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WELLINGTON CITY COUNCIL

**STRATEGY & POLICY COMMITTEE**
**18 AUGUST 2011**

**REPORT 3**
*(1215/52/IM)*

# THE NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

## 1. Purpose of Report

The purpose of this report is to approve the Council's participation in the establishment of the New Zealand Local Government Funding Agency Ltd ("**LGFA**") and to address the consultation process.

This report considers all (three) of the oral submissions heard by the Strategy & Policy Committee on 4th August 2011 plus a further five written submissions. The submissions (eight in total) originate from a special consultation, in terms of the Local Government Act 2002, to consider two separate items relating to the Council's proposed involvement in

The two items considered by the special consultative process are as follows.
1. Amendments to the Council's Long-term Council Community Plan 2009-19 Investment and Liability Management Policies.
2. Council could become a shareholder in a Council Controlled Trading Organisation.

## 2. Executive Summary

In May 2011, the Council confirmed its support in principle for its future participation in the LGFA as an establishment shareholder. The special consultative procedure that followed only generated eight submissions. We believe this was because Greater Wellington Regional Council had previously undertaken its own consultation on the same topic and had probably captured most of those parties interested in making a submission on the LGFA scheme. The consultative procedure has not revealed any issues that were not considered in the officers' initial assessment of the LGFA scheme and reports to Council.

In light of the special consultation and its outcomes, this report recommends that the Council proceed with its investment in the LGFA.

## 3. Recommendations

Officers recommend that the Strategy and Policy Committee:

1. *Receive the information.*

2. *Note that the special consultative procedure has been followed in relation to:*

   a. *the recommended investment in the New Zealand Local Government Funding Agency Limited ("LGFA") which will be a Council Controlled Trading Organisation;*

   b. *the required amendments to the Investment and Liability Management Policies in the Council's Long-term Council Community Plan 2001-19.*

3. *Recommend to Council that it amend the Investment and Liability Management Policies in Long-term Council Community Plan 2009-19 as detailed in Appendix A.*

4. *Note that to participate as an establishment shareholder in the LGFA there will be a requirement to borrow up to $2.325m to fund the investment and that the return on the investment is expected to cover the interest costs from the borrowings.*

5. *Recommend to Council that it agrees to participate in the LGFA scheme as an establishment shareholder, including the following:*

   a. *subscribing for shares in the LGFA with an aggregate issue price of up to $2.325 million;*

   b. *subscribing for uncalled capital in the LGFA with an aggregate unpaid amount of up to $2.325 million;*

   c. *entering into loan documentation with the LGFA;*

   d. *subscribing for borrower notes with the LGFA;*

   e. *committing to provide additional equity to the LGFA under certain circumstances that may arise in the future;*

   f. *entering into a joint and several guarantee with the LGFA and other Councils;*

   g. *anything which is not specifically described in paragraphs (a) to (f) above, but which is ancillary to or not materially different from those.*

6. *Recommend that Council delegates to the Chief Executive the authority to:*

   a. *agree the terms on which the Council participates in the LGFA scheme as an establishment shareholder, including which of the arrangements described above are entered into and the terms of those arrangements; and*

   b. *determine how the Council exercises its rights under the arrangements entered into in connection with the LGFA scheme, including, without limitation, the Council's rights as a shareholder in the LGFA.*

## 4. Background

At its meeting on 5th May 2011, SPC considered a detailed paper that examined the LGFA scheme and recommended that the Council agree in principal to participate in the LGFA as an establishment shareholder. It was noted that the Council would need to amend its Investment and Liability Management Policies in its LTCCP 2009-19 to participate as an establishment shareholder.

The Council meeting on 25th May 2011 agreed:

1. in principle to participate in the LGFA as an establishment shareholder, and
2. to commence the special consultative procedure on the proposal.

The consultation and engagement process began with public notification on 7th June. Submissions closed on 22nd July and oral submissions were heard by SPC on 4th August 2011.

### *4.1. Consultation and engagement*

We received a total of eight submissions as a result of the special consultative procedure. Copies of the written submissions were included with the meeting papers and agenda for the 4th August 2011 SPC meeting.

Below is a summary of submissions received.

| | |
|---|---|
| Supports the LGFA | 2 |
| Does not support the LGFA | 4 |
| Neutral on the LGFA | 2 |
| **Total** | **8** |

Greater Wellington Regional Council ("GWRC") has also undertaken a consultation on the same fundamental proposal to invest in the LGFA. A summary of GWRC's Statement of Proposal was included in the summary of the proposed Annual Plan 2011/12 and distributed to all households in the region.

GWRC received 86 submissions on the LGFA from a mixture of individuals and organisations. Of these, the overall nature of responses was as follows:

| | |
|---|---|
| Supports the LGFA | 48 |
| Does not support the LGFA | 23 |
| Neutral on the LGFA | 15 |
| **Total** | **86** |

It appears that GWRC's engagement process will have captured many of the potential submissions and may account for the relatively low number of submissions this Council has received.

#### *4.1.1. Submissions in support of the LGFA*

Two of the eight submissions supported the Council's proposed investment in the LGFA. The first submission is clearly supportive and reads as follows.

> "This appears to be a sensible step toward reducing costs and sharing risks with other local authorities"

The second submission voicing its support also sought to highlight its reservations about local authority spending decisions.

> "It makes sense to join together to gain the advantage of like-minded bodies having similar aims. But, more emphasis must be put on ratepayers having acceptable rights to object to expensive projects and associated costs e.g. Karori Sanctuary, and expenditure on stupid Rugby World Cup."

#### *4.1.2. Submissions against the LGFA*

Four of the eight submissions received opposed the Council's proposed investment in the LGFA.

The submissions in opposition raised the following issues:

1. Central government should fund local authorities at low or nil interest rates.
2. Fear of the guarantee.
3. Belief that the risks are not matched by the financial rewards.
4. The additional cost of bureaucracy associated with running the entity.

The three oral submissions provided some further written materials in support of their submissions at the SPC meeting on 4th August 2011.

#### 4.1.3. *Submissions neutral to the LGFA*

We received two written submissions that did not identify any opposition to (or support for) the proposed investment in the LGFA. We have interpreted these submissions as neutral.

#### 4.1.4. *Summary of consultation*

There were no issues raised by the consultation and engagement process to cause officers to change their views or recommendations in support of the LGFA scheme.

### 4.2. *Further developments*

The Council's officers' first report to SPC on the LGFA was considered at the meeting held on 5th May 2011. Since this time there have been further developments in the establishment of the LGFA.

The Local Government Borrowing Bill was reported to the Local Government and Environment Committee on 19th July 2011 and passed with minor amendments. It is expected to have cross-party support for its 2nd and 3rd readings and to be enacted as planned before the election in November this year.

Support for the LGFA by the local authority sector is strong.

- 49 local authorities have indicated an intention to participate in the LGFA as borrowers and/or guarantors.
- 35 local authorities have indicated their intentions to participate as shareholders.

Investment in the LGFA is expected to occur in October 2011 and again in June 2012. The June 2012 window is designed to allow some local authorities to consult on the LGFA via their LTCCP.

Most local authorities that are not part of the nine establishment shareholders[1] have opted for the minimum $100,000 capital subscription. Notable exceptions are Hastings District Council at $500,000 and Bay of Plenty Regional Council ("BOPRC") at $2.5 million.

Interestingly, BOPRC are not a net-borrower and have approximately $200 million cash invested. As such, the immediate savings benefits of the LGFA are not relevant to BOPRC but clearly, the promised return on the investment of 2% over cost of funds is considered sufficient for an investment of this quality BOPRC is keen to show its support for the sector.

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[1] Auckland Council, Christchurch City Council, Hamilton City Council, Tasman District Council, Tauranga City Council, Wellington City Council, Greater Wellington Regional Council, Western Bay of Plenty District Council & Whangarei District Council.

The LGFA will be established with paid-up capital of $25 million including $5 million from central government. At this stage, the required $25 million appears to be oversubscribed to $31 million (including NZ Government for $5 million). The Council's investment could be up to $2.325 million – although all indications are that the Council's actual investment could be less than $1.5 million if the final level of subscription reaches the levels indicated.

Measures to advance the LGFA scheme include the creation of an Establishment Board. Craig Stobo has been appointed Chairman of the Establishment Board and is expected to transition from this role to Chair the LGFA when it has been formed. A brief biography of Craig Stobo is attached as Appendix B.

The Establishment Board comprises Paul Anderson (General Manager Corporate Services, Christchurch City Council), Matthew Walker (Chief Financial Officer, Hamilton City Council) and Mark Butcher (Treasurer, Auckland Council) and is tasked with advancing its establishment in consultation with the other six establishment shareholders. Good progress is being made in forming the overall governance model for the LGFA and toward the appointment of officers and directors for the LGFA.

Following a competitive process, Russell McVeagh was engaged to provide legal counsel for the establishment of the LGFA. At a recent meeting of prospective establishment shareholders, it was agreed that the sector should engage a single law firm to act in the interests of the individual local authorities to the LGFA scheme. Simpson Grierson was appointed for this role and will peer review the work of Russell McVeagh, but from the viewpoint of the LGFA's shareholders, borrowers and guarantors. This is considered the most efficient way to protect all parties' interests in the establishment of the LGFA.

### *4.3. In order to progress the proposal*

The Council needs to formally approve the following, which can be delegated to the Chief Executive to undertake.

#### *4.3.1. Subscription for shares*

Subscribe up to $2.325 million for shares in the LGFA. This will provide part of the LGFA's establishment capital and is expected to pay an annual dividend. This investment may be reduced as more shareholders come on board. Indications are that there are currently commitments from to invest $31.0 million for $25 million of shares. Oversubscriptions will be accommodated by scaling meaning this Council's shareholding maybe reduced and funds returned as other Councils join the LGFA.

#### *4.3.2. Subscription to uncalled shares*

Subscribe to uncalled capital of $2.325 million. This amount will remain at the same level as the issued and paid-up capital.

#### *4.3.3. Borrowing from the LGFA*

Enter into borrowing documentation with the LGFA including the investment in borrower notes, or redeemable preference shares of the LGFA. All borrowing made through the LGFA requires a small proportion of funds to be used to reinvest back in the LGFA as capital. As the LGFA grows its asset base, its capital base also needs to increase to meet banking covenant requirements, or capital adequacy ratio, currently expected to be 1.6% of total LGFA assets.

#### *4.3.4. Entering into a cross guarantee*

Entering into a cross guarantee arrangement whereby the Council guarantees the debt obligations of the LGFA. This may mean that, in the case of a default, the Council may have to provide additional equity at a future date. This has been discussed with the Council previously, and while it is noted as a risk, it was agreed to be a small risk and outweighed by the benefits the LGFA can bring.

#### *4.3.5. Update the Investment and Liability Management Policies*

The Investment and Liability Management Policies contained in the Council's 2009-2019 LTCCP will need to be updated to reflect the above contemplated investment in and use of the LGFA. Revised policy wording is attached (Appendix 1) and was the subject of the special consultative process.

The changes are essentially noting that there will be an investment in the LGFA and the process is necessary to achieve this and borrowing from the LGFA. The policy wording has been approved by Simpson Grierson and Audit New Zealand.

## 5. Discussion

### *5.1. Written and oral submissions received*

The two neutral submissions and the two submissions in favour of the LGFA proposal don't require further discussion.

The key themes of the submissions against the Council's participation in the establishment of the LGFA were as follows.

1. Central Government should fund local authorities at low or nil interest rates.
2. Fear of the guarantee.
3. Belief that the risks are not matched by the financial rewards.
4. The additional cost of bureaucracy associated with running the entity.

**Item 1:** Central Government should fund local authorities at low or nil interest rates.

This sentiment is heard often but is simply not an option in relation to the LGFA.

The New Zealand government is a net borrower and it borrows on-market to fund its balance sheet. New Zealand's local authority sector is not funded by central government and even if it were the central government would need to pass on the cost of borrowing between $8 billion and $11 billion (forecast total sector debt between 2011 and 2019).

Even if central government could provide zero-cost (to the ratepayer) funding for local authorities, the idea that central government should favour some rate payers (those whose local authority borrows money) over others those whose councils don't have borrowings would be untenable.

Central government's support for the LGFA is significant. The government is investing $5 million (for a 20% equity share) in the establishment of the LGFA because it believes that the LGFA will provide tangible savings to ratepayers by lowering the average cost of borrowing for the sector.

Central government (via the Debt Management Office) is also providing a stand-by credit line for the LGFA's liquidity management needs on favourable commercial terms. A $1 billion facility would be extremely difficult to secure from the private sector for a start-up business of this nature on the same terms.

Central government support for the LGFA is both meaningful and tangible and a strong indication of its belief in the value of the LGFA scheme.

**Items 2 – 4:** The submissions raised similar issues to those noted by the Council at the time of approving the Statement of Proposal for consultation. In summary, no new issues were raised, what remains at issue is judgement as to the perceived risk/return trade-off.

The submission by Mr Gavin Kennedy was particularly well considered and well presented. His grasp of the important issues is sound but he does not raise any new issues that were not considered and discussed in the Statement of Proposal. Mr Kennedy's major objection to the LGFA is the guarantee that is fundamental to the LGFA scheme. He commented that he would otherwise consider the scheme as beneficial.

The issues raised by Mr Kennedy were considered carefully when drafting the Statement of Proposal. Council officers consider that the benefits of the LGFA outweigh the risks and re-iterate the key points that help to form this view.

The LGFA structure is designed to minimise its risk of default. By doing so, it is expected to achieve an extremely high credit rating (equal to central government). This is achieved by effectively sharing the potential burden of any possible future default by a single local authority across many local authorities. The mechanism to rectify any possible default by a local authority is to levy a special rate, and the stand-by debt facility to cover the period between default and collection of the special rate will be provided central government. In other words, there is an extremely strong mechanism (hence the credit rating) to protect all local authorities involved in the LGFA scheme.

When established the LGFA scheme is likely to be around for many years and the passive savings generated from this entity will continue year after year without any effort from participating local authorities.

The Council will receive a return of 2% over its costs of funds on its investment in the LGFA. Based on the forecast savings, the Council's investment is expected to have been recovered in full by 2018.

One lesson learnt from the global financial crisis was the importance of having access to a wide range of long term debt providers. The LGFA will provide additional long term funding options to local authorities and in the current economic climate this is considered extremely valuable to the sector and this Council.

## 6. Conclusion

The LGFA is a low risk investment by Council and is expected to generate long term cost-savings on Council's borrowings, and to increase Council's range of long term debt funding options. The LGFA scheme is an example of local authorities working together across the sector to deliver individual and collective benefits. Officers recommend that Council support the proposal for the establishment of the New Zealand Local Government Funding Agency Limited and for Council to invest in the LGFA as an establishment shareholder.

Contact Officer: Warwick Hayes, CCO Project Manager
Danny McComb, Treasury and CCO Manager
Peter Garty, Chief Financial Officer

## Supporting Information

**1) Strategic Fit / Strategic Outcome**

*The proposal supports the Council's overall vision of Wellington being an affordable city by lowering the cost of Council's borrowing.*

**2) LTCCP/Annual Plan reference and long term financial impact**

*Refer to the appropriate section of report.*

**3) Treaty of Waitangi considerations**

*This report raises no new treaty considerations.*

**4) Decision-Making**

*A special consultation process has been followed to help inform the decision-making related to this proposal.*

**5) Consultation**

*a)General Consultation*
*Section 56 Local Government Act 2002 requires the Council to undertake a special consultative procedure if it wishes to establish or become a shareholder in a CCO or a CCTO. Also, the changes to the Investment and Liability Management policies of the LTCCP were addressed by the special consultative process.*

*This process has been undertaken.*

*b) Consultation with Maori*
*See section 3, above.*

**6) Legal Implications**

*Council's lawyers have been consulted during the development of the Statement of Proposal.*

**7) Consistency with existing policy**

*This report proposes amendments to Council's Investment and Liability Management Policy contained in the LTCCP. Simpson Grierson has approved the wording of the proposed amendments.*

# Appendix A

The following amendments to the LTCCP are required to give effect to the proposal.

### *Investment Policy Wording*

Volume 2 page 103.

The following wording would be added to the current Investment Policy after the section entitled "Non income generating investments":

*"Local Government Funding Agency*

The Council may invest in shares and other financial instruments of the New Zealand Local Government Funding Agency Limited (LGFA), and may borrow to fund that investment.

The Council's objective in making any such investment will be to:

a. obtain a return on the investment; and

b. ensure that the LGFA has sufficient capital to become and remain viable, meaning that it continues as a source of debt funding for the Council.

Because of this dual objective, the Council may invest in LGFA shares in circumstances in which the return on that investment is potentially lower than the return it could achieve with alternative investments.

If required in connection with the investment, the Council may also subscribe for uncalled capital in the LGFA."

### *Liability Management Policy Wording*

Volume 2 page 105.

The following wording would be added to the current Liability Management Policy after the section entitled "CREDIT EXPOSURE":

"LOCAL GOVERNMENT FUNDING AGENCY

The Council may borrow from the New Zealand Local Government Funding Agency Limited (LGFA) and, in connection with that borrowing, may enter into the following related transactions to the extent it considers necessary or desirable:

a. contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;

b. provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself;

c. commit to contributing additional equity (or subordinated debt) to the LGFA if required;

d. subscribe for shares and uncalled capital in the LGFA; and

e. secure its borrowing from the LGFA, and the performance of other obligations to the LGFA or its creditors with a charge over the Council's rates and rates revenue."

# Appendix B

**Craig Stobo**, BA (Hons) First Class Economics

Craig Stobo was educated at Otago University and Wharton Business School. He has worked as a diplomat, economist, investment banker, and as CEO of BT Funds Management Limited. He has authored reports for the NZ Government on "The Taxation of Investment Income" and for the Taupo Group on "Creating Wealth for New Zealanders"; and chaired the Government's International Financial Services Development Group in 2010. Craig is a professional director. He is currently Chairman of AMP NZ Office Ltd, New Zealand's largest listed investor in commercial office property. Craig is Chairman of OCG Consulting Limited, an executive recruitment company. Craig is also an entrepreneur. He is Chairman and shareholder of Saturn Portfolio Management Limited, an independent investment advisory business; Chairman and shareholder of Elevation Capital Management Limited, the investment manager of the Multi Strategy Fund and Value Fund; and Chairman and shareholder of Appello Services Limited, a specialist unit registry provider. In addition Craig consults for domestic and global organisations assessing strategic industry opportunities and the execution of public and private sector business plans.