Council Debt - Future Scenarios

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1. Reason for Report

1.1 To provide Elected Members with an overview of Council's future possible debt position, based on a range of noted assumptions, to support Council's Annual Plan Deliberations.

2. Background

2.1 Councils' Long Term Plan 2021/31 (LTP21), pages 32 and 33, attached, include:

2.1.1 Planned capital expenditure of $221m for the 10 years; and

2.1.2 Maximum debt of $71m during the 10 years.

2.2 As stated later in this Report, both of these figures could now change.

2.3 Pages 32 and 33 of LTP21 also state that Council's debt ceiling for the period covered by the LTP was $91m. This debt ceiling was determined with reference to the four borrowing covenants noted on page 33 of the LTP (note: these are reported at each Council *Risk and Assurance Committee* meetings):

2.3.1 Net interest payments/total revenue must <20%

2.3.2 Net interest payments/annual rates revenue must <25%

2.3.3 Net debt/total revenue must <175%

2.3.4 External debt plus liquid investments/external debt must >110%

2.4 Each of these four covenants provides a different 'maximum debt' figure: the lowest figure is the one that determines the debt ceiling.

2.5 As noted in LTP21, assuming Council maintains a Bank Balance of $9m, the fourth of these covenants provides the lowest debt ceiling figure of the four covenants (being $91m).

2.6 Council could increase this $91m ceiling by having a greater bank balance: the resulting 'new' debt ceiling figure could then be provided by another of the four covenants.

3. Discussion

3.1 The financial projections included in LTP21 were based upon a number of financial assumptions, many of which could be different if the projections were recalculated today.

3.2 These assumptions include:

3.2.1 Impacts of proposed Three Water reforms

3.2.2 Future Capital Program Expenditure (eg Preferred Choices included in the draft 2023/24 Annual Plan)

3.2.3 Inflation rates being higher than predicted when developing LTP21

3.2.4 Underlying Other Operating Expenses budgets are now higher than those in the LTP (Other Operating Expenses for 2022/23 are $3.4m higher than the LTP figure: as shown below, increasing these budgets by a higher rate of annual inflation increases the 'maximum LTP debt figure' of $71m to around $97m)

3.3 Each of these three assumptions is summarised below, followed by future debt graphs that incorporate these matters.

Three Water Reforms

3.4 The financial impact of the Three Water reforms, for these purposes, is:

- projected debt to be repaid at 1 July 2026: calculated to be around $41m

  (current debt balance of around $23m plus significant future spend in relation to Marton Bore and Marton/Bulls Centralisation project)

- No Worse Off Funding being received by Council

Note : even though the actual repayment of this total debt is expected to be staggered over a number of years, the unpaid amount will be offset by an equal (interest bearing) amount owed to Council so, for these purposes, can all be assumed to be repaid on 1 July 2026

Future Capital Expenditure

3.5 The preferred choices in the 2023/24 Annual Plan Consultation would change the levels of future capital expenditure, and therefore debt, compared to LTP21. Specifically, the preferred choices that would have the most significant debt impact are increases of:

- $14m for the Marton Civic Centre (LTP21 already includes $19m for this); and
- $4.3m for Taihape Town Hall/Civic Centre (LTP21 already includes $9.7m for this)

(the debt impact of the new mobility pathway has been ignored for these purposes due to its relatively minor debt-impact)

Inflation

3.6 Councils were advised to use inflation rates of around 3% for LTP21. This figure would be nearer 5% (higher for the most immediate years) if the projections were restated.

3.7 All of the points noted in S3.2 to S3.6 above impact Council's future projected debt levels. Council's future debt levels will influence Council's future required rates levels (and future rate increases) as Council needs to comply with the four borrowing covenants listed above and needs to be able to afford its future interest costs.

Scenarios

3.8 The following section in this Report provides three scenarios that show future possible debt outcomes based on the impact of the items in S3.2 to S3.6 above:

3.8.1 Scenario 1: ‘as is’: Council continues to operate in its current form:

- the proposed Three Water reforms do *not* proceed;
- Council does *not* proceed with its Preferred Choices
- Council proceeds with future rate increases as per LTP21 (page 32)
- Inflation of 5%pa is applied

3.8.2 Scenario 2: ‘as is’ but assumes the Three Waters reforms proceed from 1 July 2026

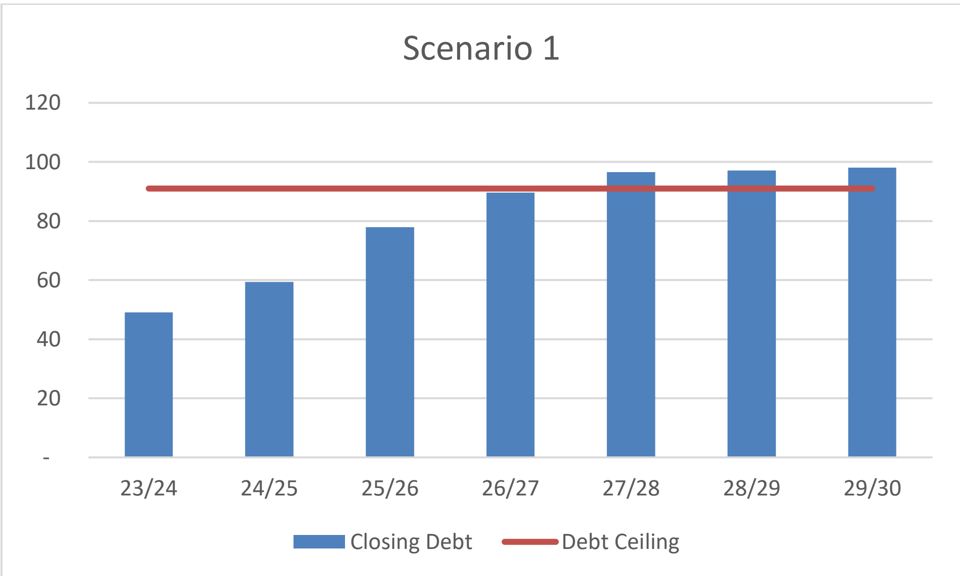
3.8.3 Scenario 3: assumes the Three Water reforms proceed from 1 July 2026 *and* Council proceeds with its Preferred Choices as per the 23/24 Annual Plan Consultation

3.9 These Scenarios all assume a rate increase of 10.01% for 2023/24 is applied.

4. Future Debt Levels

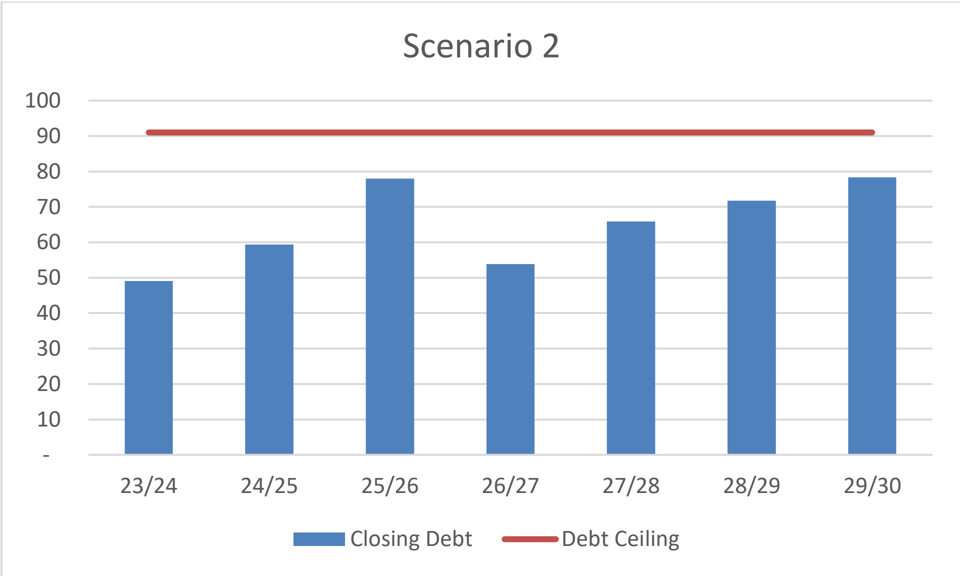
Scenario 1

- Future rate increases as per LTP
- Current Operating Expense Budgets are maintained, with future Inflation applied at 5% pa
- See S5 below for commentary relating to the Debt Ceiling being exceeded



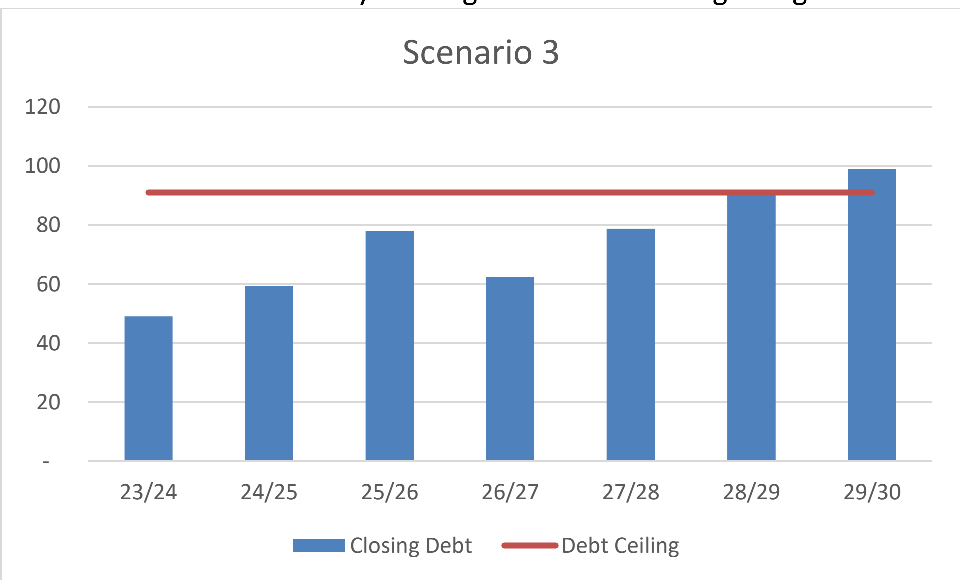
Scenario 2

- Future rate increases as per LTP
- Current Operating Expense Budgets are maintained (apart from those associated with Three Waters), with future Inflation applied at 5% pa
- Three Water reforms result in $41m debt repaid to Council in 2026/27 and $6m No Worse Off funding received (indicative amount)
  (The other borrowing covenants still provide debt ceiling in excess of $91m even without the Three Waters revenue)



Scenario 3

- Future rate increases as per LTP
- Current Operating Expense Budgets are maintained (apart from those associated with Three Waters), with future Inflation applied at 5% pa
- Three Water reforms result in $41m debt repaid to Council in 2026/27 and $6m No Worse Off funding received (indicative amount)
- Preferred Choices in 23/24 Annual Plan are confirmed
- See S5 below for commentary relating to the Debt Ceiling being exceeded



5. Financial Implications

5.1 Under Scenarios 1 and 3 Council would, if it retained the four borrowing covenants, have to increase its debt ceiling.

5.2 This could be achieved by Council holding a bank balance of over $10m.

5.3 For Scenario 3, the other three covenants would provide a debt ceiling of:

- $99m in 2027/28; and
- $105m in 2028/29; and
- 109m in 2029/30

This would leave minimal debt headroom.

5.4 This Report does not consider these matters in the context of Council having a balanced budget.

6. Impact on Strategic Risks

6.1 One of Council's Strategic Risks is '*Financial Stability Is Lost'*. The Strategic Risk Register notes that an element of this risk is that:

- Council's projections highlight financial problems that are not properly addressed

6.2 Officers highlight the degree of future Debt Headroom in the scenarios included in this Report.

Attachments:

1. LTP21 Pages 32 & 33

Recommendation

That the Report 'Council Debt – Future Scenarios' be received.

Financial Summary

Overall the District is in good shape and approaching exciting times. The Government's stimulus response to COVID-19 has presented the District with some unprecedented opportunities and there are numerous signs that we are entering a period of long and sustained growth.

Our population is expected to grow and our economy is expected to grow. Our infrastructure has to keep up. However, we must not simply focus on growth infrastructure. If we are to avoid problems other councils are facing it is critical we also maintain our existing infrastructure. Unfortunately, this is becoming more expensive to do and, in the absence of external funding, puts pressure on rates.

However, with an increasing population, in most sectors, including residential, industrial and commercial, the increasing rates burden will be spread over a larger ratepayer base. That means that if rates are increased by, say, 5% and the rate base increases by 2%, each existing ratepayer will face a rate increase of around 2.95%.

Council currently has relatively low levels of debt. This will enable us to push ahead and pursue our opportunities. Our Long Term Plan shows that we intend to invest around $221m throughout the District in the next 10 years.

However, the cost of our asset renewals has grown faster than our income in recent years. This will require higher rate increases in the first few years of our Long Term Plan than we would like.

Key Issues

Balancing the Budget

Council is required, both morally and legally, to have a sustainable balanced budget. Where considered prudent, Council may set its operating revenues at a different level to its operating expenses.

Capital grants to be received in years 1 and 2 of the Long Term Plan prevent these years from being in deficit. However, Council is planning deficits for years 3 to 5 of the Long Term Plan.

A key cause of these deficits is the increase to the depreciation cost that Council incurs – depreciation has increased from $10.6m in 2019 to a budgeted figure of $14m in 2022. Without reducing its assets and infrastructure base, Council has very limited ability to manage this cost.

Council considers it prudent to rate for such cost increases over several years, thus avoiding unanticipated and large increases in any one year. Although this will result in Council having an unbalanced budget for some years of this Long Term Plan, it will result in an ongoing, sustainable balanced budget.

Council considers this a better model than imposing large rate increases in the early years of the Long Term Plan. Council has considered its ratepayers and its favourable funding position when making these decisions.

Council has also committed to an ongoing programme of pursuing operational efficiencies. Future budgets include an element of inflation and Council has also incorporated efficiency savings in its various operating budgets. Council recognises that contemporary business practices (including greater use of technology, strategic procurement, greater focus on long term business partnerships etc) enable sustainable operating efficiencies to be obtained. The budgets included in this Long Term Plan include $8 million of 'cost reduction without impacting on levels of service delivery' in recognition of this initiative. To the extent that such savings are not achieved this will impact on future debt levels, service levels and/or rate rises.

Rates Over the Coming Years

Rates are an important source of Council revenue. Council has kept recent rate increases relatively low. Rates help pay for the renewal of its assets, the cost of which has grown faster than the recent rates increases. This needs to be addressed and Council has elected to do this over several years rather than in one year.

Overall, Council expects to increase rates (excluding penalties and remissions) over the next 10 years as follows:

1	2	3	4	5	6	7	8	9	10
7.07%	7.29%	6.54%	6.54%	8.79%	5.54%	3.79%	3.79%	2.54%	2.04%

As mentioned above, these increases are NOT what each individual ratepayer will be facing as we expect a significant larger ratepayer base over which these increases will be spread.

Council has set limits on its rate increases (excluding penalties and remissions) as follows:

1. Less than 7.5% for years 1 and 2
2. An average of less than 5% for the remaining 8 years

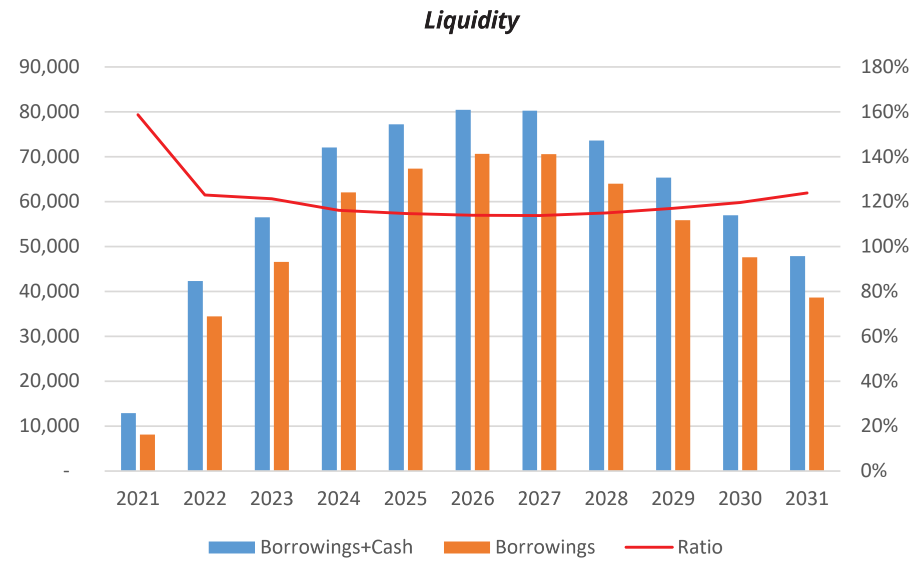
Council will use rating differentials and will amend the level of its Uniform Annual General Charge where it considers that the results of doing so are fair and equitable to the overall community. The very nature of our rating system means that, from time to time, unforeseen outcomes can arise that will be considered unfair and inequitable by some ratepayers.

Capital Expenditure

Council's planned capital expenditure programme shows we intend to invest more than $221m in the District over the next 10 years. This level of investment will be funded by a mix of rates, grants and debt. Council expects its debt to increase to around $71m during this Long Term Plan. Council also expects to maintain cash reserves of over $9m in years three to 10 of this Long Term Plan (which provides a debt capacity of around $91m).

Critically, this amount includes maintaining our existing infrastructure and flood management strategies and also investing in the District's future.

Further details of these initiatives are stated elsewhere in this strategy.



One of our challenges is whether we'll be able to complete all the capital work we've planned to do. Not completing our programme presents some risks. Our planned Capital Works programme for the 10 years is $221 million.

Delays could potentially result in increased costs or assets could fail before they are upgraded or replaced, risking continuity and delivery of services. There is also the risk that we charge rates to fund programmes that we then can't deliver in the proposed timeframe.

We have already taken steps to ensure we can complete our capital works programme, including employing more dedicated project managers and seeking early external expertise for major projects. We will continue to maintain our critical infrastructure to meet our existing levels of service.

There are some things we can't control, like the increased demand for skilled construction workers and materials, but we don't believe these risks to be significant and we are confident we can deliver our programme.

Treasury

Council recognises that it needs to increase its debt levels if it is to crystallise the opportunities that lies before it. However Council, also recognises that increases to debt must only be made in a responsible and managed manner.

Council's borrowing limits are set out in its Treasury Management Policy:

1. Net interest payments as a ratio of total revenue must be less than 20%
2. Net interest payments as a ratio of annual rates revenue must be less than 25%
3. Net debt as a ratio of total revenue must be less than 175%
4. External debt plus liquid investments divided by external debt must be more than 110%

Council's Long Term Plan shows that these limits in the next 10 years are forecast to be:

1. Ranges from 1.0% to 3.4% maximum
2. Ranges from 2.0% to 5.2% maximum
3. Ranges from 51% to 126% maximum
4. Ranges from 114% to 124% minimum

Council's Treasury Management Policy provides further information regarding Council's strategies regarding Borrowing Mechanisms and issuing security for debt. Generally, Council will primarily seek debt finance from the Local Government Funding Agency. Such debt will be secured by way of a charge over rates revenue offered through a Debenture Trust Deed ("DTD"). Under a DTD, Council's borrowing is secured by a floating charge over all Council rates levied under the Local Government Rating Act. The security offered by Council ranks pari passu with other lenders.

From time to time, and with Council approval, security may be offered by providing a charge over one or more of Council's assets.

Council's objectives for holding and managing financial investments and equity securities is contained in its Treasury Management Policy. Council's general policy regarding investments is:

- Council may hold financial, property, forestry and equity investments if there are strategic, commercial, economic or other valid reasons;
- Council will keep under review its approach to all major investments and the credit rating of approved financial institutions; and
- Council will review its policies on holding investments at least once every three years.