

## 9.7 Debt Management Strategy

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### Meeting

Council

### Date

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### 1. Purpose

This report presents the Debt Management Strategy for Council's adoption.

### 2. Recommendations

**That Council adopt the Debt Management Strategy as presented in Attachment 1 to the agenda report.**

### 3. Executive summary

Following adoption of the Long Term Financial Plan (LTFP) in February 2021, one of the key principles to be actioned was for Council to adopt and implement a debt reduction strategy which would outline how Council would manage its debt. The final strategy provides an overview of the key LTFP principles specifically relating to debt and key actions that will undertaken to manage and reduce debt.

### 4. Background

Community Plan 2030	<p><b>people:</b> connected, engaged, active, healthy</p> <p><b>place:</b> green, inviting, accessible, liveable</p> <p><b>prosperity:</b> economically strong, environmentally thriving</p> <p><b>performance:</b> accountable, efficient, inclusive, sustainable</p> <p>Adopting a Debt Management Strategy supports the theme of Performance, in particular, being accountable, efficient and sustainable in our financial management.</p>
Policy and/or relevant legislation	Long Term Financial Plan 2021–22
Who did we talk to/who will we be talking to	Consultation with the Elected Members and the community on the Long Term Financial Plan occurred from July 2020 to February 2021. Additional engagement with the Elected Members through the Finance Working Group specifically on the Debt Management Strategy also occurred.

## 5. Discussion

At its meeting on 16 February 2021, Council adopted a new Long Term Financial Plan (LTFP), which is underpinned by 16 key principles relating to services, capital works, debt and rates. Principle #12 reflects the need for Council to adopt and implement a debt reduction strategy over the life of the LTFP.

The LTFP also contains four other principles that directly relate to debt, which include adopting a dollar value debt ceiling and changing the mix of rates:debt funding mix for new capital projects. In addition, there are a number of other actions that council undertakes to manage debt, such as reviewing interest rates, and utilising cash coming into Reserves to offset debt.

When developing the LTFP, a Finance Working Group consisting of 5 Elected Members and staff was established to workshop various elements of the LTFP in more detail. Following adoption of the LTFP, the Finance Working Group continued to meet. A public meeting was held on 25 March 2021 to discuss the elements and structure that should be included in the Debt Management Strategy.

The Debt Management Strategy outlines the context that the City of Onkaparinga is operating in, the key principles underpinning the Strategy, and the key actions that will be undertaken to reduce debt.

The final Debt Management Strategy as presented in Attachment 1.

## 6. Financial implications

### Financial summary

This report outlines how Council will manage debt in line with the adopted Long Term Financial Plan principles and parameters.

## 7. Risk and opportunity management

Risk	
Identify	Mitigation
Financial/business sustainability	Our financial planning strategies, including our Debt Management Strategy, provide a framework which supports decision making within the context of future financial sustainability.

## 8. Timelines, deadlines and next steps

Once adopted, reporting against the actions in the Debt Management Strategy will be provided to Council on a quarterly basis as part of the review and update of the LTFP.

## 9. Attachments

Attachment 1 – Debt Management Strategy (10 pages)

- END OF REPORT -

# CONTENTS

Context	2
What is the Debt Management Strategy and why do we need one?	2
Why does Council have debt?	2
How much debt do we have? Why do we have this level of debt?	2
Is this level of debt manageable?	3
Alignment to Strategic Plans	4
Community Plan 2030	4
Strategic Asset Management Plan	4
Community Engagement	4
Current Economic Environment	5
Key Financial Principles	5
Key Financial Indicators	6
Indicator 2: Net Financial Liabilities Ratio	6
Indicator 3: Interest Cover Ratio	7
Indicator 4: Level of Borrowings	7
Indicator 5: Debt Servicing	8
Key Actions	8
Budget management	8
Projects	9
Debt	9

## CONTEXT

In February 2021, Council adopted its Long Term Financial Plan (LTFP). As part of the adoption, Council committed to implementing a Debt Management Strategy to assist with achieving the objectives of the LTFP. This Debt Management Strategy is therefore a sub-document to the LTFP and needs to be read in conjunction with the LTFP.

In developing the LTFP, Council endorsed a set of 16 financial principles, of which 5 related directly to debt. It is important to note that the 16 principles are to some degree related and so the Debt Management Strategy must also work with the entire suite of 16 principles.

It should also be noted that council has 3 key strategic plans, which work together and inform each other, and include:

- The Community Plan
- The Strategic Asset Management Plan (SAMP), and
- The Long Term Financial Plan

Additionally, other policies and work impact the operation of the LTFP and the debt projection within it. Two of these which are integral to the LTFP and the Debt Management Strategy are the Asset Rationalisation Policy and the Rationalisation of Reserves.

### What is the Debt Management Strategy and why do we need one?

A strategy can be described as a long term plan of action to achieve an objective. The LTFP is a critical part of council's financial planning process, helping to guide longer term decisions to maintain long term financial sustainability while meeting the needs and expectations of our communities in delivering Council's objectives.

The management of debt is a key component of the LTFP and future financial sustainability and therefore, the Debt Management Strategy is an

important tool and set of guidelines, helping to guide longer term decisions associated with debt.

The principles and actions within the Debt Management Strategy dictate how Council is going to manage debt with a view to reducing it over time.

### Why does Council have debt?

Onkaparinga is a large and growing council. In order to meet the needs of a growing community, council must maintain and upgrade existing infrastructure and provide new infrastructure, particularly in new areas where little infrastructure exists.

To deliver these important projects and infrastructure, council borrowed money from Local Government Financing Authority (a State-backed entity), which creates a debt, or money owed, to be repaid over a period of time. This is quite similar to funding a home purchase whereby a borrower takes out a loan, creating a debt which is money owed to the bank) to be repaid over time.

If council were to fund infrastructure via rates only, rates would be higher than they are now and have been in the past, with the current community footing the bill for this infrastructure, which has a significant lifespan and will be utilised and benefited now by the current community, and into the future by future communities. Debt assists with funding new infrastructure and upgrades to existing infrastructure without severely increasing rates to do so. This is what is known as intergenerational equity, where everyone contributes over time to the infrastructure they utilise.

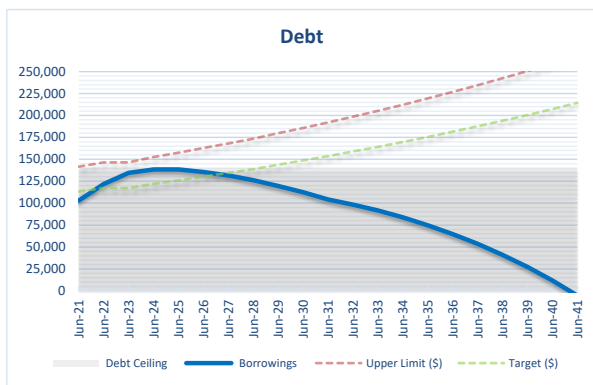
### How much debt do we have? Why do we have this level of debt?

Debt is projected to be about \$99m as at June 2021 (BR3 2020-21), projected to peak at \$138.5m in 2023-24, before beginning to recede.

About \$20m of debt was inherited at Council amalgamation and under investment in

infrastructure over time led to a requirement to invest more rapidly during the period 2008-09 to 2012-13, where debt grew to about \$60m. This delivered key infrastructure projects during this time. Through this period, council also invested about \$12m into the Waterproofing the South Project. There was a further increase in debt as other major infrastructure projects were delivered between 2014-15 and 2018-19.

The following chart shows the trajectory of projected debt as per the adopted LTFP, including the debt ceiling of \$139.5 million which peaks in the financial year 2023-24. The dotted lines show the debt limits from the previous policy.



### Is this level of debt manageable?

Keeping debt at a manageable level is important for good financial health. Let's explain why council's level of debt is manageable.

Lenders use a range of measures to determine how manageable the level of debt is for a borrower, including the borrower's ability to make repayments without undue hardship or risk. Two common measures are the loan-to-value ratio (LVR) and the debt-to-income ratio (DTI).

### Loan to Value Ratio

The Loan to Value Ratio (LVR) is how lenders describe the amount of borrowings against the value of assets, which are used as security for loans, in the event of a borrower being unable to repay their debt. The LVR is simply calculated by dividing the loan amount by the value of assets.

A low LVR is considered better from the lender's perspective because a lower LVR generally carries less risk. When it comes to LVR, 80% is widely considered the tipping point where, generally speaking, most lenders consider a LVR of 80% or more as being risky.

What is the council's LVR? Using council's projected peak debt of \$139.5m and the value of its assets (\$2.9b) creates a ratio of 4.8%. However, given that many of council's assets are not able to be sold, a more realistic LVR would be calculated using the market value of council's land and building assets only, because these are theoretically saleable, if for some reason council's loans had to be repaid. Council has about \$800m in land and building assets which produces an LVR of about 17.5%, which is significantly lower than 80%. The average Adelaide homeowner LVR is about 67.6% (\$345,000 loan and house value of \$510,000).

### Debt to Income Ratio

A debt-to-income ratio (DTI) is a finance measure that compares the amount of debt to overall income. It's probably more meaningful for council because council's debt is secured by its rate revenue.

Lenders use the debt-to-income ratio as a way to measure credit worthiness, based on the perceived ability to manage repayments. The DTI is calculated by dividing total debt by total gross annual income.

There are different debt-to-income ratios that lenders will accept when assessing borrowers as part of the credit analysis process. This process determines the borrowers credit risk, which the lender uses to decide whether to provide loans or not, and to determine the amount they will lend. A low DTI means that a bank will be more likely to lend as the borrower has the income to successfully meet repayments. For home loans, banks generally won't lend if the DTI is greater than 9 and for DTIs between 7 and 9, manual approval processes are applied.

A high DTI directly affects a borrower's ability to secure a loan. Generally speaking, a DTI higher than six times income is considered to be a high risk that could put a borrower under financial stress, particularly if the borrower's financial situation changed suddenly or interest rates were to rise dramatically.

A low DTI is generally under 3.6, depicting a low amount of credit, and is often viewed favourably by lenders. A low DTI can show an ability to successfully manage debt. If the DTI is kept low, it will help ensure that debt repayments are affordable and provide peace of mind that finances are being handled responsibly.

What is the council's DTI? Again, using council's projected peak debt of \$138.5m and annual revenue of about \$180m, council's DTI is about 0.78. Given that council's loans are secured against rate revenue, council's single largest controllable revenue source, it provides a more meaningful measure. Council's rate revenue is approximately \$136m which produces a DTI of about 1.02, which is significantly lower than 7, or 3.6 for that matter. The average South Australian homeowner DTI is 5.2 (\$345,000 loan and average gross household income of \$66,000).

## ALIGNMENT TO STRATEGIC PLANS

The LTFP (and by association, the Debt Management Strategy) is informed by key principles, which in turn were informed by the Community Plan, the Strategic Asset Management Plan (SAMP) and community feedback.

There has been significant input from the elected members through a series of elected member workshops, establishment of a Finance Working Group and involvement with the recent community engagement process (including design of the LTFP survey).

## Community Plan 2030

The Community Plan 2030 sets the focus for Council, and is the lead document informing Council's strategic planning work, guiding strategic and operational decisions about services, assets, programs, advocacy and projects. It sets a vision for the future of our communities.

The 2020–21 LTFP has been developed in the context of delivering the outcomes as set out in the Community Plan 2030.

## Strategic Asset Management Plan

The Strategic Asset Management Plan (SAMP) provides an overview of our assets, how they are performing, the service levels we provide, our asset goals and objectives, areas for improvement, and related financial projections, with strong links to the Community Plan 2030.

It is also critical that there is a strong alignment between the LTFP and the SAMP. The projections in the LTFP must align with the objectives and demands identified in the SAMP to ensure that sufficient budgets are allocated to achieve these objectives, and vice versa.

Of importance to the LTFP, capital expenditure is split into two streams – renewal, and new and significant upgrades (which includes major projects), and these are funded differently. Renewal is funded via rates and new and significant projects are funded through a combination of rates and borrowing.

## COMMUNITY ENGAGEMENT

As part of the development of the LTFP, extensive community engagement was undertaken, seeking opinions on the key elements of the LTFP – rates, debt, services and capital expenditure. Elected Members were actively engaged in the development of the questions asked in the survey, which took place between 19 November and 11 December 2020.

In addition to this consultation, community feedback from previous consultation processes, including engagement on the budget, the Annual Business Plan, and the Community Plan, also helped to inform the development of the LTFP. This was used to gauge community sentiment in relation to debt which was used to develop the key principles associated with debt.

## CURRENT ECONOMIC ENVIRONMENT

Council's financial strategies are influenced by the current economic environment, its financial position, and the impacts on the organisation from both internal and external factors.

Interest rates are currently at an historic all-time low. As such, it is possible that rates will increase over the ensuing 10-year period but this is subject to local and global economic conditions. Interest rates in the LTFP have been set at the existing loan agreement rates, with variable rates increasing in line with projections provided by Deloitte Access Economics.

The impact of the COVID-19 pandemic has impacted the world's economy throughout 2020 and council's response, via relief measures put in place, has impacted its debt position. Although not expected and subject to the recovery of the economy, council may need to remain flexible should further responses be required.

## KEY FINANCIAL PRINCIPLES

The key principles of the LTFP (Appendix 1) provide guidance for future financial decisions and have been developed with regard to future sustainability, and to the feedback received from the community. The key principles endorsed by

Council underpin the assumptions and settings used in the LTFP financial forecasts.

There are five key principles that relate to debt.

### 10. Borrow for projects on the following bases:

- **Change the mix of funding for new and significant upgrade projects from the current 80:20 debt:rates funding mix to 60:40**
- **Complete existing major projects at the current 80:20 debt:rates funding mix**
- **Start new major projects, within available funding limits, at a 60:40 debt:rates funding mix**

Community feedback supported borrowing now to undertake projects given historically low interest rates. Previous feedback also suggested council to consider different ways to fund projects.

Adopting a 60:40 debt:rates funding mix (previously 80:20) reduces the reliance on debt to deliver projects and also constrains the level of expenditure available to undertake new and major projects. This setting slows down borrowing, requires more scrutiny on decisions (for example, 40% to be funded from rates, putting pressure on rate rises in any given year) and slows down future project initiation.

### 11. Adjust new major projects to align expenditure to available funding

Major projects are a significant contributor to debt levels. The current LTFP and debt projections are based on completing committed major projects only. As such, there is no specific position on funding new major projects, although discussion at elected member workshops indicated a willingness to consider funding participation in major projects on a case-by-case and merits basis. As capacity to borrow increases within the parameters of the LTFP, Council will need to exercise some flexibility in this regard because, from time to time, council receives grant or stimulus funding specifically to deliver major projects. Such funding can be an advantage to council where the cost to council to



deliver infrastructure is somewhat reduced (typically by at least 50%).

## **12. Adopt and implement a debt reduction strategy over the life of the LTFP**

A higher proportion of the community supported maintaining current debt (noting that a proportion of survey respondents supported increasing debt and a similar proportion wanted to reduce debt). Council has committed to implementing a debt management strategy with a view to maintaining current debt levels, peaking at \$138.5m in 2023-24, before receding over time.

## **13. Improve transparency and flow of information in response to community feedback about how debt is used**

About a fifth of survey respondents said that they knew a lot about council debt, however the majority of respondents stated that they had little to no understanding. This strategy document is one of the ways council is seeking to improve the community's understanding of council debt. Council is also developing other information, materials and tools to assist in delivering on this principle.

## **14. Adopt a dollar value debt ceiling.**

A higher proportion of respondents in the engagement supported maintaining current debt and feedback from previous engagements expressed concern over increasing debt levels. Modelling based upon applying the key LTFP principles indicated that debt is expected to peak at \$139.5m in 2023-24, and with this being adopted as the dollar value debt ceiling, future LTFP's must therefore be managed within this ceiling, noting that the intent is to reduce debt over time.

appropriate for measuring financial sustainability in the context of Local Government.

Given the focus on managing debt levels and using best practice financial management principles, council has developed additional measures for Debt Servicing and Level of Borrowings. Council has adopted appropriate targets for each KFI. The following KFIs relate to debt.

## **Indicator 2: Net Financial Liabilities Ratio**

Net Financial Liabilities are what is owed to others less money already on hand and what is owed from others. The Net Financial Liabilities ratio measures the significance of the net amount owed compared to income. It is calculated by dividing Net Financial Liabilities by total operating revenue and is very similar to the Debt to Income Ratio.

A growing council can expect to have a ratio > 0%, needing borrowings to fund infrastructure and satisfy intergenerational equity. Most growth councils have ratios > 100%, however a ratio > 100% exceeds council's target.

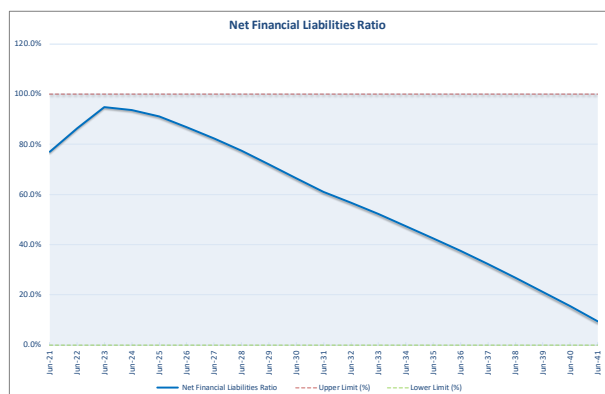
In comparison, a household with \$66,000 income (Greater Adelaide average household earnings) and a mortgage of \$345,000 (Greater Adelaide median) produces a ratio of 522%.

In the short term, the strategy of completing existing committed major and other new or upgrade projects, sees debt (the key driver behind net financial liabilities) peak with this KFI reaching about 95%. The savings strategy to achieve a balanced budget position in 4 years contributes to generating surpluses, which begin to allow debt to be repaid. This assumes no new major projects beyond the current committed projects and that surpluses are used to repay debt. Should Council resolve to undertake new projects, reduce rates or direct surpluses to other purposes, then the net financial liabilities ratio can be expected to be higher than in the chart below.

# **KEY FINANCIAL INDICATORS**

Council has adopted a suite of Key Financial Indicators (KFIs) that are consistent across the local government sector, and considered as





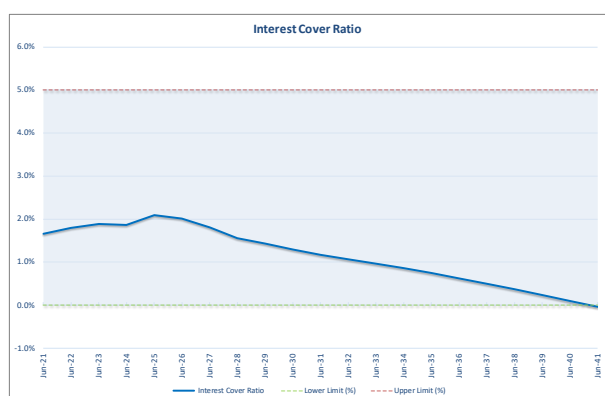
### Indicator 3: Interest Cover Ratio

The Interest Cover ratio measures how much income is used to pay interest on loans and is calculated by dividing finance charges (interest) by total operating revenue. Council targets to not exceed 5%.

Any council that has debt and pays interest will have a ratio of > 0%. Once a council fully matures, reducing the need for new infrastructure, and has repaid its borrowings, this ratio will be equal to 0%.

A household with debt of \$345,000 and annual interest of say, \$12,075 (calculated at 3.5% per annum) with a household income of \$66,000 will produce a ratio of 18.3%.

Council's projected ratio reflects the impact of the adopted strategies on the level of debt, which drives the interest expense in any given period, and peaks at just over 2%.



### Indicator 4: Level of Borrowings

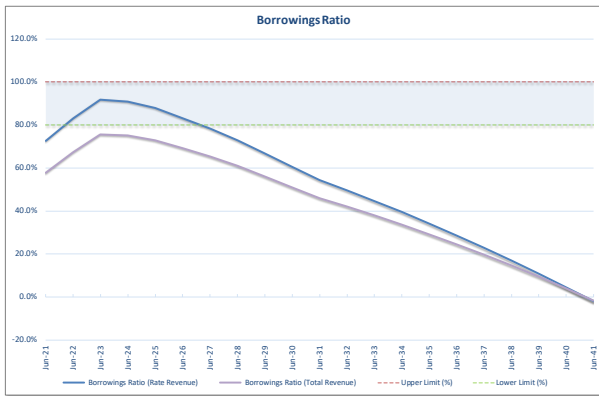
As a growth council with community concern around debt levels, council has adopted this indicator to monitor borrowing levels. It looks at the level of debt from a traditional security standpoint, against total revenue. However, given that council's debt is secured against its rate revenue, this is also included.

It is calculated by dividing total borrowings by revenue (the purple line reflects total revenue). Council previously adopted an upper limit target of 100% of rate revenue, with a target range between 80% and 100%. Whilst this is shown in the chart below, council has now adopted a hard dollar value limit of \$138.5 million.

In order to provide new infrastructure for growth, councils will from time to time require prudent debt, which assists in maintaining inter-generational equity by seeking to neither burden current nor future generations unfairly. Too much debt long term is not sustainable as this will divert a higher proportion of revenue towards debt servicing.

A household with debt of \$345,000 and a household income of \$66,000 will produce a ratio of 522%. If debt is too high, households will struggle to service the debt with interest costs forming too large a part of the household budget, and in the worst case, will not be able to repay debt at all.

The short term projection (peaking at around 75%) reflects completion of committed projects and coincides with debt peaking at \$139.5 million. Savings, matched with CPI rate increases, generate surpluses with which debt is repaid. Should Council resolve to undertake new projects the borrowings ratio can be expected to be higher.



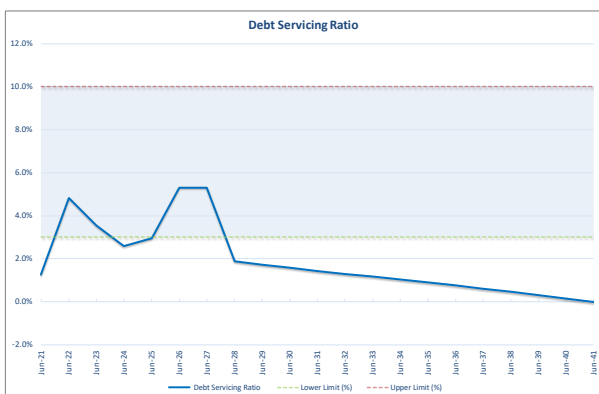
## Indicator 5: Debt Servicing

As a growth council that utilises debt, this ratio measures the proportion of total operating revenue required to service debt. It is the total cost of servicing debt (principal and interest repayments) divided by total operating revenue.

Council's debt servicing target is below 10% of rate revenue and above 3% of rate revenue. If the ratio is too high, then too much of rate revenue is being used to service debt, instead of being used to fund and provide services to the community.

In a household, if the amount of income required to service debt is too high, forming a large part of the household's outgoings, there is less income available to use for other purposes.

The short term projection shows the effect of retiring fixed term debt (with balloon payments) and whilst the servicing ratio spikes, it is still well within adopted limits. As refinancing of fixed debt occurs at lower interest rates (with no future balloon payments), the level of debt servicing reduces significantly, freeing up revenue for other purposes.



## KEY ACTIONS

The key strategies and actions for debt management, that are informed by and aligned to, the Key Principles adopted by council, are detailed in this section.

### Budget management

As part of the adoption of the LTFP, Council resolved to return to an operating surplus by 2024–25, through identification and realisation of an additional \$1.4 million savings per year for the next 4 years additional.

Given that rate increases have been limited to CPI, designed to just cover normal year on year inflationary pressures, it is therefore imperative that the target savings are achieved in order to generate the surpluses required to achieve the LTFP objectives.

#### Savings:

- Establishment of the Organisational Effectiveness team to drive, capture and realise internal efficiencies
- Undertake a systematic approach to Service Reviews so that all parts of the entire organisation are reviewed at least once every four years
- Implement an integrated and organisation wide approach to identification, quantification and realisation of savings from efficiencies
- Develop a policy around the application of savings
- Embed the amount of the \$1.4m savings targets, proportionate to divisional operating budgets, directly into each divisional budget

#### Budget within the parameters of the LTFP:

- Maintain rate rises at a minimum of CPI, to at least cover the cost of providing existing services
- Do not introduce new or enhanced services without a commensurate rise in rates

- Ensure divisional budgets are produced based on delivering existing services
- Once surpluses are generated, balance the need to repay debt, offset rate rises or undertake other initiatives
- Once surpluses generated are large enough, consider funding more infrastructure from surpluses, to reduce the reliance on debt for funding infrastructure

### Improved Reporting

- Establish a baseline, based on the adopted LTFP, and embed regularly reporting of progress against LTFP objectives (within the quarterly Budget Review process)
- The baseline is to serve as a benchmark for decision-making in general direction (but may need flexibility to deal with unforeseen opportunities and issues as they arise)
- Provide a debt-specific section within regular reporting to Council
- Review and improve the Financial Implications section in the Council Report Template to enable better information about projects and initiatives that funding is being sought for

## Projects

Different capital projects are funded differently. Renewal projects are funded 100% from rates whilst New and Significant Upgrade (NSU) projects and Major Projects (MPF) are funded from a combination of rates and debt. It therefore follows that Council's approach to funding NSU and MPF has a direct impact on debt levels.

- Establish a baseline, based on the adopted LTFP, to consider funding of new projects and other initiatives, so that any decisions made are in line with both the adopted LTFP projections and the key principles underpinning the LTFP
- Given that the SAMP and LTFP inform each other, improve the links and timing of production of both these strategic plans

- Where funding is constrained, the priority will be on renewing, upgrading and extending existing infrastructure, in preference to undertaking new major projects
- Complete existing committed major projects and start new major projects when funding capacity is available
- Within the context of the agreed LTFP Key Principles, take a flexible approach to undertake projects through stimulus and other grant funding, and other opportunities, considering the financial impacts on a case by case basis should capacity allow.
- To provide some certainty around resourcing future projects, noting the long lead in times to get a project from planning through to design and delivery, develop a projection of potential funding available to fund new major projects (based on the principle that growth revenue will be used to deliver new assets and upgrade and extend existing assets, to ensure the right infrastructure and facilities are in place to meet the needs of the community as the city grows and changes)
- In conjunction with the above, develop an approach around the use of genuine project unspent funds (that is, not timing-generated savings) to fund new projects whilst staying within the debt parameters of the LTFP

## Debt

### Funding Limit

As part of the LTFP adoption, Council adopted a new debt limit policy. The previous position had an upper limit of 100% of annual rates revenue, targeting 80%, where debt was projected to grow as rate revenue grew.

- Implement debt ceiling of \$138.5 million

### Funding Mix

Through the adoption of the LTFP, Council resolved to take a new approach to the use of debt for funding new projects. Previously, all new

projects were funded using 80% debt and 20% rate revenue.

- Fund all renewal projects 100% from rates (unchanged)
- Fund all existing committed major projects 80% from debt and 20% from rates (unchanged)
- Fund new and significant upgrade projects 60% from debt and 40% from rates
- Fund all new major projects 60% from debt and 40% from rates

**Other debt-related actions**

- Consider the proportion of fixed versus variable debt that is appropriate to meet the current and future funding needs of the organisation
- Monitor interest rates to lock in long-term fixed debt at the best rate possible
- Provide more information to the community to assist in further understanding how council uses borrowings