A snapshot of local government's financial health: a sector in good shape

Prepared by the Local Government Funding Agency

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Foreword

LGFA has concluded that local government's finances are in good shape and debt levels are modest. Credit ratings also continue to be strong with more councils now rated by accredited rating agencies. Our councils have shown themselves to be strong and conservative financial managers.

The performance of local government is a critical factor in the quality of life in our towns, cities and regions, not only because of the services the sector provides but also because of its stewardship responsibility in relation to public assets. Councils are responsible for more than $120 billion of public assets and their annual expenditure is approximately four percent of our Gross Domestic Product. So how well local authorities manage their assets and finances has major implications for the economic performance not only of our communities but the nation as a whole.

With the recent release of councils' annual reports and the publication of their 2015 – 2025 long term plans (LTPs) LGNZ decided that it was an appropriate time to look at the current state of the sector's financial health. To do this we asked the Local Government Funding Agency (LGFA) to undertake a high level analysis to identify what councils are doing well and the areas where more attention might be required.

As you will see below the LGFA has concluded that local government's finances are in good shape and debt levels are modest, falling below the levels estimated in councils' 2012 LTPs. Credit ratings also continue to be strong with more councils now rated by accredited rating agencies. Our councils have shown themselves to be strong and conservative financial managers.

This is important as local government faces a number of future challenges and councils need to be well placed financially to meet them.

Some of these are well known, such as funding asset renewals and meeting new demands for infrastructure as well-known imposts. Others are unique to this period, history such as the need to undertake earthquake strengthening and deal with extreme weather events and sea level rise. In addition the impact of demographic change, such as population ageing, means that councils will need to manage these challenges carefully.

This will require good information about the state of our assets and importantly effective alignment between councils' infrastructure and financial strategies, an issue recently highlighted by the Auditor General.

In order to help councils meet these challenges LGNZ has undertaken a number of major research projects. Our 3 Waters project has highlighted the importance of better asset information; our funding review found that the sector lacked the range of funding tools to drive economic growth and our Mobilising the Regions report looked at possible solutions to New Zealand's two-speed economy. Finally our work on risk is designed to strengthen community resilience in the face of uncertainty.

I would like to thank Andrew Michl and Mark Butcher at the LGFA for preparing this overview. I believe it should give us all greater confidence in the fiscal sustainability of our sector and in our preparations for meeting a challenging future.

Lawrence Yule,
President
LGNZ

Observations on local government sector finances

Observations on local government sector finances

The Local Government Funding Agency (LGFA) has been asked by LGNZ to provide a high level overview of the financial health of the local government sector. In undertaking this brief we have considered the levels of debt and assets held the local government sector as well as councils' ability to service that debt. The analysis not only looks at where the sector is currently, it also looks at the projected future position.

While sector debt has increased (and is projected to increase further) this is offset by other inputs into the financial assessment as well as recent developments and initiatives which have improved and strengthened the financial decision making of the sector. These are discussed below.

Debt, assets and revenue

The combined debt of the New Zealand local government sector has been rising in recent years with gross debt nearly trebling over the past six years. As a result it is perhaps not a surprise that some ratepayers and elected members are questioning whether their council's level of debt is prudent. The increase in debt, assets and revenue since 2008 is outlined in the table 1, below:

Table 1: Growth in NZ local authority debt, assets and revenue (2008 -2014)[1]

Year ended June	Gross Debt ($ million)	Percentage Change	Assets ($ million)	Percentage Change	Operating Revenue ($ million)	Percentage Change
2008	4,114	n.a.	94,654		5,980	
2009	5,211	26.7%	98,421	4.0%	6,140	2.7%
2010	7,016	34.6%	102,555	4.2%	6,582	7.2%
2011	8,646	23.2%	111,029	8.3%	7,575	15.1%
2012	10,007	15.7%	113,805	2.5%	8,049	6.3%
2013	11,368	13.6%	116,890	2.7%	9,251	14.9%
2014	11,786	3.7%	121,995	4.4%	9,679	4.6%
2015	13,037	10.6%	127,753	4.7%	10,449	8.0%

The recently completed 2015-2025 Long Term Plans (LTPs) are forecasting that sector debt will continue to increase over the next ten years, albeit at a much slower pace than previously. The growth in debt, assets and revenue is outlined below in Table 2.

Table 2: Projected growth in debt, assets and revenue

LTP Forecasts	2015	2016	2117	2018	2019	2020	2021	2022	2023	2024	2025
Gross Debt ($ million)	14,119	14,941	16,527	17,440	17,821	18,445	18,943	19,554	19,913	20,031	20,036
% change	n.a.	5.8%	10.6%	5.5%	2.2%	3.5%	2.7%	3.2%	1.8%	0.6%	0.0%
Assets ($ million)	126,450	131,685	137,693	141,373	144,685	149,753	157,926	159,351	166,377	170,584	174,573
% change	n.a.	4.1%	4.6%	2.7%	2.3%	3.5%	5.5%	0.9%	4.4%	2.5%	2.3%
Revenue ($ million)	9,786	10,327	10,977	11,437	11,645	11,916	12,429	12,858	13,248	13,560	13,999
% change	n.a.	5.5%	6.3%	4.2%	1.8%	2.3%	4.3%	3.5%	3.0%	2.4%	3.2%
Capex ($ million)	5,093	4,939	4,989	4,281	4,261	3,911	4,115	4,669	4,232	4,047	4,383
% change	n.a.	-3.0%	1.0%	-14.2%	-0.5%	-8.2%	5.2%	13.5%	-9.4%	-4.4%	8.3%

1 Note: Debt is calculated at the parent level except Auckland Council which is at group level.

The estimate of $14,119 million of sector debt for 2015 was based upon councils' annual plans. However the actual debt of the sector, drawn from councils' annual reports, was $1 billion less at $13,091 million. In addition to debt other key features of the 2015-2025 LTP's are:

- By 2025 Auckland Council is forecast to have 57.8 percent of total sector debt while Christchurch City Council will have 10.4 percent. The share of debt held by the other 76 councils will be 31.8 percent of the total;
- The total debt of the rural and provincial councils is forecast to increase by less than 9 percent over the ten year period, which is lower than the rate of inflation;
- Twenty four councils are forecast to have no net debt at June 2025 (defined as gross debt less liquid financial assets). This compares to twenty councils with no net debt as at June 2015;
- While gross debt is forecast to increase by $5.92 billion over the next ten years, assets are forecast to increase by $48.12 billion with capex averaging $4.45 billion for each of the next ten years;
- The total debt of the sector in each year of the 2015-2025 LTP's is lower than each comparable year in the 2012-2022 LTP's (after making an adjustment for Christchurch which did not produce a 2012-2022 LTP).

< Local government has increasing debt levels but these are acceptable given increasing demands for infrastructure investment. >

Sector diversity

The analysis of current and future debt levels highlights what is in fact a large difference between councils. Growth in debt is primarily forecast by those councils experiencing significant population growth and which need to invest in infrastructure to meet the demands of that growth. In contrast councils with less growth are showing more restraint in their borrowing intentions. A local authority like Auckland Council is very different compared to a council like Wairoa District, just as a territorial council is very different compared to a regional council. As a result care has to be taken when making comparisons. Councils often face very different issues and challenges from each other and should be considered on an individual basis rather than assessing the sector as a whole.

In our opinion both the debt currently held by councils and their recently forecast debt largely reflects the need to invest in core infrastructure rather than borrowing for operating purposes. Infrastructure is one of councils' key responsibilities. Changes in Government regulations have partly influenced these debt levels. For example, over the past decade increased investment in water assets has been a direct result of higher water standards required by Government regulations. A further pressure is likely to be planned changes to national building standards due to a greater understanding of the risk of earthquakes, legislation which will result in additional investment in earthquake strengthening. Other drivers behind greater investment in infrastructure have been population growth and increasing community expectations.

Role of the LGFA

The New Zealand Local Authority Funding Agency (LGFA) was formed in December 2011 and began lending to its member councils in February 2012. One of the reasons for its creation was to ensure certainty of funding for the sector in an environment where investment in infrastructure was forecast to continue to grow. The Agency has grown quickly and by November 2015 it had lent $5.541 billion to forty-five of its forty-seven council members.

< The LGFA – a provider of debt and also a key influencer in the local government sector >

Much of this has been to refinance existing debt that councils had primarily borrowed from banks. In addition there has also been some increase in debt for councils needing to fund growth infrastructure, such as Auckland Council, as well as Christchurch City Council which is funding the replacement of infrastructure assets. Excluding Auckland and Christchurch, sector debt has declined over the past three years.

LGFA's primary objectives are to provide the following to the local government sector:

- certainty of funding;
- cheaper funding; and
- longer dated funding.

LGFA currently holds an AA+ credit rating from both Standard & Poors and Fitch rating agencies. This is the same credit rating as the New Zealand Government. A key feature of why LGFA has such a high credit rating is the joint and several guarantee provided by the majority of LGFA's members. Currently LGFA have forty-seven councils as members. Of these, forty-two are guarantors (a council that is borrowing less than $20 million from LGFA does not have to be a guarantor). The implications for LGFA are that it has a responsibility not only to its borrowers but also to protect the interest of its guarantors, as well as its investors and shareholders.

To protect the interest of its guarantors LGFA monitors the financial performance of the New Zealand local authority sector extremely closely. The good news is that New Zealand has never had a council default on its debt. This is also the case in Australia, albeit they have three tiers of government rather than the two that exist in New Zealand. It is a record that the private sector would be very pleased to have.

< Credit quality of the local government sector is strong in global terms >

The local government framework

A key factor in why there has been such a long history of strong fiscal discipline is that the framework that local authorities in New Zealand operate under is very strong. Key features of this are its focus on long term planning and transparency. While some councils, in our view, have stronger financial management competencies than others the framework ensure that key information is open to scrutiny from the Office of the Auditor-General, Department of Internal Affairs, credit rating agencies and, importantly, ratepayers.

Strong credit ratings

Our views of the sector's credit quality are largely shared by the major credit rating agencies. Currently Standard and Poor's rate twenty councils in New Zealand while Fitch rate two. The rating outcomes are outlined in Table 3.

Table 3: Council ratings

Council	S&P	Fitch	Moodys
Auckland Council	AA		Aa2
Dunedin City Council	AA		
Greater Wellington Regional Council	AA		
Hutt City Council	AA		
Invercargill City Council		AA	
New Plymouth District Council	AA		
Palmerston North City Council	AA		
Porirua City Council	AA		
Taupo District Council	AA		
Waimakariri District Council	AA		
Wellington City Council	AA		
Nelson City Council	AA		
Hamilton City Council		AA-	
Whangarei District Council	AA- Positive		
Tasman District Council	AA-		
Whanganui District Council	AA-		
Western Bay of Plenty District Council	AA-		
South Taranaki District Council	A+ Positive		
Horowhenua District Council	A+		
Kapiti Coast District Council	A+		
Tauranga City Council	A+		
Christchurch City Council	A+		

Over the past two years the only changes to the credit ratings of councils in New Zealand have been upgrades. In 2015 Nelson City Council was upgraded from AA- to AA and Taupo District Council from AA- to AA. A year earlier 2014 Western Bay of Plenty District Council had been upgraded from A+ to AA-. In addition, in 2015 two councils, South Taranaki District Council and Whangarei District Council, were placed on credit watch positive outlook. Positive outlook means that there is a chance that credit ratings could be raised in the next two years. No councils were downgraded between 2013 and 2015.

The quality of councils' external credit ratings may surprise some people as it is against a background where sector debt levels have risen over the past three years. However, this is where it is important not to generalise as during the three year period ending June 2015 the debt of the total sector excluding Auckland Council and Christchurch City Councils actually went down, as shown in table 4.

Table 4: Changes in sector debt

Year ended June	Total Sector Debt ($ million)	Sector Debt Excluding Auckland and Christchurch ($ million)
2012	10,007	4,303
2013	11,368	4,552
2014	11,786	4,526
2015	13,037	4,455

While Auckland and Christchurch's debt is currently increasing the reasons, which are to build infrastructure, are abundantly clear. In Auckland's case it is to cope with growth while for Christchurch it is to replace assets that were damaged in the earthquakes.

Financial covenants

Councils which borrow from the LGFA are required to comply with a set of financial covenants. This is done to provide a limitation on the amount of debt that a council can borrow and also ensure that the council has the ability to service that debt. As mentioned above, LGFA is focused on protecting the interest of the guarantors. The covenant limits were designed to be consistent with the requirements a council would need to meet in order to maintain a credit rating of at least "A" or higher. However, it is important to remember that there are also non-financial factors that contribute to a credit rating.

These include factors like:

- the strength of the local economy;
- contingent liabilities; and
- forecast demographic changes.

The summary of the outcomes of LGFA's covenant tests for its member councils can be seen below in tables 5 and 6.

Table 5: LGFA member councils with an external credit rating (17 in 2014 and 2013)

Financial covenant	2014	2013	Change
Net debt to revenue <250%	104.7%	111.8%	-7.1%
Net interest to revenue <20%e	6.6%	7.3%	-0.7%
Net interest to rates <30%	9.6%	11.1	-1.5%

Table 6: LGFA member unrated councils (26 in 2014 and 21 in 2013)

Financial covenant	2014	2013	Change
Net debt to revenue <175%	42.6%	52.5%	-9.9%
Net interest to revenue <20%e	2.9%	3.2%	-0.3%
Net interest to rates <25%	4.0%	4.1%	-0.1%

As at June 2014 both tables show an improvement from the previous financial year for all three financial covenants and for both rated and unrated councils. While we have yet to fully analyse the 2015 numbers we are expecting a further improvement relative to the 2014 financial year. This perhaps should not come as a surprise. Revenue for the sector has been rising and with debt relatively constant the result has meant that the net debt to revenue covenant has improved. Likewise, councils have benefited from falling interest rates over the past few years. With debt levels relatively stable, councils' ability to service their debt has improved. This can be seen in improvements to both the net interest to revenue covenant and the net interest to rates covenant (see Tables 5 and 6 above). For example, the average net interest as a percentage of revenue for the LGFA's unrated council members in 2014 was 2.9%, compared to 3.2% in 2013.

LGFA has forecast covenant outcomes for each of its forty-seven member councils based on the financial forecasts contained in the 2015-2025 LTPs. In aggregate, there is little change to the covenant outcomes, however, on an individual basis, some councils show improved performance while some deteriorate. This should be expected as councils are often at very different points in their infrastructure investment cycles.

In summary while debt is forecast to increase, so too is revenue. This means the sector's ability to service its aggregate debt will be largely unchanged. It is pleasing to note that over the next ten year period no councils are forecast to breach any of LGFA's financial covenants.

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Changes to the statutory framework

It is also worth touching on some of the changes that have occurred over the past few years which we believe have been beneficial and have enhanced the financial performance of local government. The 2012 and 2014 amendments to the Local Government Act 2002 have assisted councils' financial management and long term planning.

From LGFA's viewpoint some of the key changes have been:

- **The setting of financial prudence requirements.** While looking at any of the outcomes for an individual council may have limited usefulness, looking at the trends over time can be insightful. It was positive that this reporting, in addition to being required as part of the annual report, was also part of the 2015-2025 LTP. Of particular interest to LGFA has been the balanced budget benchmark. We think that it is important for local authorities to meet this test over the cycle. This will assist them in ensuring core renewal infrastructure can be funded. We do have some concerns when we see debt being used to fund operating deficits. However, this does need to be looked at council by council as there are some councils that are cash rich, where running an operating deficit can be justified as a sensible way of returning money to ratepayers. Bay of Plenty Regional Council is a good example of this.

< Recent developments have strengthened the financial position of the sector >

- **Changes to the assistance and intervention options available to the Minister of Local Government.** There are now six options that the Minister can use to assist councils should a local authority show signs of financial stress.
- **Encouraging greater collaboration between councils to improve efficiencies and reduce costs.** While it could be argued that this was already starting to occur before the legislative changes, these changes do provide some assistance in terms of providing a clearer mandate and framework for joint initiatives.
- **The requirement to produce a 30-year infrastructure strategy.** This has been a very important step in requiring councils to identify the significant infrastructure issues that they are likely to face over the next thirty years. Given that the 2015-2025 LTPs are the first to contain 30 year infrastructure strategies we expected that the quality would be mixed. While this proved to be the case they do provide a good base on which to make improvements. As a lender to the sector one of the key things that LGFA is looking for is the quality of the linkages between infrastructure strategies and financial strategies. It is positive that a number of councils were able to achieve this. It is also positive to see Waimakariri District Council planning for the replacement of their assets over the next 100 years. We are pleased to see a council thinking about managing infrastructure assets over a whole cycle.

Audit and risk committees

There have also been other positive developments over the past few years. One of these has been the increase in the number of councils establishing Audit and Risk Committees. These committees play an important role in ensuring councils understand, monitor and mitigate risks. We have been particularly pleased to see local authorities adding at least one independent member to their committees. Not only does this bring additional expertise to Audit and Risk Committees it also helps to ensure that the hard questions are asked. In the future we expect that greater sharing of ideas and experiences between councils will mean that the quality of council Audit and Risk Committees is further enhanced. Consideration could also be given to the appointment of an independent member to other council committees where the additional expertise might be important.

Funding depreciation

Another key improvement has been the decision by more councils than previously to fully fund, or move towards fully funding, depreciation on core infrastructure which they intend to renew and/or replace. This is important for councils' investment in infrastructure over future cycles. A large number of councils did not fully fund deprecation over the past thirty years which enabled them to keep rates lower in a period when core infrastructure, other than roading, did not need to be replaced. We believe that this is not a sustainable approach over the long term.

< Audit and Risk Committees play an important role in ensuring councils understand, monitor and mitigate risks. >

While it is not a perfect science, LGFA believes that generally replacements should be funded through the depreciation charge while level of service improvements and growth should be funded through debt. This approach is, by and large, equitable to both current and future ratepayers (the principal of inter-generational equity). We would accept that the deprecation charge is only a proxy for the future cost of renewals and would recommend that the industry does more work on investigating whether a more accurate approach can be identified.

Conclusion

In summary we believe that the sector as a whole is in a very sound financial position. We are not expecting, based on the forecasts contained in the 2015-2025 LTPs, any change to this over the next ten years, although some councils face greater challenges than others. In addition, the sector faces challenges over the longer term with regard to the affordability of rates. Again, this is an issue that is more pressing for some councils than others and addressing it will require central government to work with local government.

In our view the majority of councils have produced sound financial strategies as part of their LTPs. However, more work still needs to be done to ensure that financial strategies, infrastructure strategies and forecast changes in demographics are linked together rather than being stand-alone documents.

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