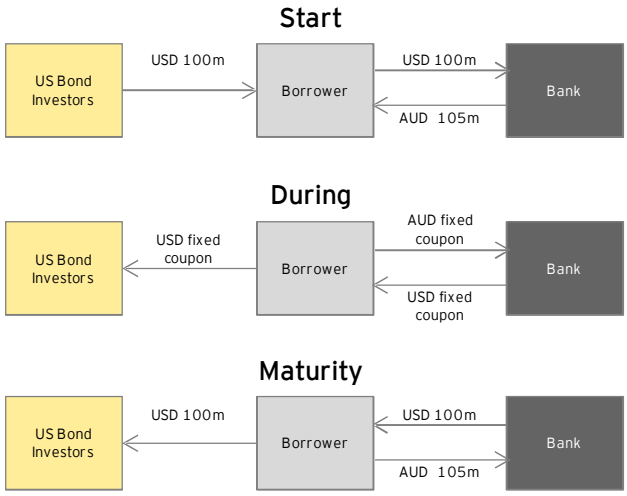
We have reviewed current bond yields for AUD public bonds with 9-10 year maturities. The data set includes the six Treasury Corporations and eight other issuers. The observed yields vary significantly for different issuers.

The data sourced from the market indicates that there would be a potential interest rate savings compared with conventional bank borrowing.

Costs include fees for an arranger or investment bank, obtaining and maintaining a credit rating, and legal advice. These vary but can be considerable relative to a smaller bond issuance.

Flexibility	AUD public bonds are considered to be moderately flexible. Loan tenor (up to 10 years) and fixed or variable interest rate can be tailored to the council's borrowing requirements. Bonds are typically interest only, however a degree of flexibility can be achieved regarding repayment structure via structuring multiple tranches subject to different maturities. However, there is no ability to renegotiate terms during the bond tenor, and the cost of refinancing is higher as a result of the fees paid to an arranger or bank, legal fees and credit rating fees. The typical minimum loan size of $200m significantly reduces flexibility regarding frequency of debt raisings and availability for smaller debt requirements. Bond issuances can be combined with bank debt to achieve a required level of flexibility.	
Simplicity	There is a moderate level of complexity in the form of typical market requirements and establishment process. Market requirements include the need for a credit rating, legal opinions, debt listing and a road show to present to investors. The establishment process incorporates preparation of a detailed bond offering memorandum and other documentation and disclosures. Bond issuers typically engage an arranger or bank to coordinate the process which significantly reduces the administrative burden. However, a council will be required to provide a supporting role with respect to the provision of information and will be actively involved in presentations to investors. Once a bond has been issued once, the process can be replicated more easily. Execution risk is moderate.	
Overall evaluation	AUD bonds have the potential to provide considerable pricing benefits, but involve a greater degree of complexity in going to market when compared with bank term loans.	

3.	US public bond
Overview	A US public bond is a debt security which is issued by an entity (corporate or governmental) to raise medium and long-term funds in the US market. In common with an AUD public bond, the borrower or issuer is typically required to make periodic interest payments for the life of the bond, and at the maturity of the bond the principal is repaid. Australian corporates typically issue more bonds overseas than they do in Australia. The key rationale is that it is easier to raise large amounts of capital at a competitive price in capital markets offshore due to the depth of liquidity and availability of longer tenor debt, in particular the US public bond market. The Commonwealth Government has also historically issued bonds overseas denominated in multiple currencies including USD, GBP and EUR. The US bond market is the largest bond market in the world, with total outstanding debt at December 2012 of approximately US$38 trillion. The US bond market attracts a diverse range of domestic and international issuers, with one of the key difference to the AUD public bond market being the well developed municipal bond market. Municipal debt in the US incorporates a broad range of governmental entities at or below the state government level including: ► States ► Cities

	► Counties ► Redevelopment agencies ► Special purpose districts ► School districts ► Public utility districts ► Publicly owned infrastructure Municipal bonds benefit from tax exemptions for US investors which results in cost savings for issuers - but this is not applicable for offshore issuers such as Australian local councils. The US bond investor base comprises over one thousand institutional and other large investors.
Lending structures	Lending structures are broadly in line with AUD public bonds, with the addition of US regulatory / disclosure requirements. For US public bonds, longer tenor bonds generally amortise through annual principal repayments.
Typical market requirements	Typical loan size: US$250m minimum Typical tenor: 3 – 30 years Rating required: Typically two Legal opinion required: Yes Debt listing: Yes Road show required: Recommended Financial covenants: Typically none Upfront fees: None Lender relationship: None
Establishment process	Establishment processes are broadly in line with AUD public bonds, with additional administrative burden given increased US regulatory and disclosure requirements. Accessing offshore capital introduces foreign currency risk, and a US issuance will therefore require cross currency swaps to convert the proceeds of the loan in to AUD, and indicated in the figure below (forex rates are illustrative only):  A cross currency swap converts the USD proceeds raised (i.e. the principal loan amount) from the US bond market into a synthetic AUD debt obligation for the borrower over the life of the debt. ► The borrower swaps the USD proceeds for AUD proceeds with a bank

	at the start of the transaction. ► During the term of the debt, the borrower pays AUD fixed coupons to the bank and receives USD fixed coupons from the bank which are passed onto the US bond investors. ► At maturity, the borrower pays the AUD principal loan amount to the bank and receives the USD principal loan amount from the bank which is passed onto the US bond investors. The currency exchange rates and fixed coupons are agreed and documented at the commencement of the transaction with the bank. Should the transaction be terminated early for any reason there may be break costs payable under the cross currency swap to the bank.
Costs	Issuance costs are broadly in line with AUD public bonds, with additional costs of cross currency swaps.
Current market conditions	There is a strong appetite for Australian issuers in the US bond market which has resulted in tightening of margins. An example is the Australian mining services company, Barminco, which recently closed a $US485 million high-yield bond offering. Heavily oversubscribed by US and Asian investors, this high-yield bond offering was used to replace Barminco's existing secured senior bank syndicate, subordinated debt and mezzanine facilities.
Advantages	► Longer tenors up to 30 years ► Depth of liquidity
Disadvantages	► Complexity given foreign currency risk ► Typically requires cross-currency swaps ► Swap break costs if the debt is repaid early ► Two credit ratings are required ► Increased disclosure requirements
Options for councils to act on a collective basis	In line with AUD public bond.

Evaluation		
Price/ cost	While pricing in the US public bond market can be attractive, the funds are denominated in USD and therefore require a swap to convert into AUD. From discussions with banks, we understand there may currently be a modest all-in modest pricing benefit associated with raising USD bonds and converting the proceeds into AUD via a cross currency swap for investment grade issues. However, while there may be a modest pricing benefit to conventional bank debt, the additional costs and risk associated with cross currency swap are such that we consider it appropriate to assess the potential benefit as modest rather than high. We would recommend further analysis of the market and the hedging costs, if this option were to be considered further.	
Flexibility	AUD public bonds are viewed to be moderately flexible in line with AUD public bonds. Bonds are typically interest only, however a degree of flexibility can be achieved regarding repayment structure via structuring multiple tranches subject to different maturities. However, there is no ability to renegotiate terms during the bond tenor, and the cost of refinancing is higher as a result of the fees paid to an arranging bank, legal fees and credit rating fees. A minimum loan size of US$250m significantly reduces flexibility regarding frequency of debt raisings and availability for smaller debt requirements.	

Simplicity	US public bonds are considered to involve a high level of complexity because of the additional US market requirements and establishment process compared to an AUD public bond. This includes the requirement for an additional credit rating and the administrative burden associated with increased US regulatory and disclosure requirements. Importantly, a US road show is recommended which would involve key council individuals travelling to the US to participate in the investor presentations. There is a high level of financial complexity associated with the typical requirement for a cross currency swap derivative transaction to mitigate foreign currency risk. Cross currency swaps (a derivative instrument) may be beyond a reasonable level of community acceptability. Execution risk is moderate.	
Overall evaluation	Overall, the complexity of issuance and the risks of hedging are considered to outweigh the potential pricing benefits of this option.	

4. US private placement		
Overview	US private placements (USPPs) are unregistered debt or equity securities that are directly negotiated between an issuer and a limited number of US investors in a private and unregistered transaction. Similar to a loan, the borrower or issuer is required to make periodic interest payments (coupons) for the life of the private placement and at maturity the principal is repaid. Transaction sizes range from $AU30m to over $AU1bn and maturities typically stretch from five years to 30 years. Issuers include a diverse range of domestic and international corporates. UK housing associations have previously raised financing in the USPP market. Whilst they are not specifically UK government entities, the housing associations are regulated by the state and commonly receive public funding. There are approximately 50 active investors in the US private placement markets typically US insurance companies and pension funds seeking medium to long term fixed income to match their liabilities. Private placements require minimal regulatory approval and do not require public disclosure. As direct issues, there is typically no underwriting or legal due diligence, with deals not registered or listed on an exchange.The private placement market may be accessed directly or through an agent.	
Lending structures	Lending structures are transaction specific, however the most common form is a private, medium to long maturity fixed rate debt instrument similar to a bond Self-arranging borrowers can build a direct relationship with providers of capital. Through closer direct relationships, borrowers can achieve tighter pricing and more bespoke terms from fewer investors, and can also facilitate efficient future raisings and refinancings.	
Typical market requirements	Typical loan size:	US$25m minimum
	Typical tenor:	3 – 30 years
	Rating required:	No
	Legal opinion required:	Yes
	Debt listing:	No
	Road show required:	No
	Financial covenants:	Typically
	Upfront fees:	None
	Lender relationship:	Yes

Establishment process	Private placements are direct issues, typically with no underwriting or legal due diligence with the onus on the buyer to undertake their own due diligence A USPP issuance typically requires an agent to broker the transaction or an advisor to assist with arranging the deal directly with investors. Whilst there is no requirement for a formal credit rating, issuers must have an investment grade financial profile. The USPP notes are given a private rating by the Securities Valuation Office of the National Association of Insurance Commissioners (the "NIAC" rating). As issues are commonly denominated in USD, changes in market prices, such as foreign exchange rates or interest rates are factors borrowers need to carefully consider. Many issuers hedge such issues with cross currency swaps, which also have additional cost elements requiring consideration. AUD issuance is possible which removes some of the currency risk elements; however such issues may reduce investor demand.
Costs	In Australia and New Zealand, nearly all placements to US investors are 'agented' by banks, however by self-arranging a US issue, borrowers can eliminate the need for an agent or bank. Commonly this is achieved with an advisor to assist with the preparation of transaction materials, strategy, process and pricing. This results in substantial bank arranging fee savings, as high as 50 points. The coupon rate is dependent on the NAIC rating achieved. Interest is usually at a fixed rate. Pricing and interest rates of privately placed debt closely follow the market for publicly traded bonds.
Current market conditions	The US private placement market has consistently proved liquid despite recent volatile credit market conditions. Australian issuance volume in 2012 was relatively subdued, however deal flow in 2013 appears to have picked up with margins tightening. There is currently s strong investor appetite for infrastructure and utility assets and other investment grade credits
Advantages	► Minimum transaction size of A$25m ► Longer maturity alternatives ► Ability to tailor the transaction ► Limited disclosure ► No requirement for a rating ► Quick and efficient ► Sophisticated investors ► Long-term relationship with investors
Disadvantages	► Issuers must broadly have an investment grade financial profile ► In line with a US public bond, will require cross currency swaps (derivative instrument) to covert the proceeds to AUD ► Lump sum payment required based on the financial obligations for the full term, in the case of early repayment
Options for councils to act on a collective basis	The borrowing structure for a USPP could be either on an individual or a collective basis.
Evaluation	
Price/ cost	While we do not have access to recent market data on USPPs, we consider that – once converted into AUD – they are likely to be more expensive than conventional bank debt as a result of the additional costs and risks associated with cross currency swaps. 

Flexibility	USPPs are considered to be moderately flexible. Lending structures are transaction specific with a degree of additional flexibility compared to bond structures noting longer tenors available and the direct relationship with capital providers. Fixed or variable interest rate can be tailored to the council's borrowing requirements. In line with bonds, USPP's are typically interest only, with multiple tranches achieving a degree of flexibility regarding repayment structure. Minimum loan size of US$25m provides the option for smaller issuances.	
Simplicity	USPPs are considered to involve a high level of complexity due primarily to the location of the investors and the foreign currency risk. Meetings are typically required with USPP investors as part of the due diligence process. Accordingly, key council individuals may be required to travel to the US. In line with the US public bond option, there is a high level of financial complexity associated with the cross currency swap which may challenge community acceptability. Execution risk is moderate.	
Overall evaluation	Overall, the complexity of building relationships with offshore investors and the risks of hedging are likely to outweigh any potential pricing benefits associated with this option.	

5. AUD private placement		
Overview	In line with USPPs, AUD private placements are unregistered debt securities that are directly negotiated between an issuer and a limited number of investors in a private and unregistered transaction. The AUD private placement market operates in a similar manner to the USPP market, however on a smaller scale and in a less developed market. Issuers are typically Australian corporates, however this market would also be suitable for Australian local councils. The Treasury Corporation of Victoria has previously issued debt in the private placement market. Investors are generally Australian superannuation funds and other institutional investors.	
Lending structures	Lending structures are transaction specific, however the most common form is a private, medium to long maturity fixed rate debt instrument similar to a bond. Self-arranging borrowers can build a direct relationship with providers of capital. Through closer direct relationships, borrowers can achieve tighter pricing and more bespoke terms from fewer investors, and can also facilitate efficient future raisings and refinancings.	
Typical market requirements	Typical loan size:	$20m minimum
	Typical tenor:	3 – 10 years
	Rating required:	Yes
	Legal opinion required:	Yes
	Debt listing:	No
	Road show required:	No
	Financial covenants:	Typically
	Upfront fees:	Typically
	Lender relationship:	Yes
Establishment process	The establishment process is bespoke and dependent on the investor's requirements.	

	An AUD private placement issuance typically requires an agent to broker the transaction or an advisor to assist with self-arranging the deal directly with investors. Issuers must obtain at least one credit rating from an external credit rating agency (such as Standard & Poor's, Moody's or Fitch). The key difference to the USPP process is less reliance on own due diligence give the requirement for a credit rating	
Costs	The coupon rate is dependent on credit rating achieved. Other costs include an arranging fee payable to a broker or agent, upfront fees payable to the investor and legal fees.	
Current market conditions	The market for AUD private placements is less developed than the USPP market, with lower transparency regarding general market activity and pricing. A number of investors are focussed on sub investment grade issuers and targeting higher yielding investments.	
Advantages	► AUD issuance ► Investors are willing to consider sub investment grade issuers	
Disadvantages	► Limited market ► Credit rating required ► Upfront establishment fees	
Options for councils to act on a collective basis	The borrowing structure for an AUD private placement could be either on an individual or a collective basis.	
Evaluation		
Price/ cost	There is limited market data available on AUD private placements, as a result of tenor limitations and a general lack of transparency in this relatively undeveloped market. We note, however that investors in this market are typically looking for higher yield sub-investment grade issuers which will limit their pricing competitiveness. As a result, the potential to achieve a significant pricing benefit is considered to be moderate.	
Flexibility	AUD private placements are viewed to be moderately flexible. Lending structures are transaction specific with a degree of additional flexibility compared to bond structures noting longer tenors available and the direct relationship with capital providers. Fixed or variable interest rate can be tailored to the council's borrowing requirements. Minimum loan size of $20m provides the option for smaller issuances.	
Simplicity	Overall, AUD private placements are viewed to involve a relatively high level of complexity. As the establishment process is bespoke and dependent on the investor's requirements, it involves a considerable degree of uncertainty for the borrower. There is also the added complexity of a need for a credit rating and to identify investors and establish a strong relationship with them.	
Overall evaluation	Potential to be complex, with an unknown pricing benefit.	

6. AUD retail bond	
Overview	An AUD retail bond is a simplified AUD public bond which is targeted at the public. The retail bond market in Australia is not particularly deep, with only a handful of retail bonds recently issued in Australia including Waratah (NSW State

	Government), Tatts Group and Healthscope. Although legislation was introduced in March 2013 to encourage the development of the market, it remains largely constrained by fundamental demand side investment factors rather than regulatory factors. Retail investors in Australia are more incentivised to invest in equities or property given more favourable tax treatments compared to retail bonds. The NSW Waratah bonds are an example of an Australian government entity raising debt in the Australian retail bond market. In addition, Australian "treasury" bonds have been tradable on the Australian Stock Exchange ("ASX") since May 2013, which may lead to new government debt being raised from the retail market.
Lending structures	Retail bonds can take the form of either fixed rate bonds or floating rate bonds. There are a number of specific structural constraints imposed by current legislation including: ► Senior unsecured: retail bonds should not be subordinated other than to secured debt ► Tenor: maturity of up to 10 years is permitted In general retail bond issues do not involve the complex covenant packages that accompany bank debt and wholesale capital market issues. The main difference is in the degree of capacity to monitor and react to covenant performance. Structuring a retail security is a process of integrating the market security requirements for retail debt issue. This is typically achieved by: ► Issuing the bond on an unsecured basis, ranking parri-passu with existing and future unsecured senior debt; ► Negative Pledge provisions should be adopted as the primary lender protection on gearing levels; ► Strong cross default provisions; ► Permitted additional encumbrances that capture the day to day finance needs of the entity and future firm capital expenditure programs; and ► Clearly delineating current lender rights in offer documents.
Typical market requirements	Typical loan size: $50m minimum Typical tenor: 1 – 10 years Rating required: Not permitted Legal opinion required: Yes Debt listing: Yes Road show required: Recommended Financial covenants: Typically Upfront fees: Typically Lender relationship: Yes
Establishment process	A retail bond issuance typically requires the engagement of an investment bank as an underwriter / lead manager who will coordinate the process. In the case of Australian "treasuries" and "semis" these bonds are typically coordinated by the Australian Office of Financial Management ("AOFM") and the respective Treasury Corporations of each state. Preparation of a prospectus and documentation is required, as is marketing of the bond to generate investor appetite.
Costs	Upfront fees are typically twice as high as AUD public bonds due to the requirements to pay commission to distribution channels and the time intensive nature of the due diligence requirements of the prospectus.
Current market conditions	The issue of debt instruments direct to retail investors has a long and chequered history in Australia.

	Prior to the accelerated globalisation of the Australia debt capital markets, a wide variety of funding institutions regularly tapped the public market, including bank owned finance companies and semi-government authorities. The contraction of the government borrowing market and easy access to efficient global capital markets gradually eliminated demand from the major lending entities for retail debt funds. The banks developed a range of hybrid instruments as their primary conduit to the retail market but have been forced to make these more and more complex to achieve their balance sheet aims under IFRS and this has made them less attractive to "mum & dad" investors. The withdrawal of the major banking institutions left the retail market largely to small specialist finance entities and the more aggressive property development funds. The very public failures of Westpoint and Fincorp triggered additional ASIC regulation of this process such that prior to the current financial crisis smaller lease broker/funders and consumer finance entities were the primary regular issuers, mainly targeting "sophisticated" investors as defined by ASIC. The market dislocation caused by the Federal Government bank guarantee facility effectively truncated this funding conduit by inducing a strong preference for bank paper at the expense of higher yielding specialist instruments. As a result of this chequered history, there have been limited transactions in Australia in recent years. This is also because of the punitive tax treatment for retail investors compared to other asset classes such as equities and property. Furthermore, credit ratings are not permitted for retail bonds as the credit rating agencies do not hold retail financial services licences. This limits the availability of independent information for retail investors to assist in assessing the investment risks. It is noted that in New Zealand, Auckland City Council issues retail bonds with relative success. In December 2012 it offered NZ$125m for 6 years. The issuance attracted 14,800 retail lenders, bidding $270m for the $125m offered despite an interest rate 4.41%.
Advantages	► Minimum transaction size of A$50m ► No credit rating required
Disadvantages	► Legislative changes may be required to facilitate local council retail bond issuance ► Higher upfront costs and margins compared with AUD public bonds
Options for councils to act on a collective basis	The borrowing structure for an AUD retail bond issuance could be either on an individual or a collective basis.

Evaluation		
Price/ cost	Because the retail bond market in Australia is not particularly deep, with only a handful of retail bonds recently issued, it is not clear that there would be a considerable pricing benefit compared with a public bond. Furthermore, retail debt issue can be expensive, and the indirect and direct costs are considered to be materially higher than councils are used to in securing debt funding. Upfront fees are typically twice as high as AUD public bonds due to the requirements to pay commission to distribution channels and the time intensive nature of the due diligence requirements of the prospectus.	
Flexibility	AUD retail bonds are viewed to be moderately flexible in line with AUD public bonds. The key difference to AUD public bonds is that there are a number of specific structural constraints imposed by current legislation designed to protect retail investors - however these are unlikely to materially impact a local council issuer.	

Simplicity	Overall, AUD retail bonds are viewed to involve a moderate level of complexity, noting typical market requirements and establishment process. Listing rules and corporations law requirements would impose an administrative burden on council, as well as exposing office bearers to additional legal liabilities. Market requirements include legal opinions, debt listing and a road show. The establishment process incorporates preparation of a detailed prospectus and other documentation plus marketing of the bond to generate investor appetite. Bond issuers typically engage an arranger or bank to coordinate the process which significantly reduces the administrative burden. Execution risk is moderate.	
Overall Evaluation	Moderately flexible and complex but unlikely to provide the most attractive pricing and cost benefit.	

Appendix 5 Financial data

This section provides the data used in the analysis within the report.

Table 18 AUD Public bonds

Borrower	Rating	Tenor	Yield	Above swap
State Treasury Corporations				
Victoria	AAA	9 years	4.44%	0.01%
New South Wales	Aaa	10 years	4.42%	-0.01%
Western Australia	Aaa	10 years	4.70%	0.27%
SAFA	Aa1	8 years	4.61%	0.18%
Queensland	Aa1	10 years	4.89%	0.46%
Tasmania	AA+	9 years	4.80%	0.37%
Corporates				
NAB	Aa3	9 years	4.55%	0.12%
WESTPAC	Aa2	9 years	5.60%	1.17%
New Zealand Milk	AA-	9 years	5.53%	1.10%
Telstra	A2	9 years	5.99%	1.56%
HSBC	A1	9 years	5.45%	1.02%
ANZ	A-	10 years	4.66%	0.23%
ICPF FINANCE	A	9 years	6.30%	1.87%
AMP BNK	A	9 years	4.94%	0.51%

Source: Reuters 27 June 2013

Table 19 Average 10 year pricing

Borrower rating	Above swap
AAA	0.09%
AA	0.57%
A	1.42%

Table 20 10 year swap rate (27 June 2013)

Borrower rating	P.a.	
Swap rate	4.43%	http://www.afma.com.au/bbsw.html
All in AA	5.07%	
All in A	5.47%	

Table 21 Bank debt pricing (quotes provided in the last week of June and first week of July 2013)

Borrower	Borrower rating	10 year fixed rate
"Big 4" Bank A	**AA**	**5.70%**
	A	**5.80%**
"Big 4" Bank B	**A**	**5.80%**

Table 22 AUD bond calculations

(AUD $M) on $50m Bond	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Margin Saving	0.24	0.24	0.24	0.24	0.24	0.24	0.24	0.24	0.24	0.24	2.40
Upfront Costs											-
Investment Bank Fee	0.75	-	-	-	-	-	-	-	-	-	0.75
Credit Rating	0.15	-	-	-	-	-	-	-	-	-	0.15
Legal Fees	0.10	-	-	-	-	-	-	-	-	-	0.10
Ongoing Costs											-
Credit Rating	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.50
Net Saving	- 0.81	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.19	0.90
Cumulative Savings	- 0.81	- 0.62	- 0.43	- 0.24	- 0.05	0.14	0.33	0.52	0.71	0.90	

(AUD $M) on $100m Bond	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Margin Saving	0.48	0.48	0.48	0.48	0.48	0.48	0.48	0.48	0.48	0.48	4.80
Upfront Costs											-
Investment Bank Fee	1.25	-	-	-	-	-	-	-	-	-	1.25
Credit Rating	0.15	-	-	-	-	-	-	-	-	-	0.15
Legal Fees	0.10	-	-	-	-	-	-	-	-	-	0.10
Ongoing Costs											-
Credit Rating	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.50
Net Saving	- 1.07	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	2.80
Cumulative	- 1.07	- 0.64	- 0.21	0.22	0.65	1.08	1.51	1.94	2.37	2.80	

(AUD $M) on $200m Bond	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Total
Margin Saving	0.96	0.96	0.96	0.96	0.96	0.96	0.96	0.96	0.96	0.96	9.60
Upfront Costs											-
Investment Bank Fee	2.00	-	-	-	-	-	-	-	-	-	2.00
Credit Rating	0.15	-	-	-	-	-	-	-	-	-	0.15
Legal Fees	0.10	-	-	-	-	-	-	-	-	-	0.10
Ongoing Costs											-
Credit Rating	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.50
Net Saving	- 1.34	0.91	0.91	0.91	0.91	0.91	0.91	0.91	0.91	0.91	6.85
Cumulative	- 1.34	- 0.43	0.48	1.39	2.30	3.21	4.12	5.03	5.94	6.85	

Appendix 6 Public bond issuance considerations

This section explores some of the administrative and compliance requirements that a council would need to consider in exploring a public bond issuance, in particular:

- Obtaining a credit rating
- ASIC and Corporations Law procedure
- State Government approvals

The focus of these considerations is on the pre-issuing phase. It is anticipated that this phase of the process would be led by the issuing council with input from expert advisors. In contrast, the issuing phase will be largely market-led.

Obtaining a credit rating

The process for obtaining a credit rating is likely to take around three months and consist of the following phases:

Table 23 Credit rating process

Phase	Description/ overview
1. **Preparatory phase**	▸ Prepare detailed rating plan and identify key rating drivers ▸ Hold informal meetings with agencies to gauge application of methodologies ▸ Select agencies and agree content of key deliverables moving forward
2. **Draft and submit deliverables**	▸ Undertake research and analytical work ▸ Consider full range of credit issues ▸ Prepare information and analysis including risk mitigation points ▸ Draft ratings presentations and documents ▸ Continue engagement with rating agency ▸ Draft and submit deliverable
3. **Present to agencies**	▸ Conduct meetings with agencies and respond to supplemental questions
4. **Ratings determination**	▸ Agencies conduct determination

ASIC and Corporations Law procedure

Bond issuances are governed by the *Corporation Act 2001* (the Act), Section 2L. The Act requires that an offer of bonds states that prospectus disclosure is required to investors unless excluded by section 708.

Subsections 708(8) to 708(20) identify persons and circumstances that do not require disclosure. Persons described in this subsection 708(8) include a sophisticated investor who is recognised as an investor who is able to protect their own investment interests without regulatory protection. A person is considered a sophisticated investor if they meet one or more of the following requirements:

- the minimum amount payable for securities is at least $500,000, or
- the collective amount invested in the same class of securities amounts to $500,000, or
- a qualified accountant certifies (no more than 6 months before the offer is made) that the net asset worth of $2.5 million or gross income for each of the last two financial years is at least $250,000 annually.[28]

Where no prospectus is published, it is standard practice that a bond offering memorandum is prepared.

There are a number of regulatory guides, class orders and reports that have been issued by the Australian Securities Commission (ASIC) in respect fundraising activities. These would need to be reviewed to ensure adhere with these regulatory documents in any bond raising activity undertaken by a council.

State Government approvals

The requirements for State Government approval vary from jurisdiction to jurisdiction. It is anticipated that in every jurisdiction, the government would to require the debt raising process to be transparent and auditable, and would ask the issuing council to submit the entire process to ASIC so that potential investors have access to:

- transparent and accurate data on council finances and project performance,
- full prospectus style information fully describing the investment risks
- an efficient process with an error-free application and payment mechanisms
- evidence of a strong commitment to the ongoing management of the debt facility.

The other key concern on the part of State Governments is likely to be the financial efficiency of the debt raised. The State Government acts as the implicit financial supporter of all local government entities and therefore has a clear stake in ensuring councils do not enter into transactions which ultimately expose the state to liabilities that are overpriced. The State Government would probably require a detailed business case that addresses:

- the key rationale for seeking to issue public debt
- the likely costs, both transactional and recurrent that will accompany such a process
- a comparison of the estimated costs of the debt with viable alternatives
- a comprehensive plan showing how council intends to implement the transaction.

[28] Corporations Act 2001 – Sect 708

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