SECTION 4: Financial strategy | Rautaki pūtea

Financial strategy | Rautaki pūtea

INTRODUCTION

The Local Government Act 2002 requires local authorities to prepare and adopt a financial strategy as part of its long term plan (section 101A).

The purpose of the strategy is to facilitate:

- prudent financial management by the local authority by providing a guide to consider proposals for funding and expenditure against
- consultation on the local authority's proposals for funding and expenditure by making transparent the overall effects of those proposals on the local authority's services, rates, debt and investments.

The financial strategy brings together the overall direction for the financial aspects of the long term plan (LTP) with a summary of the financial issues and consequences that arise from policy and service delivery decisions made by the council through the development of the LTP (consequences of emerging issues, prioritisation and trade-offs).

The objectives set through the financial strategy are implemented through a series of policies and plans which make up the complete LTP, specifically:

- Revenue and financing policy, which sets out how the activities undertaken by the council should be funded.
- Activity plans, including cost of services statements which summarise the work programme the council plans to undertake and the impact of these activities on the various funding streams.
- Asset management plans which define the levels of service provided by the council's key assets, and the costs to maintain these assets.
- Funding impact statement, which translates the rating requirements into the rating factors to be applied to properties in the region. This will include the fees and charges policy, which sets out the way in which the council will levy direct charges for the services it provides.
- Treasury management policy (including investment policy and liability management policy), which sets out how the council will manage its investments and borrowings (if any).
- Rates remission policies, which set out the criteria that the council will consider when remitting rates charged.

STRATEGY DIRECTION

The council is currently in a strong financial position, illustrated by:

- modest rates increase of between -1.3% – 2.9% over the last five years
- no external debt – borrowings are currently managed by way of internal borrowings against the investment fund
- externally managed investment fund valued at $82.701 million (30 June 2017) providing an annual return which supports council activities by providing a subsidy to the rates revenue requirement and funds the council's contribution to regional development.

This long term plan has identified a number of challenges that will result in a change from the council's recent financial position. The most significant of these challenges is in relation to the maintenance and renewal of the council's infrastructure asset network. With increasing costs and community expectations regarding the performance (including environmental performance) of these assets, the council is proposing to commence an external borrowing programme in order to meet the financial demands of these assets. Overall, it's considered that an external borrowing programme will provide cost-effective funding for this work, and will allow the council to spread the cost out over time so that future generations will pay for the benefit they receive. This change will see the elimination of the council's current internal borrowing programme (via its investment fund) – moving from a "net" balance sheet (where financial assets and liabilities are offset) to a "gross" balance sheet (where financial assets and liabilities are managed separately).

Other objectives previously stated in the strategy continue to remain relevant:

- Rates affordability.
- Financial risk management.
- A diversified investment strategy.

A NEW BORROWING PROGRAMME

The shift to external borrowing is a significant change for the council. However, on balance it is believed that this will provide the greatest benefit for ratepayers as we are better able to match the costs of our assets over their lives with the funding of those costs. The alternative to an external borrowing programme is to extend the use of the council's current internal borrowing which utilises the capital of the investment fund. With projected funding requirements over the term of this LTP, internal borrowing would consume a significant portion of the fund, leading to issues with respect to fund diversification. Commencing a new financial arrangement has benefits and consequences – these are summarised in the following table:

	Net balance sheet	Gross balance sheet
Pros	Typical balance sheet structure for councils in financial management of ratepayer monies	External debt funding is currently sources at a lower cost that the level of returns recently generated on investment balances
	Reduces/eliminate credit margins on external debt and investment manager fees	External borrowing costs are known at the time of sourcing the funding and therefore provide a clear and verifiable cost to be passed on to ratepayers (either directly or in the setting of a capital rate)
	Funding, liquidity, interest rate and counterparty credit risks associated with management of external debt funding reduced/eliminated	External borrowing costs are near historical lows and can be fixed for periods of up to 16 years vis the Local Government Funding Agency (LGFA)
	Council's risk profile is reduced to only focus on financial management of investment balances	External investment balances are maintained to support the provision of intergenerational benefits to the general ratepayer base
	Reduces administrative burden in managing external debt (e.g. interest payments, debt facility rollovers, interest rate re-sets, derivative settlements etc)	Aligned with council's Revenue and Financing policy for purchase or construction of long lived assets which are to be funded by way of borrowings to maintain intergenerational equity
	Reduction of ratepayer security on debt obligations	
Cons	Maintenance of external investment balances for intergenerational equity is compromised unless internal borrowing rates match that of investment returns sacrificed. As this internal borrowing rate is currently set in advance of the actual level of returns being known, a potential mismatch occurs and benefits / costs will be accrued by ratepayers in a potentially inequitable manner	Risk of counterparty default and loss of investment capital
	A net balance sheet will see a significant increase in internal borrowings and could impact the ability to achieve effective diversification in external investments	Illiquidity of some investment types and reduced ready access to funds
	Recent investment performance has provided returns in excess of the current cost of external debt funding (noting that this relationship may not always hold), implying that internal borrowing for the benefit of specific ratepayers could have been achieved at a lower cost than the internal borrowing rate which had been charged	Greater administrative costs, time and expertise requirements (internal or external management) to maintain both investment balances and external debt funding
	Potential opportunity cost in sacrificing future investment income in order to reduce / eliminate cost of credit margins on external debt	Use of external debt capacity within LGFA covenants
	Reduces overall council revenue, which may impact on debt ratios (e.g. LGFA borrowing covenants – Net Debt to Total Revenue) and reduce capacity to borrow externally	Provision of ratepayer security and cross guarantee of LGFA
		Potential public consultation requirement
		Increased financial disclosure requirements
		Tax and legal implications of investments to be considered

On balance, the council supports a gross balance sheet approach for the following key reasons:

- Increasing the level of internal borrowing will result in a reduction in the diversification of investments able to be maintained within the investment fund. This is contrary to one of the Financial Strategy objectives, which is to maintain a diversified investment strategy to assist with risk management.
- Extending the internal borrowing programme may distort the equity between ratepayer groups (general ratepayers vs targeted ratepayers) as the investment fund returns available to offset the general rate are reduced with the decline in the investment fund value. The Treasury Risk Management Policy (section 4.2.6.3) places a cap on the level of internal borrowing of 20 per cent of the investment fund value, noting that borrowings in excess of this would compromise the investment structure and the ability of the fund to leverage its size to achieve diversification across asset classes and fund managers.
- An external borrowing programme associated with the council's infrastructure assets better allows the council to match funding requirements with asset lives. This will help to support the affordability of the council's infrastructure to the targeted ratepayers who currently fund the majority of these costs.
- In the current market the cost of external borrowing via the LGFA is cheaper than internal borrowing.

KEY OBJECTIVES

The following strategic objectives have been identified by the council as key matters that should be addressed through the financial strategy.

Rates affordability

The council recognises the need to balance the demand for additional work with the community's ability to pay. Achieving this balance has been particularly difficult as we have developed this LTP. The result is a higher increase in the rates revenue that the council requires compared to what has been seen over the last five to six years. However, the council believes that the proposed rates increases are required in order to deliver the services that our communities are expecting of us.

Commencement of an external borrowing programme provides another tool for the council to use to achieve this objective.

Financial risk management

The council provides a range of core services to its community. In doing this, it is recognised that there is a need for clear financial risk mitigation strategies in relation to key areas of the council's business. Examples of this are disaster recovery provisions in relation to catchment management works and maintaining the sustainability of the region's flood infrastructure both from financial and environmental performance perspectives.

Infrastructural assets

Events over the last year have highlighted the importance of the council's flood infrastructure to our communities, but also its vulnerability to extreme weather conditions. Given the importance of these assets to the protection of both properties and people, as well as their role in enhancing the productive capacity of the land, adequate protection against the impacts of weather events and other natural disasters is critical.

Insurance coverage for these assets is provided in a variety of ways, with each insurance vehicle providing protection against a different level of risk. The insurance framework is delivered through the following mechanisms:

- Commercial insurance
- Self insurance through:
  - regional disaster recovery reserve
  - zone disaster recovery reserves
- Central government funding through the National Recovery Plan. It is anticipated that this funding agreement will be revised sometime over the period of this LTP. The council has worked to ensure that its other financing options (in particular its commercial insurance contracts) provide an appropriate level of cover should any changes occur.

The planned introduction of an external borrowing facility provides a new potential funding stream.

These insurance vehicles fit within a Risk Financing Strategy, summarised in the table below.

Treatment option	Item	Description
Internal financing	Zone funding (operating and zone disaster recovery reserves)	To meet routine damages up to a 20 year (5% AEP) event for both insured and non-insured assets
	Regional disaster recovery reserve	For the risk cost for insured assets between the 20 year event and events which qualify for insurance cover and/or Government funding For the risk cost of non-insured assets between the 20 year event and events which qualify for Government funding For the "insurance excess" in events which qualify for insurance and/or Government funding
Risk transference	Insurance	For 100% of the risk cost for insured assets and damage between the insurance excess and $10 million For 40% of the risk cost for insured assets between the $10 million primary layer and the Maximum Probable Loss
	Central government funded (National Recovery Plan)	For 60% of the risk cost for insured assets between National Recovery Plan excess and the Probable Maximum Loss

Based on flood risk assessments, the council has determined that the following reserve balances should be held:

- Routine event response costs – an annual provision of $260,000
- Zone disaster recovery reserve – balance of up to $3.12 million
- Regional disaster recovery reserve – balance of up to $6.5 million.

Implementation of this risk financing strategy was started in 2012. Disaster recovery reserves are now in place at the required levels. Additional insurance cover has been put in place to address risks associated with the more frequent weather events that may cause damage to assets, reducing the requirement for self-insurance through the regional disaster recovery reserve. While the budget forecasts reserve balances in excess of the limits set above, the council is aware that weather events in early 2018 will require funding to be drawn down from these reserves in order to meet costs of remedial works.

Sustainability of the infrastructure asset network

As noted previously, the maintenance of our infrastructure assets is a key driver of changes within this financial strategy. The challenges we face with respect to these assets are important both regionally and nationally – protection of productive land that provides economic benefit to the region as a whole; protection national infrastructure such as state highways; protection of local communities.

We will be continuing conversations with our communities through the course of the 2018-2028 LTP about river scheme sustainability and the ongoing implications of climate change.

Diversified investment strategy

The council holds an investment fund which originated from the sale proceeds from shares in the Port of Tauranga and Ports of Auckland in the early 1990s.

In the 2015-2025 LTP, the council proposed to gradually reduce the proportion of investment fund income that was being used to offset rate revenue requirements, with this portion of the fund return being applied instead to regional development. The decision at this point in time was to reduce the rates subsidy by half, over a five year period. While first priority continues to be to inflation proof the fund in order to maintain the fund's real value, the council is now proposing to retain the subsidy to rates at the level included in the 2017/18 Annual Plan, rather than reduce the subsidy for a further two years as originally proposed. This means the funds available for regional development will be reduced.

It remains important for the council to continue to receive a steady return from the investment fund because of the retention of the rates subsidy. Through the review of the Statement of Investment Policy and Objectives and Strategic Asset Allocation, the council has aimed to balance this requirement for cashflow with what it considers to be an appropriate level of risk for the fund.

As part of the review of the investment fund objectives, the council has identified that if the current asset allocation (40% growth assets) is maintained, the return from the fund is anticipated to be lower than in previous years. Given the balance in the investment equalisation reserve ($12.339 million at 30 June 2017), it is possible to maintain the current level of spend by utilising the equalisation reserve to complement the low investment returns anticipated over the next five years. Beyond this period, if current market trends continue the council may need to consider either lowering spending or changing the asset mix.

Given the recent performance of the fund, and on the advice of the council's fund advisors, up to $5 million has been made available as a drawdown from the investment equalisation reserve. The council has prioritised where these funds should be applied as part of its budget setting process.

In taking this approach, the council acknowledges that there is some risk that investment returns are so poor that the equalisation reserve is eliminated which would affect spending over both the near and the longer term. This risk needs to be balanced against the potential for returns to be better than anticipated, in which case reserve balances would increase to levels beyond which are required for prudent risk management.

GROWTH ASSUMPTIONS

The council has assumed a regional growth rate of 1.5 per cent for the term of this LTP.

This rate has been used to determine the level of rates funding that can be anticipated in relation to those rates the council charges on a per rating unit basis (for example, the Natural Heritage rate).

This growth estimate has been assessed based on actual growth across the region over the last three years.

Overall, population growth projections for the region are largely in line with the national average (10 per cent cumulative growth compared to national growth of 11 per cent)[12] for the period to 2028. However, due to the nature of the services provided by regional councils, growth in population does not have a direct impact on the demand for service or level of operating or capital expenditure.

The impact of changes in land use are set out in the council's key forecasting assumptions.

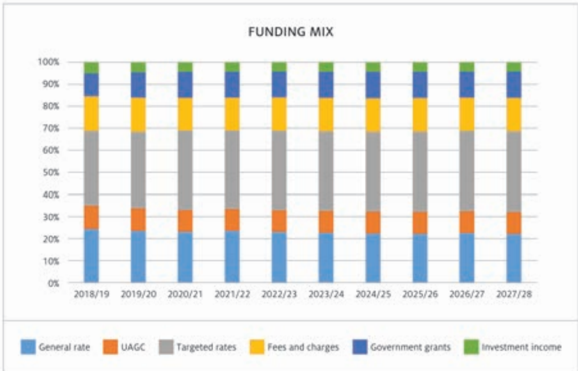
FUNDING MIX

The way in which the activities the council undertakes are funded is set out in the Revenue and Financing Policy. Key considerations that must be taken into account when determining how to fund an activity include the:

12 *Source: Statistics NZ – based on "medium" growth projections from 2018 to 2028*

- distribution of benefits between the community as a whole, any identifiable part of the community, and individuals
- period over which those benefits are expected to occur
- extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity
- costs and benefits of funding the activity distinctly from other activities
- overall impact of any allocation of liability for revenue needs on the community.

The funding mix over the period of the LTP is shown below:



General rate requirements are reduced by the investment income received from working capital funds invested.

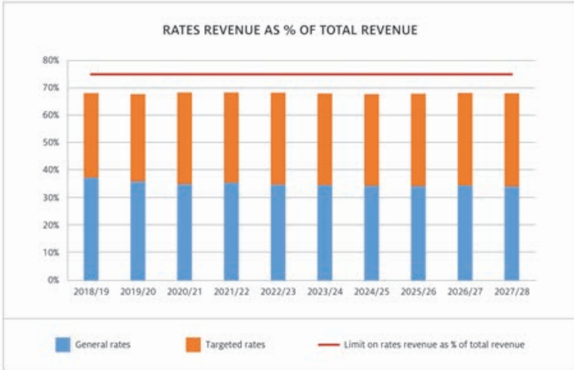
RATING LIMITS

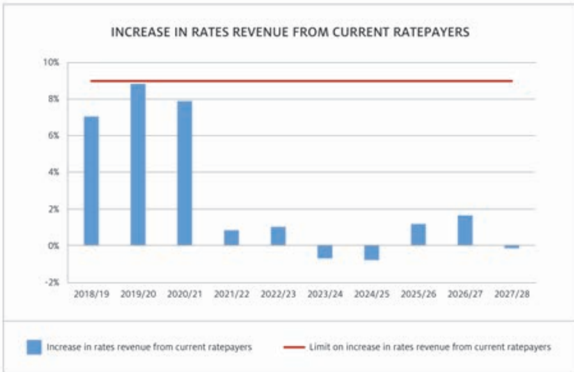
The council has set the following limits in relation to its rates revenue:

- Total rates revenue will comprise up to **75 per cent** of the council's annual revenue requirements.
- Increases in the annual rate revenue requirement will be limited to **9 per cent** increase in rates revenue from current ratepayers.

These limits have been set having had regard to:

- recognition that the demand for increased services is coming from those areas of the council's business that are funded almost completely through rates
- the need to provide for increases in costs incurred by the council as a result of inflation. The level of these forecast price changes is best illustrated by referencing the Local Government Cost Index.





INFRASTRUCTURE MANAGEMENT

The council's infrastructure strategy identifies the following key issues that are driving our approach to asset management:

- ageing of assets and impact on levels of service
- increasing environmental and regulatory performance expectations
- climate change
- risk of natural disasters
- economic conditions and affordability
- growth and development
- business continuity.

These issues and the options to address them are explored in detail in the council's Infrastructure Strategy 2018-2067.

The budget includes provision for the delivery of the council's preferred approach to managing each of these issues.

Overall, the council is satisfied that it can respond to these issues within the overall budget, rating and borrowing parameters set within the financial strategy.

CAPITAL EXPENDITURE

The council's key capital expenditure costs relate to the maintenance and construction of its flood protection networks. At 30 June 2017, these assets were valued at $496.003 million.

This capital expenditure is funded through the following means:

- depreciation expense
- targeted rates charged in relation to local community works
- reserve funds
- borrowing.

Annual provision is also made for the replacement of operational assets such as vehicles, information technology, plant and equipment.

A summary of planned capital expenditure is shown below:

$000	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Infrastructural capital expenditure • New works	-	-	2,500	2,500	-	-	-	-	-	-
• Renewals	12,133	11,784	12,132	9,976	10,517	11,299	9,697	11,497	11,011	10,266
Operational capital expenditure	5,498	13,489	4,380	3,753	3,237	3,129	3,132	3,228	3,408	3,360
Total capital expenditure	17,631	25,273	19,012	16,229	13,754	14,428	12,829	14,725	14,419	13,626
Capital expenditure by Group of activities										
Flood protection and control works	13,410	11,895	14,713	12,675	10,688	11,342	9,741	11,542	11,195	10,313
Public transport	160	79	52	52	53	54	55	56	57	59
Resource use	140	1,340	1,658	714	149	152	155	158	161	164
Science and strategy	1,131	1,479	1,162	1,340	1,362	1,387	1,412	1,439	1,466	1,495
Corporate and self-funding	2,790	10,481	1,427	1,448	1,501	1,492	1,465	1,530	1,540	1,595
Total capital expenditure	17,631	25,274	19,012	16,229	13,753	14,428	12,828	14,725	14,419	13,626

INVESTMENTS

The council maintains investments in the following assets from time to time:

- Direct equity investments in council-controlled organisations (CCOs) and other shareholdings.
- Property investments incorporating land, buildings, a portfolio of ground leases and land held for development.
- In-house managed financial investments incorporating the management of working capital and longer term fixed income investments.
- Externally managed equity and fixed income funds.

The council aims to achieve the following returns from the investments it holds:

- Internal borrowing – internal loans will be charged interest at the rate of 4.7 per cent per annum, based on the forecast long-term returns anticipated on fixed term investments held as part of the council's investment fund. In light of the commencement of an external borrowing programme, current internal borrowing will be eliminated in this plan, however internal borrowing will still be allowable under the Treasury Risk Management Policy.
- Working capital funds – a return in excess of the Reserve Bank 90 day bill rate.
- Investment fund – a return of 4 per cent per annum on the real base capital of the fund, net of inflation, tax and investment-related fees. Inflation on the fund is assumed at 2.2 per cent on the inflation adjusted base capital of the fund. The real capital base of the fund is defined as the fund value in 2009 ($73 million) plus accumulated fund preservation (inflation proofing) provisions.
- Direct equity investments in CCOs – these investments are generally made for strategic purposes consistent with council's LTP rather than because of the return on investment achieved. The key objective for the council is to ensure that the capital investment made in such entities is protected.

Projected return from the council's investment fund

$000	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Total fund return	5,143	5,256	5,371	5,490	5,610	5,734	5,860	5,989	6,120	6,255
Applied to:										
- fund inflation proofing	1,727	1,765	1,804	1,844	1,884	1,926	1,968	2,011	2,055	2,101
- offset to general rates	1,903	1,945	1,987	2,031	2,076	2,122	2,168	2,217	2,265	2,314
- regional development fund	1,513	1,546	1,580	1,615	1,650	1,686	1,724	1,761	1,800	1,840
	5,143	5,256	5,371	5,490	5,610	5,734	5,860	5,989	6,120	6,255

The council may use the investment fund equalisation reserve to smooth the impact of fluctuations in returns from the investment fund. Should investment returns fall below budgeted returns, the Investment Policy sets out the points at which some form of intervention should be taken. These interventions include:

- a reduction in operational expenditure to reduce reliance on investment fund returns
- a review of the strategic asset allocation to ensure the risk profile for the fund remains appropriate given the council's objectives for the fund.

Overall, the return from the council's investment assets is projected to be between three per cent and seven per cent per annum over the term of the LTP.

BORROWING

The council proposes to borrow up to $52 million over the next 10 years to fund capital expenditure. Projected borrowings fall well within the limits set:

Financial covenant	Limit
Net external debt/Total revenue	<100%
Net interest on external debt/Total revenue	<10%
Net interest on external debt/Annual rates revenue	<15%

Financial covenant	Limit
Liquidity	>110%

Total revenue is defined as earnings from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue and excludes non government capital contributions (e.g. developer contributions and vested assets).

Net debt is defined as total consolidated debt less liquid financial assets/investments.

Liquidity is defined as external debt plus committed loan facilities plus liquid investments divided by external debt.

Net interest is defined as the amount equal to all interest and financing costs less interest income for the relevant period.

Annual rates revenue is defined as the amount equal to the total revenue from any funding mechanism authorised by the Local Government (Rating) Act 2002 together with any revenue received from other local authorities for services provided and for which the other local authorities rate.

The council's borrowings and interest rate risk management instruments will generally be secured by way of a charge over rates and rates revenue. Where appropriate, the council may seek project financing which may have a charge over the project or specific asset/s rather than rates. The utilisation of special funds and reserve funds will be on an unsecured basis.

Physical assets will be charged only where:

- there is a direct relationship between the debt and the purchase or construction of the asset which it funds (such as an operating lease or project finance)
- the council considers a charge over physical assets to be appropriate.

Balanced budget

The 2018-2028 Long Term Plan proposes an unbalanced budget for the first three years of the plan and also in year six of the plan. This means that in each of these years, the money we expect to spend on operating expenditure is greater than the money we will receive. The main reasons for this position are:

- The council's decision to spread the funding of depreciation expense in the Lower Waikato, Waihou and Piako catchment zones over the first three years of the Long Term Plan, to manage the affordability of rates increases for these communities. By year four of the plan, depreciation expense will be funded as it is incurred.
- The council's decision not to fully fund depreciation on the new regional ticketing solution for public transport. The capital cost of this new system has been funded from accumulated reserve funds and contributions from the New Zealand Transport Agency. It is assumed that any replacement system will also receive partial funding from the Transport Agency, and so only depreciation on the share of costs paid for by the council has been funded. ($276,000 in year one of the plan, $414,000 per annum for years two to year four, and $138,000 in year 6 of the plan).
- The council's contribution to the proposed Waikato Regional Theatre would be paid over two financial years, but funded over a 20 year period resulting in an operating funding deficit.
- System development and set up required for the implementation of the Healthy Rivers/Wai Ora Plan Change is to be funded through borrowing, with the associated loan to be repaid over 10 years. Depreciation expense for this project will not be funded, as to do so would mean that current ratepayers are paying twice.
- Similarly, the redevelopment of the council's premises in Paeroa will be funded through borrowing so depreciation on the new asset will not be funded for the period of the loan (20 years).

The council's assumptions regarding the regional development fund also impact on the balanced budget test. It is assumed that funds will be accumulated over three financial years, with the funds fully allocated to a project in the third year. This means that, as funding is allocated, the budget may be in deficit.

Overall, the council believes that the budget it is proposing for the period of this LTP is financially prudent.