LGFA
New Zealand Local Government Funding Agency
Te Pūtea Kāwanatanga ā-rohe

Briefing to the Incoming Minister of Local Government

cc. Minister of Finance

cc. Minister of Infrastructure

27 November 2023

Local Government Funding Agency – Briefing to the Incoming Minister

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Introduction

The New Zealand Local Government Funding Agency (LGFA) specialises in financing the New Zealand local government sector. LGFA was established in 2011 to raise debt on behalf of councils on terms that are more favourable to them than if they raised the debt directly.

The establishment of LGFA was a result of recommendations from the 2009 Jobs Summit and the 2010 Capital Markets Development Task Force, receiving cross-party political support. LGFA is one of the best examples of collaboration between Central and Local Government.

There are currently 31 shareholders, comprising the New Zealand Government at 20% and 30 councils at 80% of the paid-up capital.

An important advantage of the multiparty shareholding is that debt raised by LGFA in its own name sits off individual council balance sheets. There is no requirement for the New Zealand Government to guarantee debt. However, the New Zealand Government provides a liquidity facility to LGFA of $1.5 billion and this facility has never been drawn.

As at 30 September 2023, there are NZ$18.948 billion of LGFA bonds listed on the NZX across eleven maturities from 2024 to 2037, A$1 billion of AUD bonds and $968 million of LGFA Bills on issue. LGFA is the largest issuer of NZD bonds after the New Zealand Government and the largest issuer of listed debt on the NZX.

The success of the LGFA operating model is contingent on maintaining the same credit rating as the New Zealand Government. Currently, S&P Global Ratings assigns a "AAA" credit rating to LGFA. This is the same as the New Zealand Government and is influenced by important role that LGFA provides to the sector and the closeness of the relationship between Central Government and LGFA as highlighted with the liquidity facility.

Benefits of LFGA and financing programme

The benefits to councils and council-controlled originations (CCOs) include:

- **Lower borrowing margins.** Estimates of savings vary between larger councils and CCOs around 0.2% (20 basis points) and 1% (100 basis points) for smaller councils. Of total sector borrowing from LGFA, that equates to at least $36 million each year or $360 million over a 10-year planning horizon.
- **Access to longer-term financing**. Before LGFA, banks would only lend to councils for up to five years, while councils and CCOs typically issue bonds in their own name for up to seven years. We offer councils and CCOs financing for any term up to fourteen years (2037) but could offer financing up to 30 years (2054) if there was sufficient demand from councils to do so.
- **Certainty of financing for councils**. This includes in times of a natural disaster (flooding, earthquakes) or when there is a dislocation in financial markets: e.g., a credit crunch. During the 2020 pandemic, for example, many corporates struggled to borrow but LGFA lent $3 billion to the sector over the 2020 calendar year.
- **Access to more financial products at cheaper cost**. We offer additional lending products to councils and CCOs at a lower cost than banks: e.g., standby facilities and short-dated lending.
- **Access to global capital markets.** Offshore investors hold 35% of LGFA bonds and councils / CCOs would not be able to access this pool of capital through borrowing in their own name due to the small scale of each council borrower. This is important given that total local authority sector debt now exceeds $20 billion which is reaching the limit of what NZ domestic capital markets can provide.

- **Reduced costs.** Establishment and maintenance of debt issuance programmes are expensive for councils and CCOs to undertake on their own.
- **Sector leadership.** This work includes financially incentivising councils and CCOs to become more sustainable; advocating for independent member appointments to council audit and risk committees; providing quarterly updates for councils and hosting forums such as the annual LGFA Stakeholder Day where DIA, Treasury, OAG, and the Infrastructure Commission have presented.

LGFA supports Central Government by de-risking council finances and reducing the possibility of Central Government intervention in the future.

The benefits include:

- Standardisation of financial covenants and the way councils borrow.
- Strong financial oversight of the sector and each council. We undertake credit assessments and monitor each council.
- Intelligence and reporting: We regularly and formally share insights and information with the Office of the Auditor General, Department of Internal Affairs, and Audit NZ.
- Assisting Central Government as required: e.g., natural disaster support. LGFA has been working with the Treasury to facilitate the Central Government's financial assistance to Gisborne District Council following the recent weather events.

Perspectives on Local Government Sector Issues

Debt Levels of the New Zealand Local Authority Sector

In New Zealand, local authorities primarily borrow to finance capital investments, such as infrastructure and amenities that benefit current and future generations. Debt is an important way of smoothing the cost of construction over generations that make use of and benefit from the service. It is a way of meeting the principle of "inter-generational equity."

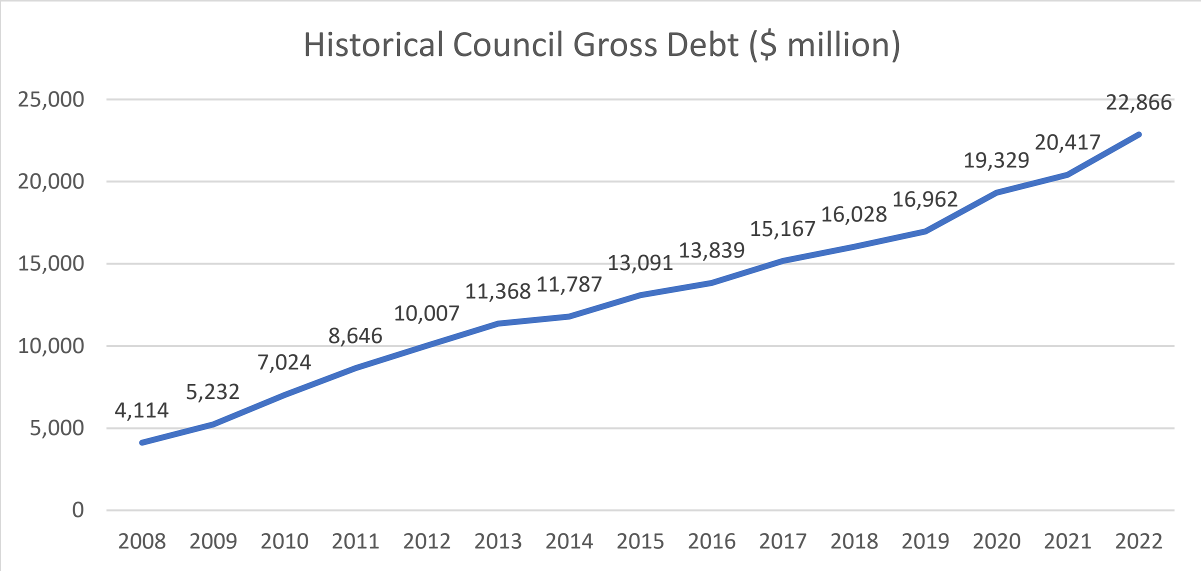
Unlike central government (which is free to borrow to fund operational expenditure), councils typically borrow for capital investment. This is because the Local Government Act 2002 requires that local authorities balance their operating budgets.

Historically, the sector has been relatively conservatively geared when you compare LGFA estimates of local authority sector debt of $22.5 billion to sector assets of $171 billion[1]. The more recent growth in debt tends to have been driven by those Councils with higher-than-average growth (e.g., those in Auckland, Waikato, and Bay of Plenty).

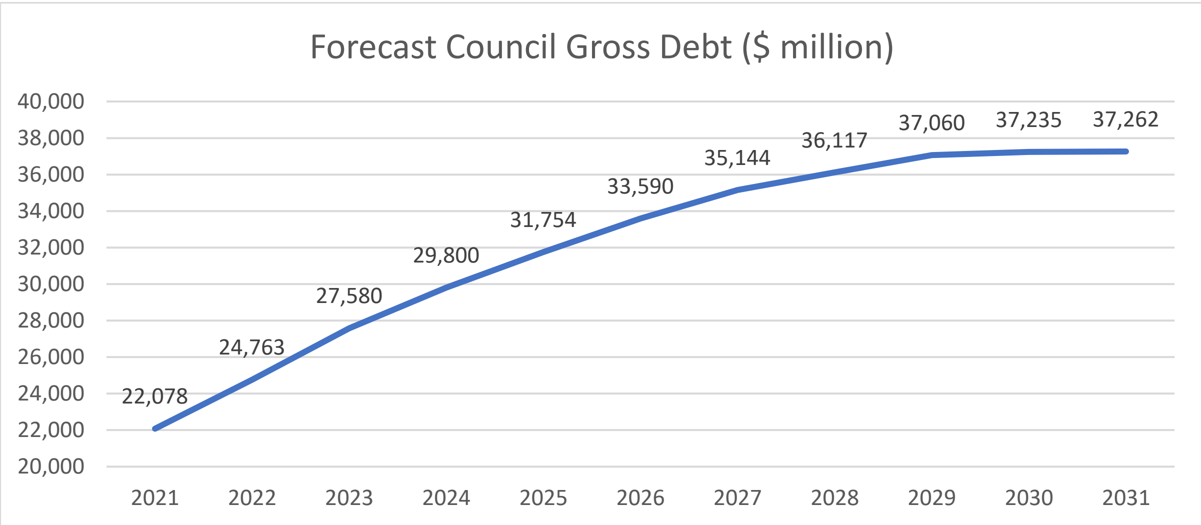
At the time of LGFA establishment first being mooted in 2009, local authorities were forecasting a significant increase in debt levels in their 2009-2019 Long Term Plans. Local authorities required a high level of infrastructure investment given the increasing pressures from population growth, a tourism boom and ageing infrastructure.

The increase in local authority debt over the past fifteen years is shown in the graph below. Official figures for June 2023 are not yet available, though our estimate is total sector debt will have increased to over $24 billion at June 2023.

[1] The problem is that most local authority assets do not generate revenue, are typically fully funded for depreciation but spending on asset renewal is less than depreciation.



Local authorities 2021-2031 Long Term Plans forecast that sector debt would increase to $37.3 billion by 2031. This highlights that there is an ongoing need by councils for additional debt to finance infrastructure.



Note: Council debt levels are the debt of councils at the parent level, other than the Auckland Council which is measured at the group level. It does not include the debt of council-controlled trading organisations (CCTOs) such as Christchurch City Holdings.

Local government financing of infrastructure

The biggest challenge facing the local government sector is the need for additional infrastructure (growth-related, public transport, water quality improvement) that has been historically provided either solely by local government or jointly with central government.

A number of the high-growth councils (Auckland, Tauranga, Hamilton, Waikato District, Queenstown Lakes, Wellington City) are constrained financially to provide more infrastructure due to concerns over credit ratings and long payback periods on infrastructure investment that is debt-funded upfront.

A number of the high-growth councils do not have the revenue to take on additional debt to fund the infrastructure, remain compliant with LGFA financial covenants, and maintain credit ratings above A+. This can also disincentivise councils to invest in growth infrastructure.

These councils must prioritise the infrastructure they can deliver or seek alternative sources of financing.

By way of example:

- Auckland Council has publicly said that they are highly constrained in their ability to finance and fund infrastructure across the region to support growth such as new housing in Drury. The Council was reluctant in 2020 to approve the development as it did not have the circa $1 billion needed to fund transport, water, and community facilities infrastructure within its Long-Term Plan. The Council have now agreed to approve subject to the payment of $1.1 billion of development contributions over the next 30 years but this is being challenged by the developers.

- Tauranga City Council has applied for $175 million of Infrastructure Finance Fund financing for the Western Bay of Plenty Transport System Plan and is considering applying for $151 million of additional financing for the Civic precinct. Together these two projects equate to around 82% of Tauranga City Council's forecast 2024/25 adjusted revenue. The Council has also considered applying for IFF financing for the greenfield infrastructure to support housing at Tauriko West.

It has been suggested that the provision and funding of infrastructure could be done via Public Private Partnerships or the issuance of infrastructure bonds, but the problems include:

- Any private sector provider via PPPs or financing of SPVs will be borrowing at a significantly higher interest cost than the central or local government's cost of debt.

- Any issuance of infrastructure bonds will be costly as investors will seek a higher return than on bonds issued by the central or local government or LGFA.[2]

- The issuance of bonds into the domestic or international capital markets will attract high distribution fees charged by banks and additional establishment costs.

- The solutions are unlikely to remove the assets (and debt) from council balance sheets.

Affordability of Infrastructure

New Zealand has a significant infrastructure deficit. The Infrastructure Commission estimates that New Zealand would need to double the amount spent on infrastructure from 5% of GDP to 10% per year and sustain this rate of investment over 30 years.[3]

In a report released in February 2023 on New Zealand's water reforms, S&P Global Ratings said "Someone must pay, and it will always be residents. While general property rates and council targeted

[2] An example is the Wellington City Council Moa Point Sludge Facility that is being financed under an IFF structure. We have heard that the financing cost on the $400 million project is 1% higher than LGFA funding so that is $4 million cost p.a. or $132 million over the project life.
[3] New Zealand's infrastructure challenge: Quantifying the gap and path to close it | Te Waihanga

charges are likely to be much lower under the reforms, the overall costs for New Zealanders will be much higher given the perceived scope of investment required."

LGFA agrees that significant investment in infrastructure is required. With this in mind, we offer the following observations:

- Hard choices will need to be made on what infrastructure the public sector invests in, given affordability issues and financing constraints.
- The need for an overall infrastructure strategy for the country is important. The creation of an infrastructure priority list by the Infrastructure Commission is a good starting point to prioritise strategic alignment and obtain the best value for money.
- Achieving the lowest financing costs for infrastructure is critical. More money spent on higher interest "borrowing margins" is less money that can be spent on infrastructure.
- With its "AAA" credit rating, LGFA can raise debt at lower costs than is possible from either the banking system or capital markets. It can also provide certainty to its members about the availability of finance.

Local authorities' financing of costs of extreme weather events

Local authorities have always been exposed to the impact and costs of flooding. The floods in Buller District (July 2021, February 2022), Northland, Auckland, and Coromandel (January 2023) and Hawkes Bay / Gisborne (February 2023) shocked the local authority sector in terms of the severity of the flooding and the financial cost.

It will take some time to work out the eventual costs borne by these events. Some of the costs the councils incurred include:

- Emergency management activities.
- Capital expenditure to renew damaged assets.
- Remission of rates for impacted property owners.
- Revenue reduction from storm-damaged facilities, including the loss of public transport revenue.
- Buyback of category three houses.
- Additional capital expenditure that will increase resilience.
- Higher insurance costs (and in some cases an inability to insure some assets in the future).

Following the early 2023 weather events, the Government reached a 50/50 cost-sharing arrangement with several of the impacted councils. The arrangement covered the buyback of category three residential properties; the rebuilding of some infrastructure; and an investment in new flood protection works.

The councils impacted by the 2023 weather events were able to absorb the financial cost, although it will result in higher rates in future years. This is because they had sufficient headroom under their financial covenants.

Should a similar weather event take place in the next few years, we believe it unlikely that the councils impacted would be able to absorb the additional financial costs.

Local authorities' capacity to invest in resilience projects

Financing of resilience projects is increasingly becoming an issue for councils as they grapple with the consequences of climate change and other natural disasters. Construction costs and insurance costs continue to rise at a pace exceeding inflation, bringing additional financial pressure onto councils and communities.

The issues are particularly acute for road networks and rural councils, but resilience is also becoming a significant issue for council infrastructure in major centres. Earthquake strengthening of libraries and council buildings, for example, is placing additional financial strain on councils such as Wellington and Christchurch City Councils.

We note the Productivity Commission's 2019 report[4] into Local Government funding and finance made the following recommendation in respect of climate change:

- The Government should create a new agency and a Local Government Resilience Fund.

This would help councils with the redesign and possible relocation of key infrastructure. It would also provide a better model to ensure that the costs of adaption are shared fairly across communities and generations.

Water entity restructure

There is widespread agreement within the local authority sector that:

- High-quality drinking water, wastewater and stormwater services are critical to the ongoing health and success of communities.
- Some councils may be better off financially and in service delivery by amalgamating their water assets with those of neighbouring councils.

LGFA can assist the local authority sector, and the new water service entities, with their financing requirements. If the new Water Service Entities are CCOs then LGFA would potentially be in a stronger position to lend to them than under the previously proposed WSE model.

This model that has been deployed successfully in many other jurisdictions. For example, Tasmania's TasWater is owned by twenty-nine councils and the State of Tasmania and has been operating successfully since 2013.

This model would still be subject to:

- the business plans of each individual CCO, the security offered and the agreement of financial covenants. We note it is likely most lenders would prefer volumetric water charging and for security to be offered to lenders.
- the approval of Council shareholders of the Water CCOs for the CCOs to be established and then to join LGFA.
- the approval of the LGFA Board. LGFA Directors would have to consider whether there is additional risk to LGFA and our guarantors from the accession of new members and any impact on the LGFA credit rating. As a reminder, it is very important to LGFA's business model that it retains a credit rating equivalent to that of the New Zealand Government.

Infrastructure Funding and Financing Act (IFF)

The IFF Act 2020 provides a new way for local authorities to finance and fund infrastructure.

[4] https://www.productivity.govt.nz/assets/Documents/a40d80048d/Final-report_Local-government-funding-and-financing.pdf

Its original aim was to facilitate infrastructure projects at greenfield sites that would support housing development. It also provides financing for a wider criterion of infrastructure that assists urban development.

Importantly, it allows councils to undertake infrastructure projects that they would otherwise not be able to fund under existing financial covenants.

The challenges that councils have found with the implementation of the IFF Act 2020 are:

- There are not many large parcels of land owned by a single landowner. The original test case of Milldale worked well as it was owned by Fulton Hogan. When land is owned by multiple parties there are often different objectives and timeframes as to how the development should proceed.
- The process for getting an IFF project approved is complex. This means that getting a project approved takes time and has costs associated with doing so.
- The costs and complexity associated with IFF have resulted in the approval of only a few relatively large projects. In practice, IFF has only been used by larger councils.
- The cost of finance associated with IFF projects is more expensive than financing available to councils from LGFA. Ultimately this cost of up to 1% per annum over the 30-to-35-year life of the project is borne by residents that pay the IFF levy. This is an additional cost to ratepayers for infrastructure who already pay rates to councils for the provision of infrastructure.
- We note that whether residents are paying for infrastructure through a targeted rate or an IFF levy, it is ultimately the same people who are paying. Consideration must be given to whether the infrastructure is affordable for the community.

Nevertheless, IFF has been a useful additional financing tool for several larger, high-growth councils. The two projects that have been approved to date are:

- Tauranga City Council: $175 million for thirteen projects in the Western Bay of Plenty Transport System Plan.
- Wellington City Council: $400 million for the Moa Point Sludge Minimisation Facility.

Several councils are also currently considering the use of IFF financing. This includes Tauranga City Council, which signalled intention to seek approval for $151 million of financing for its civic precinct.

Ratepayer Assistance Scheme

Ratepayers are facing affordability issues with the prospect of rising rates as councils deliver more services and build infrastructure.

Initiatives like the proposed Ratepayers Assistance Scheme (RAS) will help residential ratepayers with affordability issues by taking out low-cost loans to pay for approved improvements to their homes, such as insulation and efficient home heating.

The RAS would also allow ratepayers to smooth the cost of rate increases into the future by deferring the payment of rates until the property is sold.

LGFA supports the RAS concept and has been providing expertise and technical support to a group of metro councils (Auckland, Hamilton City, Tauranga City, Wellington City and Christchurch City), LGNZ and Cameron Partners looking to establish the RAS.

Appendix – About the Local Government Funding Agency

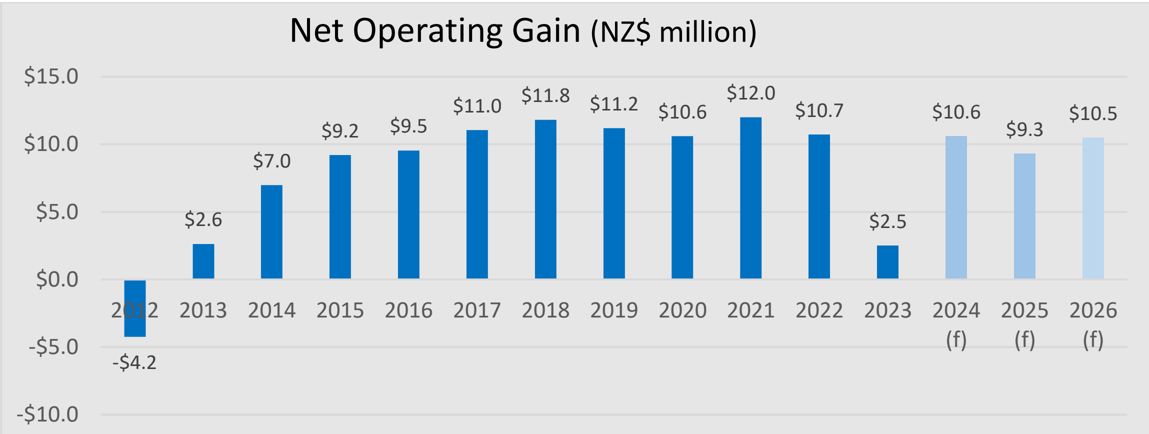
Council and CCO membership

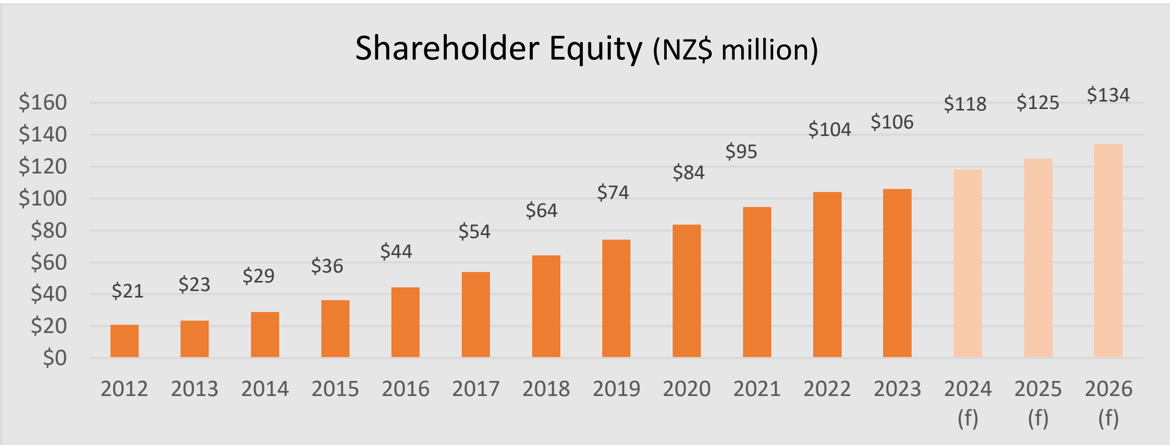
As at 30 September 2023, there are seventy-seven councils and five CCOs who are members of LGFA. The only council that is not a member is Chatham Islands Council. LGFA provided 93% of all council borrowing in the year to June 2023.

Capital structure and shareholding

The capital structure of LGFA comprises fully paid shares, unpaid shares, retained earnings and borrower notes. As at 30 September 2023, LGFA had forty-five million ordinary shares on issue, twenty million of which remain uncalled. There are currently 31 shareholders, comprising the New Zealand Government at 20% and 30 councils at 80% of the paid-up capital.

Borrower notes are subordinated convertible debt instruments which each council that borrows from LGFA must subscribe to (in an amount equal to 2.5% of the long-term borrowing from LGFA by that council). LGFA will redeem borrower notes when the council's related borrowings are repaid or no longer owed to LGFA. Currently, there are NZ$381 million of borrower notes on issue.





Borrowing and lending

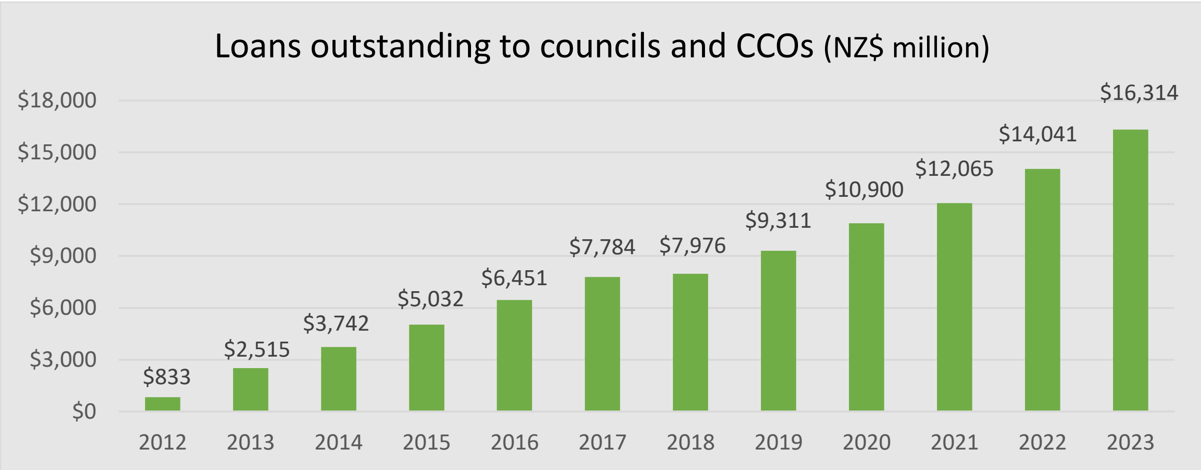
LGFA operates with the primary objective of optimising the debt funding terms and conditions for participating councils.

LGFA borrows by issuing LGFA bonds (greater than one-year maturity) and LGFA Bills (less than one-year maturity) to investors and banks, and then on-lends the proceeds to councils and CCOs.

As at 30 September 2023, there are NZ$18.948 billion of LGFA bonds listed on the NZX across eleven maturities from 2024 to 2037, A$1 billion of AUD bonds and $968 million of LGFA Bills on issue. LGFA is the largest issuer of NZD bonds after the New Zealand Government and the largest issuer of listed debt on the NZX.

LGFA charges councils and CCO borrowers a modest loan margin that reflects their credit rating and whether they are a guarantor or non-guarantor of LGFA.

LGFA has experienced strong growth in lending to the sector. As at 30 September 2023, LGFA had lent $556 million on a short-term basis and $16.84 billion on a long-term basis to councils and CCOs.



The ten largest council and CCO borrowers from LGFA as at 30 September 2023 have borrowed $11.2 billion or 64% of total lending:

Council	$ Amount	% of Total Lending	Cumulative %
Auckland Council	3,490,000,000	20.1%	20.1%
Christchurch City Council	2,220,715,000	12.8%	32.8%
Wellington City Council	1,393,500,000	8.0%	40.8%
Tauranga City Council	815,000,000	4.7%	45.5%
Hamilton City Council	795,000,000	4.6%	50.1%
Greater Wellington Regional	782,000,000	4.5%	54.6%
Queenstown Lakes District Counil	546,609,828	3.1%	57.7%
Hutt City Council	440,700,000	2.5%	60.3%
Rotorua District Council	360,628,639	2.1%	62.3%
Hastings District Council	352,000,000	2.0%	64.4%

The remaining 72 borrowers comprise 36% of loans and have borrowed $6.2 billion from LGFA. Due to its large size, Auckland Council is restricted to borrowing no more than 40% of LGFA lending.

It is not compulsory for councils to join LGFA and once a member, councils do not have to borrow from LGFA.

To remain a member, councils must ensure they comply with financial covenants that include Net debt/total revenue, Net interest/total revenue, Net interest/rates revenue and a Liquidity ratio. This is to protect the quality of the LGFA lending book, to provide protection to our guarantors and to preserve our credit rating.

Guarantee structure

LGFA's obligations in relation to its securities issued are guaranteed by the councils that are guarantors under the Guarantee and Indemnity Deed.

Other than the New Zealand Government, each shareholder in LGFA must be a guarantor.

In addition, any council that borrows in aggregate NZ$20 million or more from LGFA must be a guarantor. The guarantee will be in favour of the obligations of LGFA and not that of the council borrowers. Any call under the guarantee will be allocated across all the guarantors on a pro-rata basis in relation to their rates revenue.

There are 72 Guarantors of LGFA. The only non-Guarantors (due to their small amount of borrowing) are Buller, Kaikoura, Kawerau, Opotiki and Wairoa District Councils.

The New Zealand Government does not guarantee LGFA.

Governance and oversight

The LGFA Board is responsible for the strategic direction and control of LGFA's activities and comprises five independent and one non-independent directors. LGFA is governed by a highly experienced board with deep banking, funds management, technology, infrastructure, listed and unlisted company and public sector expertise. LGFA also runs a Future Director programme where a council or CCO staff member is appointed for an 18-month term to gain governance experience.

The LGFA Shareholders' Council comprises five to ten appointees from the council shareholders and the New Zealand Government. The role of the Shareholders' Council is to:

- Review and report the performance of LGFA and the board, and recommend to shareholders appointments, removal, replacement, and remuneration of directors.
- Provide recommendations to shareholders on changes to policies, or the SOI, requiring their approval.
- Update shareholders on LGFA matters and co-ordinate shareholders on governance decisions.

The current members of the Shareholders' Council are Auckland Council, Bay of Plenty Regional Council, Christchurch City Council, Hamilton City Council, New Plymouth District Council, Tasman District Council, Tauranga City Council, Wellington City Council, Western Bay of Plenty District Council and representatives from Department of Internal Affairs and the Treasury.

LGFA is audited by KPMG on behalf of the Office of the Auditor General. As our bonds are listed on the NZX, we must meet the NZX listing requirements for continuous disclosure and fall under the Financial Markets Conduct Act.

LGFA stakeholders are provided with a six-monthly Statement of Intent, annual financial statements, and a quarterly report to shareholders.

Sustainability

LGFA has achieved Toitū net carbonzero certification and we have committed to reduce employee emissions by 30% by 2030.

LGFA has a Head of Sustainability and a Sustainability Committee that advises the Board and senior management on sustainability issues and the adoption of GRI standards for reporting.

LGFA is a small organisation. Our direct environmental impact is modest compared to our indirect environmental impact through our lending programme. Our lending programme is designed to encourage reduced environmental impact through:

- An assessment of climate change impact and resilience into our credit assessment of councils and CCOs.
- Establishment of a Green, Social and Sustainable (GSS) lending product for councils and CCOs where borrowers receive a discounted loan margin for eligible projects. Current GSS loans to councils and CCOs outstanding are $340 million.
- Establishment of Climate Action Loans (CALs) to councils and CCOs where borrowers receive a discounted loan margin if they have a greenhouse gas emission reduction plan in place and are meeting its targets. Current CALs to councils and CCOs outstanding are $940 million.

Any investments in our Liquid Assets Portfolio are managed under our Responsible Investment Policy.

An important role for LGFA is to be an advocate for sustainability within the sector and to encourage councils to do more where possible.

Credit rating

LGFA has credit ratings from both S&P Global Ratings ("S&P") and Fitch Ratings Services. The credit rating of AAA from S&P is the highest rating possible and is the same as the rating of the New Zealand Government. Fitch Rating Services has assigned a credit rating of AA+ to both LGFA and the New Zealand Government.

Further Information

For further information regarding LGFA such as our Annual Reports, Statement of Intent and Investor presentations please see our website www.lgfa.co.nz