Financial Strategy – Investing for Growth

Our ten year plan

WELLINGTON CITY COUNCIL'S

LONG TERM PLAN 2015-25.

A CHANGING FINANCIAL LANDSCAPE

In 2012 the Council's financial strategy was underpinned by fiscal restraint, recognising the organisation's big financial challenges, including earthquake strengthening, leaky buildings and rising insurance costs. Confidence in the economy was low and ratepayer expectations were for rates increases in line with inflation. The strategy conformed to existing practice and complemented existing financial policies. It set an annual rates increase target for 2012/13 equal to the Local Government Cost Index, lowering to CPI (around 2.5%) in subsequent years and planned for debt ratios significantly lower than all other metropolitan cities in New Zealand. But growth forecasts were low. The strategy was not sustainable and risked service cuts and minimal new offerings unless rates increased above the strategy's forecasts.

We have since reviewed how we deliver our services and consolidated our council controlled organisations, implemented shared services in water, IT and procurement programmes. These and similar initiatives are expected to deliver savings in excess of $50m for Wellington ratepayers over the next 10 years – though this is not enough to fund the increasing expectations that we, our residents and businesses have for the city.

Rates increases equal to or less than CPI (household inflation) are not sustainable in the long-term without cutting services. This would not be enough to fund what we provide now and meet ratepayer expectations for improved services.

Rather than risk cuts to services and a stagnating city, our new Financial Strategy provides a platform for the Council to invest and support economic growth, which in turn will create jobs, grow our ratepayer base and increase prosperity. We will achieve this by prioritising proposals for funding and expenditure that:

- Rebalance our spend and investment between key strategy areas
- Identify areas where service levels and performance are already high and increase the use of existing assets, rather than spending on new investments
- Invest in projects that grow the economy and deliver returns on our investment
- Encourage urban growth in areas where we have existing infrastructure and public transport and in a way that improves environmental performance
- Improve our asset management to better manage risk while also maintaining high levels of service delivery
- Achieve ongoing efficiencies within the organisation, with a focus on shared services and improved customer experiences.

WORKING FROM A POSITION OF FINANCIAL STRENGTH

Wellington City is in a strong financial position. Our debt to income ratio is currently less than 100%. This compares favourably with other metropolitan councils whose equivalent ratios range from over 175% to around 275%. The Council also holds investments in Wellington Airport and a substantial ground lease portfolio that are valued at more than our $384m borrowings. So the Council could theoretically sell these assets and have no debt at all.

In its 2014 review of the Council's credit rating, the independent credit rating agency Standard & Poors judged Wellington City's stand-alone credit profile to be the highest of Local Government in New Zealand, and even higher than the Government's, but have capped it at the central government level. S&P's assessment that the Council has 'very strong financial management and budgetary flexibility, strong budgetary performance and liquidity and low contingent liabilities' supports our view that our credit strength and institutional framework will allow higher debt burdens as we progress our strategy to invest in projects to grow the Capital City's economy.

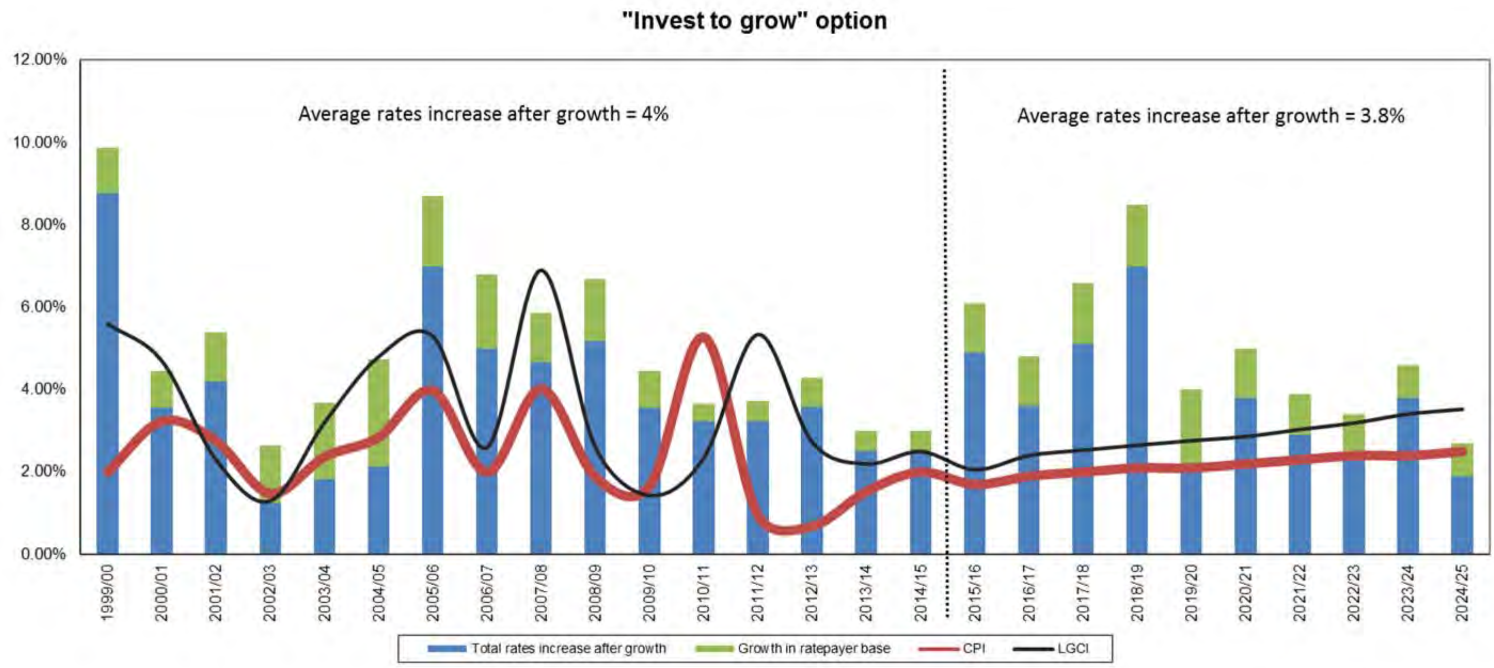
Council uses debt to spread the cost of buying assets and services across those who will benefit from use of the asset over its life. This means we also need to consider the impact of servicing debt on the affordability of rates. In formulating our Financial Strategy we have ensured that the cost of servicing and repaying borrowing for each asset is catered for with proposed rating limits.

RATES FORECASTS AND LIMITS

Our 'invest to grow' strategy provides to limit average rate increases at 4.5% over the first three years of the LTP and an average of 3.9% across the 10-year plan.

If we keep going as we are...		If we invest for growth	
3.1%	**Rates would increase by 3.1% on average annually over the next 10 years.** **And would be limited to 4.1% annually, on average, over the next 3 years**	3.9%	**Rates increases will be limited to a 3.9% on average after growth annually over the next 10 years.** **And to 4.5% annually, on average, over the next 3 years**

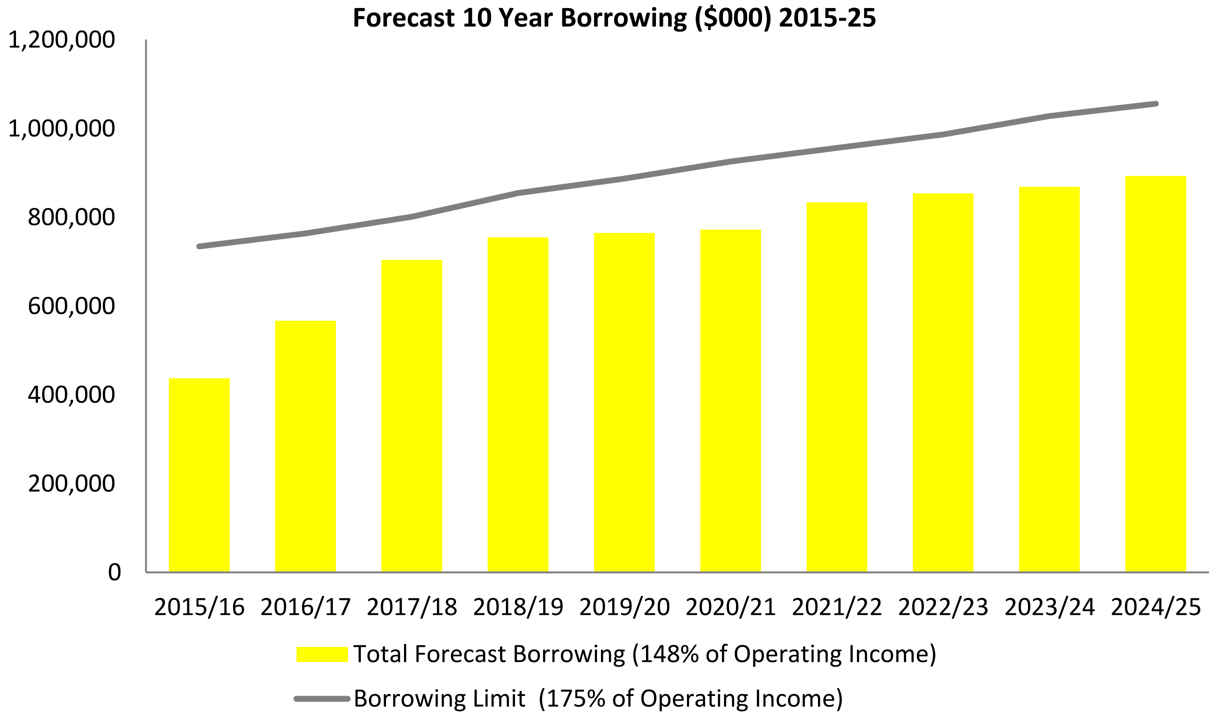
The 3.9% average annual rates increase limit proposed within this strategy compares favourably with the average increase of 4.1% over the last 15 years.



DEBT FORECASTS AND LIMITS

We are forecasting debt across the period of this LTP to peak at approximately 135% of operating income. The limit to the amount of debt the Council will take on over the period of this strategy is 175% of operating income. This limit provides some contingency for Council to respond immediately to an unplanned emergency or natural disaster. The cost of servicing the forecast debt, and the assets we build or buy, is built into our forecast rates increases.

If we keep going as we are…		If we invest for growth	
130% forecast 150% limit	**Council debt will be capped at a maximum of 150% of annual income – the same as a household earning $50,000 a year having a mortgage of $75,000.**	**135% forecast 175% limit**	**Council debt will be capped at a maximum of 175% of annual income – the same as a household earning $50,000 a year having a mortgage of $87,500.**



CHALLENGES AND OPPORTUNITIES

In the pages that follow we explain how we propose to manage the financial challenges, opportunities and risks the city faces to enable the Council to deliver on this strategy in a financially prudent manner.

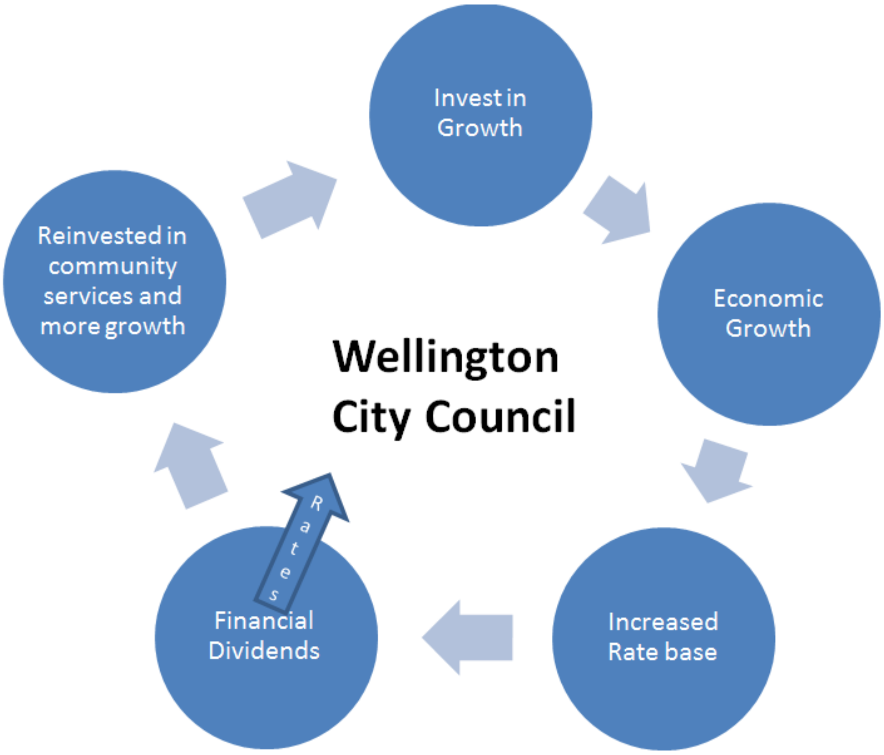
Population, land use, and rating base growth

Since 2010 Wellington City has had slow population growth of 0.7% per year (0.2% below the national average). The 2015 population is estimated at around 203,000 people. It is expected to increase by about 12,000 to around 215,000 by 2024, a modest 0.6% average growth rate per year. Limited changes to land use are forecast, however the northern growth management plan provides for the conversion of open space to residential development. The capital cost to provide for these changes over the 10 years is forecast at around $75 million and the associated operating costs $9 million.

In the past five years, the ratepayer base has grown at an average rate of just 0.4%. History shows that Council investments can be a catalyst for economic growth. This was evident in the last significant growth spurt, when our rating base growth peaked at around 2.2% per annum in the early 2000s on the back of game-changing projects like Te Papa, Westpac Stadium and development of the waterfront.

This Financial Strategy aims to create the capacity to invest in initiatives that act as a catalyst for growth in the economy and the city's rating base. Our LTP includes a number of key investment projects that we expect will accelerate growth in our ratepayer base, which we conservatively expect to peak at around 1.8%, an average of 1.2% over 10 years. The larger rating base is expected to generate a $37m boost for existing ratepayers by 2024/25, a cumulative benefit of over $205m across the 10 years – and this benefit will continue to accumulate in subsequent years.

The financial benefit, or return, that the Council receives from prudent investments can be re-invested in the city. We call this the ‘virtuous circle’.



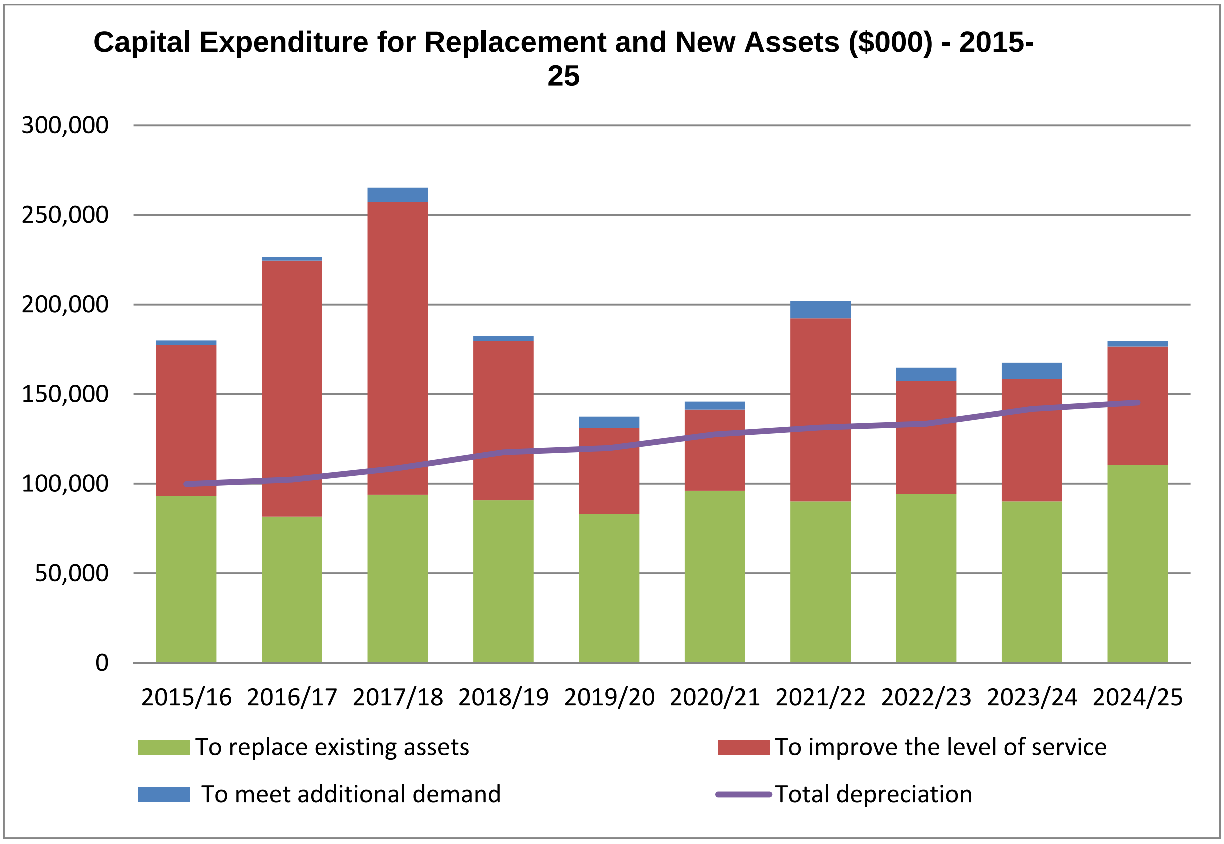
A strategic approach to asset investment

This plan is different in direction and approach to the past. The emphasis is strategic and long-term with a focus on short-term delivery.

The first three years of the plan is detailed and reflects a work programme that is realistically deliverable in the timeframe. A rolling three year forecast provides flexibility for the Council to respond to unanticipated changes and to consider new opportunities.

We’ve done a lot of work to better understand the quality of our assets. They are generally in good condition and we have a robust asset renewal programme in place. Continuing to improve the quality of asset information, particularly for our network infrastructure, means we can get more value from our assets without exposing the Council or the community to undue risk. We have used updated information to better plan and make decisions about assets that need renewing over the 10 years of the LTP. Our Infrastructure Strategy expands this timeframe out to 30 years and gives us confidence that we have the financial capacity to maintain our existing infrastructure in the longer term.

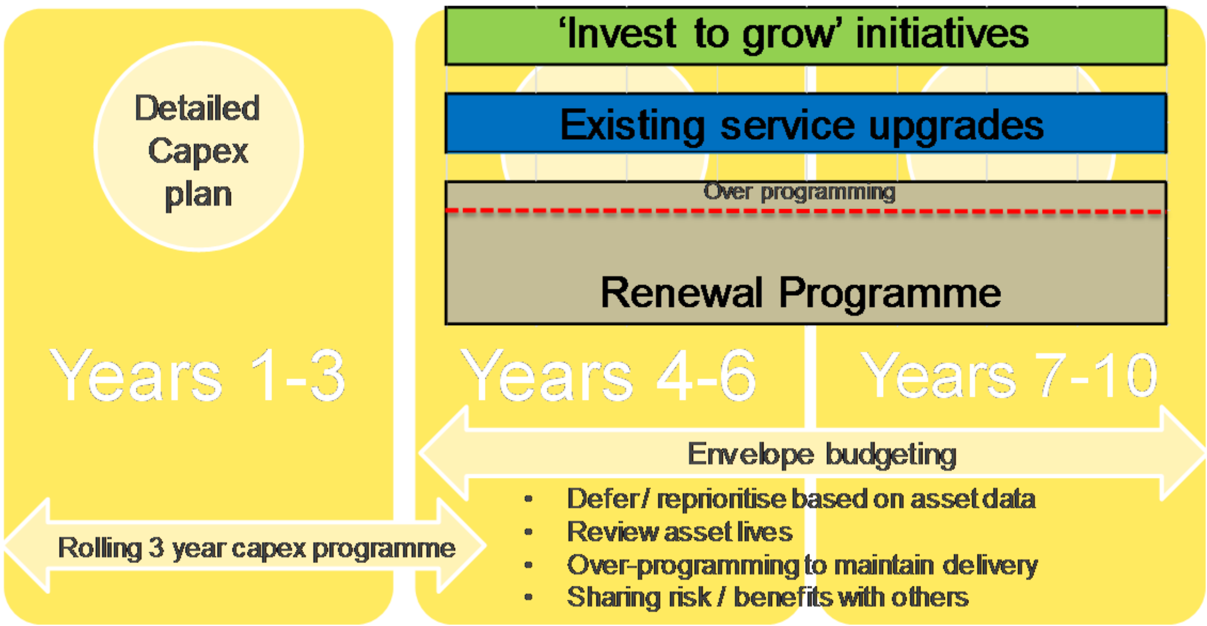
The expected capital costs for network infrastructure required to maintain existing levels of service and meet additional demands is as follows:



Significant projects to upgrade or improve services include increasing the cycling network, building a new library in Johnsonville and improving the resilience of the city's water supply. We also plan to continue to improve earthquake resilience, including the Town Hall, Central Library and civic offices.

There is less certainty, however, around the details, costing and timing for a range of potential new economic growth initiatives. While these initiatives will all be subject to robust business cases and public consultation, it's also important that we demonstrate the Council's capacity to invest in projects such as an indoor music arena, extending the airport runway and urban development initiatives.

We have used an envelope budgeting approach to reflect the capacity that Council has within its financial strategy to fund 'invest to grow' economic initiatives in years 4 to 10 of the LTP.

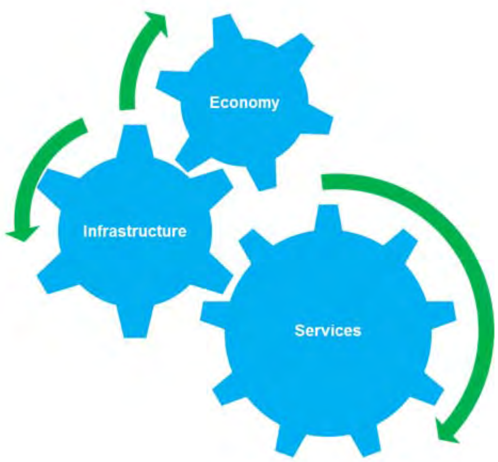


Managing investment expectations

Annual surveys and benchmarking data show that service levels for social, recreational and community infrastructure are high in Wellington. However, over the last ten years there has been an expectation in the community that the Council will continue to increase service levels in these areas.

It is also recognised that during this period investment to support the broader Wellington economy and the city's rating base has been low.

This Financial Strategy recognises the importance of investment in the economy to grow the city and increase the rating base to provide the financial capacity to continue to invest in our infrastructure. In turn, this provides the resources for the Council to deliver on recreation, social and cultural services, amenities and events. The risks of not doing so are summarised in the diagram below.



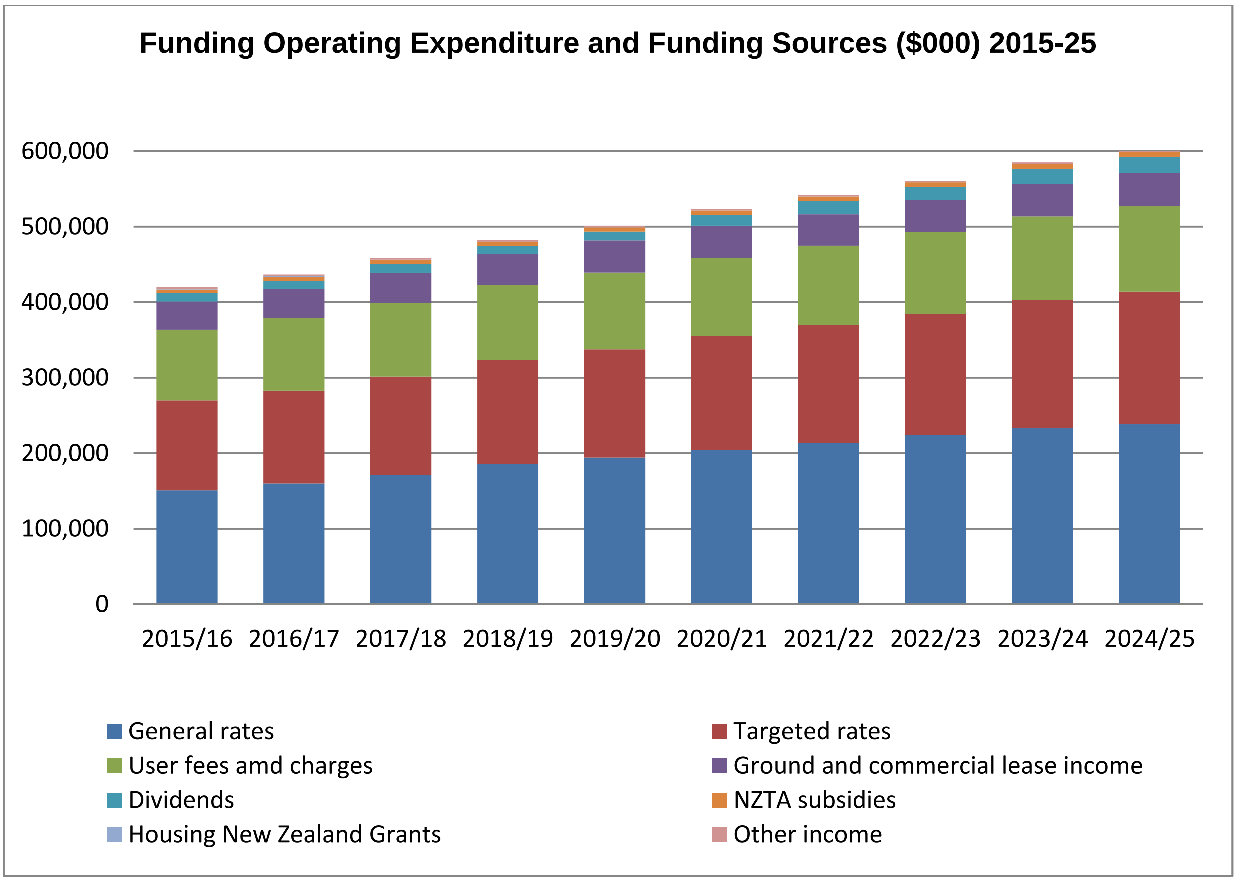
Risks:

- ❖ Economy shrinks
- ❖ Insufficient growth to drive GDP, jobs & prosperity
- ❖ Shrinking rating base
- ❖ Cuts to services

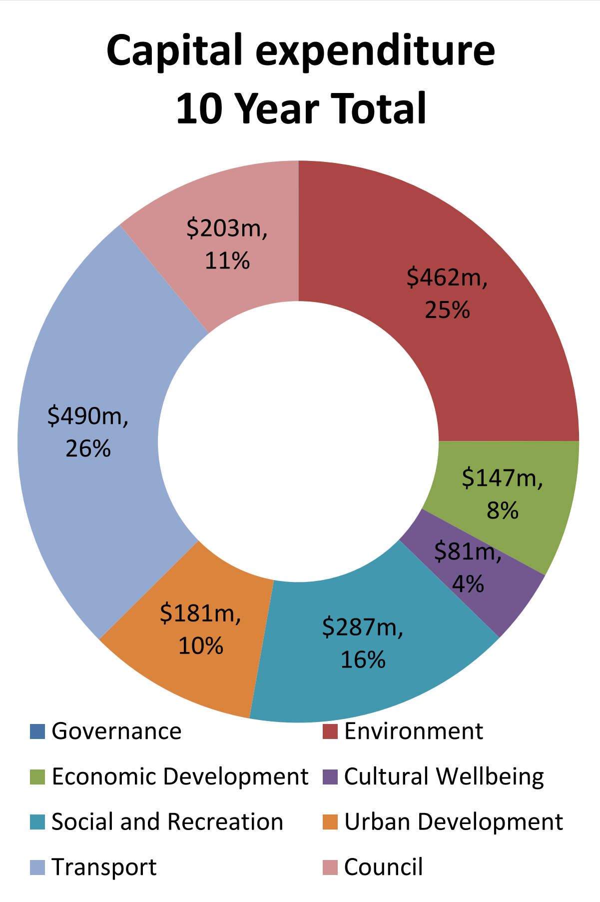
Continuing to do the basics well

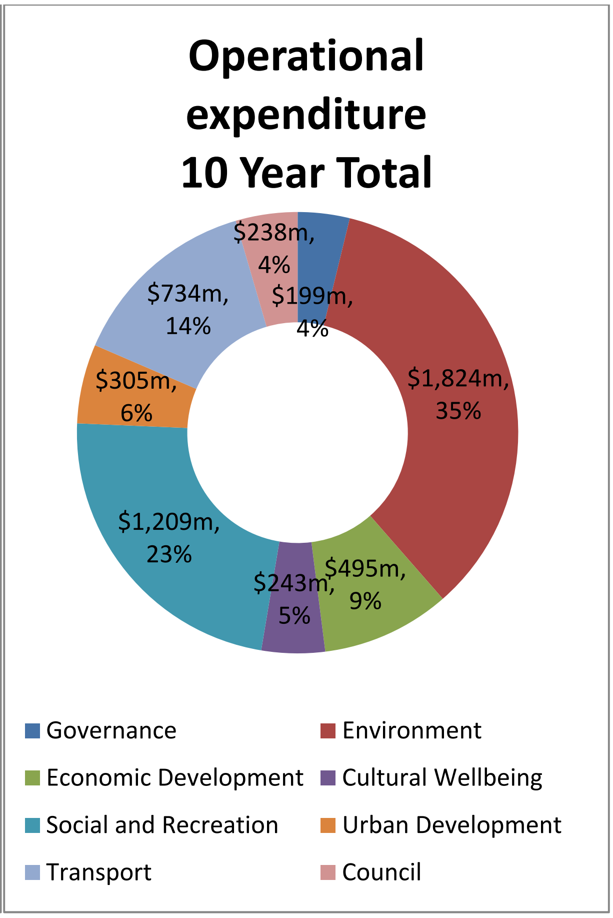
There is a risk that in investing to improve the economic resilience of the city, we compromise the delivering of core services. We will manage this risk by providing capacity within our rates and debt limits to ensure that we can continue to provide the services we do now. We will increase the emphasis on improving utilisation of the assets and services we currently provide. To ensure we maintain high levels of service delivery we will continuously drive operational efficiencies within the organisation. We will also focus on shared services and improved customer service - for example combining of CCOs to create the Wellington Regional Economic Development Agency, shared IT infrastructure and a range of procurement and contract related initiatives.

Our plan is to continue to deliver the full range of services we currently offer.



The graphs below show that in our proposed LTP financial strategy we will continue to fund and invest in the full range of services we currently provide.





Maintaining an affordable and prudent balance between service, rates and debt

Our financial strategy sets a framework for investment decision-making by:

- Setting maximum limits for rates and debt supported by funding policies that will ensure rates remain affordable
- Linking to a clear set of funding principals as contained in the Council's Revenue and Financing Policy
- Using quality asset data to drive its infrastructure asset renewal and upgrade
- Requiring the Council to be specific about the costs, delivery timeline and impact on service levels of its investment decisions in the first three years of its plan.
- Being transparent about the assumptions used in longer-term (years four to 10) initiatives for which full business cases are yet to completed, and providing flexibility for investment intentions to be modified, depending on these cases and other external factors.

There is a risk that in attempting to maintain or increase service levels the Council could compromise its funding principles that underpin its robust and prudent financial management. This risk is mitigated by continuing to make provision in our Financial Strategy to:

- Maintain a balanced budget. The Council will raise sufficient income each year to fund the costs of providing services consumed by the city that year. No profit is budgeted or rated for. Note that our financial statements will show a surplus because revenue received for capital expenditure is required to be shown as income.

- Continue to fully fund depreciation on assets that the Council will be required to renew when they reach the end of their useful life. This is needed so we can pay for their replacement in the future.
- Debt fund to maintain intergenerational equity. Debt is used to initally fund assets. This debt is repaid over the life of the asset through depreciation funding. This ensures that ratepayers only pay the cost of a service when they benefit from a service
- Enable asset management planning to inform and complement financial planning. This considers the condition and deterioration of assets to estimate their useful life and the costs of their replacement and repair. It balances risk and the and timing of replacement, as well as asessing the capacity required for growth.
- Manage investments and equity securities. The primary objective of holding and managing investments and equity securities is to optimise the return on the overall investment portfolio. Investments are also held for the purpose of achieving Council's strategic objectives and to provide diversity to the Council's revenue sources. For non-strategic investments, the target return for investment is to achieve an average return over time greater than Council's long term cost of funds, currently forecast at 6.3% per year.The Council's investment policy sets out the mix of investments, strategies and other policy considerations in greater detail.
- Operate a policy on securities. To be able to borrow money we need to offer security to the lenders. Security is a guarantee which can be redeemed in case of default, like a house as mortgage security. Our borrowings are secured by creating a charge over our rates revenue. This security relates to any borrowing and to the performance of any associated obligations to borrowing. As a shareholder in and borrower from, the New Zealand Local Government Funding Agency we also use rates revenue as security over all borrowing from the agency.
- Implement our Insurance Strategy which balances externally-procured insurance, internal 'self-insurance', risk retention and transfer. Our insurance policy aims to achieve an adequate level of insurance with a balance of insurers from local and international markets. Our insurance is mainly for material damage and business interruption. Material damage covers catastrophe losses only, with an internal $10m insurance reserve fund (being increased over time) to cover excesses and day to day working losses. The insurance coverage includes natural disasters to a limit of liability of $400m material damage (buildings, infrastructural assets and contents) and business interruption combined over an asset portfolio of $4.658bn (2014/15). Our earthquake cover and other natural disasters are informed by Geological and Nuclear Sciences (GNS) on potential losses caused by these events.

This strategy also allows for Council to maintain a reasonable balance between services, rates and debt. Increases in service levels will be generally restricted to those services that are expected to provide an increase in the rating base, reducing the impact on existing ratepayers. Where debt funding is required to spread the cost of an investment across a number of years, we will focus on those investments that provide a return to reduce the impost on ratepayers.

Strategic partnering

We will develop a more focused and strategic approach to partnering with central government and the private sector. To reflect this we have assumed that in addition to the $1.7 billion of asset investment proposed in the 2015-25 LTP, some investments to which we contribute will be undertaken by other organisations. To reflect this we have assumed that as part of our economic growth funding envelope we will provide sufficient grant funding to service $90 million of investment by an external party, but transfer the capital risk and not hold the associated debt on the Council's balance sheet.

We will also continue to investigate the philosophy of 'earn/back' with central government. When ratepayer/funded Council investment results in improved economic performance of the city and a higher tax take, we believe the Council should receive a portion of the financial benefit accrued by the Government.

Rates affordability

In developing our financial strategy we have been very conscious that our rates are affordable. Our strategy is underpinned by an assumption that affordability will be maintained.

Wellington residents have significantly higher incomes than the national average.

	Wellington	National average
Household income >$70,000	54.6%	38.7%
Household income <$30,000	12.4%	18.7%

We know there are small pockets of deprivation in Wellington City. We will continue to manage this factor by providing rates remission and rates postponement policies. The central government/funded rates rebate scheme can also be used in hardship cases that result in difficulty paying rates.

Residents fund approximately 55% of total rates. As Wellington residents have significantly higher average incomes that the national average, our average rates equates to approximately 2.7% of average Wellington household income. Throughout the period of this LTP we intend to keep this below 3.5%, significantly lower than the 5% affordability threshold identified in the 2007 Local Government Rates Enquiry.

Commercial ratepayers fund 45% of total rates. Generally rates are a relatively small proportion of total business income, varying between 0.1% and 0.4%, depending on the sector.

Factors such as increased insurance and earthquake resilience costs are placing additional pressure, on the likes of the not-for-profit sector and heritage property owners. While many not-for-profit organisations already receive lower rates under legislation, the Council is cognisant of the pressures on owners of earthquake prone buildings and has initiated a rates remission policy to help.

Earthquake and weather/tightness risk

The Council's 2012 Financial Strategy highlighted earthquakes, weather/tightness and increasing insurance costs as key risks which warranted a conservative fiscal approach. The Council's own financial exposure to these risks is now better understood – all are catered for within this strategy and specifically budgeted for within the 2015-25 LTP. We have made provision to strengthen the Town Hall, the Central Library and administration building. We will fully repay the borrowing taken out to cover the Council's contribution to leaky building costs over the period of this LTP and will utilise recent reductions in insurance premiums to replenish our self-insurance reserves and increase our level of cover.

Delivering on the strategy

This Financial Strategy supports and enables an ambitious plan to invest in the city. We have been conservative in our growth assumptions, but there is still a risk that the investment projects we propose will not deliver the economic and rating base increases we are forecasting. We will manage this risk by conducting detailed business cases for each investment to assess their cost/effectiveness and economic contribution. We will also consult before deciding to proceed. We will also measure and report on our performance against this strategy annually and review the strategy every three years.

Our view is that there is significantly greater risk in not investing to support the city's economy, making it more difficult for us to compete nationally and internationally, a loss of businesses, jobs, cuts in services and higher long/term rates for the ratepayers that are left behind.

'Current service' strategy	'Invest to grow' strategy
No / or very limited new offering Renewing assets based on a depreciation profile rather than asset quality	New offerings to reinvigorate the city and its economy Greater ability to reprioritise capex renewals and upgrades based on improved asset information
Limited ability to respond to opportunities	Enhanced ability to respond to opportunities
Limited ability to respond to growth, economy and ratepayer expectations	'Envelope' budgeting to provide for economic investment in years 4-10 ($150m over 10 years)
Minor reprioritisation of capex renewals (only) based on improved asset information	Flexibility to adjust 'envelope' in response to growth, economy and ratepayer expectations
No opportunity to grow business and community confidence through investment in the city	Opportunity to significantly grow business and community confidence
Growth in rating base will be low – fluctuating in response to economy – limited ability to influence Potential cuts to services	Elevated growth in rating base support long-term sustainability and vibrancy of the city ($200m cumulative direct ratepayer benefit over 10 years plus city-wide benefit)
Slightly lower rates increases in the short-term (4.1% over 3 years, 3.1% over 10 years)	Slightly higher rates increases in the short/ medium term (4.5% over the first 3 years of

	the plan, average of 3.9% over the full 10 years)
Lower investment = lower borrowing levels, but no improvement to ratepayer equity in the city	More investment = higher borrowing levels, but maintain ratepayer equity in the city
Risk of stagnation	Opportunity for the city to grow and flourish