Te Tari Taiwhenua
Internal Affairs

August 2024

LOCAL WATER DONE WELL

Factsheet: Financing for councils and water organisations

This is one of a series of factsheets giving an overview of key Local Water Done Well policy decisions, including those that will be reflected in the proposed Local Government Water Services Bill, which is expected to be introduced to Parliament in December 2024.

It is based on Cabinet decisions announced by the Minister of Local Government and Minister of Commerce and Consumer Affairs in August 2024.

This factsheet provides an overview of financing options for local government water service providers[1] under Local Water Done Well, resulting from ongoing work with New Zealand Local Government Funding Agency Limited (LGFA). It covers current and emerging options.

It should be read alongside other Local Water Done Well factsheets. More detailed information can be found in the associated Cabinet papers that have been proactively released on the Department of Internal Affairs' website.

What are the proposed changes?

LGFA has confirmed that it will provide financing to support water council-controlled organisations (CCOs) established under Local Water Done Well and look to assist high growth councils with additional financing.

LGFA will extend its existing lending to CCOs to new water organisations[2] that are CCOs and are financially supported by their parent council or councils. The ability of councils to establish water organisations will be provided for by the Local Government Water Services Bill.

- LGFA will support leverage for water organisations up to a level equivalent to 500 percent of operating revenues[3] (around twice that of existing councils), subject to water organisations meeting prudent credit criteria. LGFA will treat borrowing by water organisations as separate from borrowing by parent council or councils.

[1] 'Water service provider' means all forms of local government provider – including councils that continue with direct (in-house) delivery, and water organisations.

[2] 'Water organisation' means the separate organisations that councils may establish to provide water services – and does not include councils. There will be various types of water organisation under Local Water Done Well, and LGFA will only be lending to water organisations that meet the qualifying criteria for LGFA membership as a CCO. In particular, financially independent water organisations will not meet the qualifying criteria.

[3] Note that this metric is being used for comparative purposes only and a more appropriate metric for water organisations will ultimately be used.

- LGFA will lend to multiply-owned water organisations, who are supported by the parent councils.
- LGFA will make available to water organisations its existing suite of financial products that are currently made available to councils and CCOs. These include green and sustainable loans and climate action loans, short and long-term loans and standby facilities.

Councils will also retain the ability to borrow through LGFA should they choose to keep water services ‘in house’ rather than establish a water organisation.

LGFA is also reviewing whether it can prudently provide additional flexibility to councils to meet the future challenges faced by the sector. That work will include consideration of the following options:

- LGFA increasing debt limits for high growth councils beyond the current ceiling of 285 percent of operating revenues; and
- In time, and subject to prudent criteria and LGFA stakeholder approval, LGFA lending to water organisations on an unsupported basis.

The Crown confirms the existing supports it provides to LGFA, and as part of the review will consider whether those supports remain appropriately sized given the growth in LGFA’s balance sheet.

Why are these changes needed?

LGFA is the source of most debt financing accessed by local government. This is because LGFA is the lowest cost provider of financing to local government as a result of its scale and its AAA credit rating which is similar to that of central government due to the support of both central and local government.

LGFA has various requirements that councils need to meet and stay within to access LGFA funding. These requirements are to preserve the credit quality of the LGFA lending book in order to maintain its AAA credit rating. A key requirement is that total council debt cannot be more than 285[4] percent of council operating revenues for rated councils and 175 percent for unrated councils, plus there are interest cover ratios based on rates and total council revenues.

Many councils will need to increase borrowing in order to make the necessary investments to bring water infrastructure up to standard and support new housing. Some councils are already close to their LGFA debt limits.

Without change to key financing ratios, some councils will find it difficult to stay under the current LGFA debt to revenue ‘ceiling’ while making necessary water investments.

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[4] This reduces to 280% from 1 July 2025.

The changes proposed under Local Water Done Well enable councils to choose what structural options for water services delivery work best for them. One of those options is to establish a water organisation. That option is expected to have multiple benefits:

- It will result in an organisation that is dedicated to water services, their delivery and their quality.
- It will reduce the debt directly attributed to the parent council(s) if councils transfer water related debt to the water organisations.
- Water organisations will be able to borrow more than councils can and therefore make the necessary investments to provide quality water services.

If councils establish water organisations and do not provide financial support, those organisations could not as it currently stands, access LGFA funding and would need to seek debt funding directly from the private sector.

In addition to cost benefits, an advantage of financing through LGFA is that there will be no transition issues for eligible water organisations. Water organisations are not required to join LGFA and once they have joined, they are not obliged to borrow from LGFA.

Under Local Water Done Well, the Government has been working with LGFA to confirm its intended approach to increased lending to councils and water organisations.

LGFA has also taken steps to improve its working capital and financial strength over time. From 1 July 2024, both borrower loan margins and the borrower notes subscription rate have been increased.

Financial benefits for new water organisations and parent councils

The establishment of new water organisations will enable additional debt financing to fund capital investment into water infrastructure. In practice, this will enable:

- An increased proportion of capital expenditure for water infrastructure to be financed by debt rather than operating revenues – spreading the cost of the infrastructure asset over its useful life;
- A reduction in operating revenue requirements for a financially sustainable water organisation against the status quo – where additional debt financing will mean operating revenues will only need to cover the interest costs and debt repayments, as opposed to direct funding investment;
- Enable borrowings for water services infrastructure to be directly supported by water services revenues at a higher gearing, negating the requirement to use non-water services council revenues to borrow for water services;
- Additional borrowing headroom to be realised for parent councils whose current water services borrowings exceed council borrowings for other activities on a debt to revenue basis; and

- The opportunity for parent councils to pass on the benefit of any additional debt headroom created to consumers, by utilising this to finance non-water capital expenditure with a corresponding reduction to rates revenue requirements.

Proposed economic regulation of all local government water services providers will ensure closer scrutiny that costs are ring-fenced and providers become more efficient. The recovery of costs through water rates are expected to give lenders greater confidence in the financial sustainability of water service providers.

To illustrate these benefits, the new financing arrangements have been applied to a hypothetical council in Annex A.

What does this mean for consumers?

Consumers will benefit from increased lending flexibility because it will support greater investment to improve water infrastructure and services at a lower cost of borrowing than other sources.

Increased borrowing to fund necessary investment in water infrastructure reduces the need to fund investments directly from rates and other revenue. This can smooth the impact of investments across longer periods of time, which should be reflected in smaller increases in rates and water charges.

Next steps

LGFA and the Government will update the sector on how these proposed changes can be implemented ahead of LGFA's November 2024 Annual Meeting of Shareholders.

The Department of Internal Affairs will work with LGFA to develop guidance for councils on financing options, as this work progresses.

Local Government (Water Services Preliminary Arrangements) Bill

The second Local Water Done Well Bill, the Local Government (Water Services Preliminary Arrangements) Bill, is currently before Parliament and is expected to be enacted in August 2024.

The Department will be providing guidance and information for councils' development of Water Services Delivery Plans, following the enactment of the Bill.

Further information

For further information about Local Water Done Well, visit www.dia.govt.nz/Water-Services-Policy-and-Legislation

Questions? Contact waterservices@dia.govt.nz

Annex A: An illustrative example for 'Council A'

To illustrate the financial benefits for new water organisations and parent councils, the new financing arrangements have been applied to the hypothetical 'Council A' which has established a new water organisation ('Water Organisation A'), which LGFA has agreed to lend to at up to 500% of operating revenues. Water Organisation A is financially supported by uncalled capital issued to Council A.

'Water Organisation A':

- Has been established as a company, owned by 'Council A', with appropriate protections against privatisation;
- Owns Council A's water infrastructure assets and has the power to assess, set and collect water services charges from consumers;
- Has its activities limited to the provision of water services and directly-related activities; and
- Is governed by a board which is independent from the council in terms of having no council staff or elected members, with directors appointed for their competency and to ensure an appropriate mix of skills, knowledge and experience.

Through the creation of 'Water Organisation A', Council A has transferred staff, assets and debt relating to water services to the new water organisation. LGFA has agreed to lend up to 500% of operating revenues, subject to 'Water Organisation A' demonstrating sufficient projected cashflows to meet LGFA's covenants and meeting prudent credit criteria.

'Water Organisation A' has identified that it can reduce its projected revenue requirements, by utilising debt financing for capital expenditure, keeping revenues to a level sufficient to cover the costs of service and to meet LGFA's cashflow covenants requirements. These lower revenue requirements are translated into savings for consumers.

The establishment of the new water organisation has also generated additional borrowing headroom for Council A, as its water services were more highly leveraged than remaining council business. Council A has opted to utilise this additional borrowing ability to fund non-water capital expenditure over three years, passing on a corresponding saving to ratepayers.

This arrangement will enable:

- 'Water Organisation A' to reduce projected water charges by $16.4 million over three years (15.4% saving), through more efficiently utilising debt to fund capital expenditure; and
- 'Council A' to utilise additional debt headroom of $14.1 million from the separation of water services for funding non-water capital expenditure, reducing rates requirements by $13.7 million over three years (7.7% saving); for
- Total savings passed on to ratepayers and water consumers of $30.1 million over three years (10.6% saving).

Table 1: Council A's projected rates revenues and charges in the current LTP

Council A's current LTP	Year 1	Year 2	Year 3	3 Year Total
Council rates revenue ($m)	$85.3m	$95.0m	$104.1m	$284.4m
Council rates revenue increases, including water charges (%)	13.6%	11.3%	9.6%	38.7%
Council rates revenue increases, excluding water charges (%)	10.4%	6.1%	4.2%	22.0%
Water services charges ($m)	$29.2m	$35.4m	$42.1m	$106.7m
Water services charges increases (%)	20.3%	21.4%	18.8%	73.5%
Projected debt for water services ($m)	$103.0m	$114.9m	$131.3m	
Water debt to operating revenue (%)	332%	308%	299%	

Table 2: Water Organisation A's projected charges, borrowings and savings to water services consumers

Water Organisation A	Year 1	Year 2	Year 3	3 Year Total
Water services charges ($m)	$27.0m	$29.9m	$33.4m	$90.3m
Updated water services charges increases required (%)	11.4%	10.7%	11.8%	37.7%
Reduction in water services charges – savings ($m)	$2.2m	$5.5m	$8.7m	$16.4m
Reduction in water services charges – savings (%)	7.4%	15.6%	20.6%	15.4%
Projected debt for water services ($m)	$105.3m	$123.1m	$149.0m	
Water debt to operating revenue (%)	364%	387%	423%	

Table 3: Councils A's additional debt headroom passed as savings to ratepayers

Council A (excluding water services)	Year 1	Year 2	Year 3	3 Year Total
Debt headroom from separating water services ($m)	$14.1m			$14.1m
Updated non-water services rates increases required (%)	2.9%	5.1%	3.1%	11.5%
Capital expenditure financed by debt headroom ($m)	$3.8m	$4.7m	$5.6m	$14.1m
Additional interest costs ($m)	$0.0m	$0.1m	$0.2m	$0.4m
Reduction in non-water services rates – savings ($m)	$3.8m	$4.6m	$5.4m	$13.7m
Reduction in non-water services rates – savings (%)	6.8%	7.7%	8.6%	7.7%

Table 4: Combined savings to ratepayers and water services consumers

Council A and Water Organisation A (combined)	Year 1	Year 2	Year 3	3 Year Total
Projected rates increases – per current LTP (%)	13.6%	11.3%	9.6%	38.7%
Projected rates increases – Council/Water Org combined (%)	5.6%	7.0%	6.1%	20.0%
Savings to water services consumers – Water Org A ($m)	$2.2m	$5.5m	$8.7m	$16.4m
Savings to ratepayers – Council A ($m)	$3.8m	$4.6m	$5.4m	$13.7m
Total savings ($m)	$6.0m	$10.1m	$14.0m	$30.1m
Total savings (%)	7.0%	10.6%	13.5%	10.6%