STRATEGY AND POLICY COMMITTEE
23 FEBRUARY 2012

REPORT 2
(1215/52/IM)

FINANCIAL STRATEGY

1. Purpose of Report

To agree the principles and funding limits in this report to develop the financial Strategy for Council as required under the 2010 amendment to the Local Government Act (LGA) 2002 to be included for deliberations for inclusion into the draft Long Term Plan.
The Financial Strategy equally applies to all Strategic Outcomes of Council as it provides the basis for funding and financial management of all activities and services the council provides.

2. Executive Summary

The Financial Strategy is a new requirement of the Local Government Act (LGA) to be included in the Long Term Plan. The Strategy has two main purposes:

- To facilitate prudent financial management
- To facilitate consultation on the proposals for expenditure and funding

The proposed Financial Strategy for Wellington City Council is based on a 5 key principles or considerations to guide the funding of proposals and expenditure:

- Fairness and equity
- Willingness to pay
- Value for money
- Risk management and assessment
- Good Financial governance and stewardship

The strategy also outlines the significant challenges faced by the council over the Long Term Planning period (10 years) and the impact those challenges will have on current services and service levels, rates, debt and investments.

The Council is required to include in the Financial Strategy quantified limits on rates, rates increases and borrowings. It is recommended that these limits be set as follows:
Limit on rates increases – The forecast rate of Council inflation
Limit on Rates – The dollar value associated with the rates increase limit
Limit on borrowings – 105% of Operating income

It is also recommended that the Council adopt:

A rates increase target – based on the forecast rate of household inflation and GDP growth (which are forecast at similar levels)
A Borrowings funded Capital investment limit

3. Recommendations

Officers recommend that the Strategy and Policy Committee:

1. *Receive the information.*

2. *Note the Financial Strategy is required to be included as part of the Long Term Plan and will form part of the statement of proposal (SOP) for the Long Term Plan and will be consulted on by way of the special consultative procedure for the statement of proposal.*

3. *Agree the guiding principles of the Financial Strategy (outlined in section 5.1) be included in the draft financial strategy to be considered by the Strategy and Policy Committee during the Long Term Plan deliberations.*

4. *Agree the funding limits and targets (outlined in section 5.3 be included in the draft financial strategy to be considered by the Strategy and Policy Committee during the Long Term Plan deliberations.*

5. *Note that the funding and expenditure for the Long Term Plan deliberations on 6 -8 March 2012 will be considered against the above principles targets and limits.*

4. Background

Council currently operates a financial strategy which is based in its policies (i.e. Revenue and Financing Policy, Investment and Liability management Policy, rates postponement policy, Development Contributions policy etc) and prioritisation tools (e.g. $20m new borrowings cap, limiting rates increases to an "acceptable" level).

Amendment to the LGA in October 2010 changed a number of the reporting requirements of Long Term Plans (LTP's) with a view to increasing transparency and accountability. The main change includes the requirement to "prepare" a consolidated financial strategy document within the Long Term Plan. While most elements of the financial strategy are included in the current financial policies, there are some additional requirements.

The key additions are the requirements to include a statement of the Councils quantified limits on rates, rates increases and borrowings. In addition, the Council is required to assess and clearly disclose the council's ability to maintain existing service levels and its ability to meet additional demand for services within the limits set.

The Financial Strategy is intended to demonstrate good governance and guide decision making when responding to current expenditure and funding challenges and issues.

These requirements have evolved from recent reviews of Local Government costs and funding including the Local Government rates inquiry (the 'Shand' report) in 2007, former Minister Hyde's 'Transparency, Accountability and Financial Management' (TAFM) review of Local Government and continuing pressure from ratepayers on local government costs and rates.

5. Discussion

The Financial Strategy aids in delivering a financially sustainable city in the long term, one in which its citizens can afford to live in the near future, but also in 50 and 100 years from now. This, together with the vision of *Wellington Towards 2040: Smart Capital* sets the strategic direction of our organisation and the city we serve and will require us to look at how we will adapt to deliver on all of our strategic goals.

The Financial Strategy focuses the organisation on the financial impacts of its decisions. With the use of tools within the strategy, such as parameters and limits within which we want to operate, it will help guide the decisions we need to make to ensure the long term financial sustainability and affordability of the city for its residents. This may mean prioritising new investment, looking at the services we deliver and how we are delivering them and require strong leadership to ensure all of our strategic goals are being met.

5.1 Guiding Principles

The following Principles form the basis which guides the councils funding of expenditure. These principles are already effectively in operation and embedded in our existing Financial and funding policies such as the *Revenue and Financing Policy, Investment and Liabilities Management policies, Rates Remission policy, Rates Postponement policy, Development Contributions policy* and the *policy on partnerships with the private sector*. The Financial Strategy clarifies the meaning of these principles and how they should be applied in decision making and policy:

5.1.1 Fairness and equity

Fairness and equity includes a number of factors that are already included in council policies and considerations that are required by the *LGA*, and Local Government Rating Act. These include:

- ability to pay (affordability)

- o Intergenerational equity (contribution to the cost of a service or an investment, by those who benefit from that service or investment over the period of when the benefits occur)
- o Distribution of the benefits (of an activity)– over identifiable parts of the community, the whole community or individuals (users)
- o ‘Exacerbater’ pays and ‘polluter’ pays principles where those creating a need for a service should pay for the cost of providing it.
- o Market neutrality – the impact of councils funding mechanisms on the commercial market should be neutral where possible.

5.1.2 Willingness to pay

Ratepayer concerns often reflect unwillingness rather than inability to pay – based on

- o dissatisfaction with perceived value for money from rates
- o dissatisfaction with council decision making/consultation
- o real or perceived inadequacy of benefit from rates
- o private versus public good issues (ratepayers perceive that they are paying for services that largely benefit others, for example)

5.1.3 Value for money

Value for money has three main elements.

- o The first is considering the degree the outputs contribute to community outcomes – The value.
- o The second is that all expenditure is ‘efficient’ or the relative outcome contribution per dollar of cost.
- o The third element is ensuring the total cost is reasonable. This analysis includes the cost of financing an initiative, market analysis, an assessment of risks, and ensuring market neutrality where appropriate.

5.1.4 Risk management and assessment

Risk management is important when managing public services and assets and includes consideration of insurance, self insurance reserves and any other provisions and/or reserves (Weather-tight homes provision for example)

Risk assessments consider the likelihood and consequence of risks associated with an expenditure proposal. Following a risk assessment consideration needs to be given to risk mitigation.

5.1.5 Good Financial governance and stewardship

Good Stewardship of Council’s assets and finances requires Council to ensure that its actions now do not compromise the ability of future Councils to fund their needs. Under this principle:

- o assets are not rundown for future generations to pay for
- o debt is not used to fund operating expenditure
- o the level of debt is regularly reviewed to ensure it is at a level that is both aligned with Council’s assets and rating base, and that it will not

unreasonably restrict a future Council's ability to fund new assets through debt

- o the operational expenditure implications of capital expenditure decisions are considered under this principle.

5.2 Structure and content

The structure of the Financial Strategy document is recommended to take the form outlined in Appendix 2.

5.3 Funding limits

Funding limits required to be set by council must be measureable. The limit can be expressed as a proportion, ratio, quantity, dollar amount or any other means as long as it can be measured.

The Council is now required by the LGA to publish a pre-election report explaining its performance against the Financial Strategy including the performance against the self-imposed funding limits

There are numerous possible options for the required funding limits to be set, ranging from arbitrary amounts (e.g. $10m), linking limits to an indexation (e.g Inflation), or linking to an absolute amount (e.g. Interest cost as a % of Operational expenditure) or some other measure. As discussed at the Council workshop on the 25th of October and 25th November 2011, a number of options have been considered for each limit and the ones that appear to best match to the guiding principles above are recommended.

Rates

The level of rates revenue required is determined by the level of operating expenditure budgeted for the year, net of any non-rates income, and excluding income for capital purposes. It is proposed that Council sets a limit and a target to be clear about it's intentions.
Limits should not be confused with targets. Targets are a level that is intended to be achieved. 'Limits' are a level that is <u>not intended</u> to be breached.

Limits on Rates

The council has a number of options by which to set its rates limits. For example:

- A flat rate e.g. a dollar amount of highest rates in the LTP
- A proportion of total expenditure, so as rates levels can increase proportionally to non-rates income

It is recommended that the limits on rates be stated in dollars of total rates income and are a direct function of adopted limits on rates increases below.

Limits on rates increases

The council has a number of options to set its rates increases limits. For example

- A ratio linked to the forecast rate of Council/Local Government inflation
- A ratio linked to the forecast rate of household/commercial sector inflation
- A flat rate increase in dollars annually
- A % increase above the prior year.

The following limits and targets on rates increases are recommended to be set -

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Rates Target	3.8%	2.9%	2.4%	2.4%	2.5%	2.5%	2.6%	2.6%	2.7%	2.6%
Rates Limit	3.8%	3.5%	3.2%	3.3%	3.4%	3.3%	3.4%	3.7%	3.9%	3.9%

The rates increase limits are based on the forecast rate of inflation the council's current operational expenditure is expected to incur.

The rates increase targets from 2014/15 is based on the ratepayers inflation (Consumer Price Index) and increase in Gross Domestic Product (GDP) which are forecast at similar levels.
As affordability of rates is relative to income, and to other expenditure items

The combination of these rates increase limits and targets are recommended based on affordability to ratepayers, commercial and residential, and respond to both measures of ability to pay and recent consultation on 'willingness to pay'. They are also intended to provide some flexibility between the target and the limit to enable council to either respond to unexpected events, and/or capitalise on unforeseen opportunities when they arise.

Essentially when the Council sets a limit based on inflation, and it intends to increase service levels and/or services, it will need to make efficiencies and/or make efficiencies.
If the council wishes to set a limit based on a factor which is forecast to be lower than the forecast rate of Council inflation, and it intends to maintain or increase service levels and/or services, it will need to make efficiencies and/or make changes to the range of services and/or service levels.

Limits on borrowings

Prudential borrowing limits

To ensure finances are managed carefully, the borrowing levels have been controlled in the past by adhering to self imposed '*prudential borrowing limit*s'. These are –

Ratio	**Limit**
Net borrowing as a percentage of equity	<10%
Net borrowing as a percentage of income	<150%
Net Interest as a percentage of income	<15%
Net Interest as a percentage of annual rates income	<20%
Liquidity (Term borrowing + committed loan facilities to 12 month peak net borrowing forecast)	>110%

These are a similar range of limits that other TLA's use. Generally Wellington City Council's limits are lower and reflect a strong credit quality. It is recommended that Council continue with these limits as they represent good practice. There is also a covenant with the Local Government Funding Agency (LGFA) that Council will not breech these limits. It is also recommended that council implement an '*operational borrowing target*' and '*Capital Investment Limit*' to complement these limits.

Operational borrowing target and Capital investment limit

An operational borrowing target is recommended as it is closely aligned with the council's independently assessed credit rating. This will help ensure that we are able to maintain a strong independent credit rating and in turn limit the impact of interest rate increases. A target is not a requirement of the LGA, however this suggested as a means to:

- Clarify the distinction between a limit not to be breached and a target to achieve
- Enhance the prudent financial management of Council

The first proposed *operational borrowing target* is that our net borrowings (net of cash and housing funding) will be maintained at a level no higher than 105% of our Operating Expenditure.

Secondly *Capital investment limit* is proposed which will impact on borrowings by limiting Capital Expenditure that is funded by borrowings (i.e. not funded by a 3rd party like NZTA or by Development contributions).

As there is an exhaustive list of investment opportunities for Council, one way of prioritising investment opportunities (planned or unplanned) is to set an overall new investment limit. This limit will be a decision largely based on the Council's comfort levels of new investment. In any event the investment limit would need to be within other prudential or operational borrowings limits and targets.

Living within this *Capital investment limit* will require the Council to prioritise its investment decisions. Although a limit on new capital expenditure funded by borrowings is similar to the current practice of having a "new borrowings" limit it would operate to limit new borrowings and capital expenditure.

It is proposed to set the amount of this limit at the Strategy and Policy Committee on 6-8 March 2012.

It is important to note that this limit does not include the level of asset replacements ('renewals') that occur annually when existing assets are at the end of their useful lives. These asset replacements (determined through Asset Management Planning) are forecast to cost around $110 million of capital expenditure annually over the next ten years.

5.4 Operating environment and financial challenges

5.4.1 The Global Economy

The Global debt crisis will continue to impact on the New Zealand economy and will impact directly on the Council's access to funding and funding costs. Council's recent support and subsequent investment in the NZ LGFA is a response to this.

5.4.2 Earthquake strengthening and other natural hazard resilience costs

The cost of ensuring the Council's infrastructure is resilient to the impact of natural disasters will also impact on the Council's cost base in the next ten years. Key costs related to earthquake strengthening include:

- Relocation of staff during strengthening work.
- Depreciation and interest costs associated with the Capital expenditure required to the Councils buildings.

The frequency of natural disasters is also a key driver for significant increases in the Council's insurance costs.

5.4.3 *Population and workforce growth*

The 2012 resident population of Wellington City is estimated to be 200,212. This is forecast to grow at a rate of 0.76% per annum on average to reach 216,476 in 2o22.

While this limited population growth will make continuing economic growth more difficult, the Council still must complete projects to ensure there is sufficient capacity in Wellington's network of infrastructure and social and recreational facilities to maintain levels of service to the growing population.

In the past the higher level of population growth has offset rates burden to existing ratepayers. The lower level of forecast growth will reduce the ability to offset any rates increase

5.4.4 *Ratepayer ability to pay*

Ratepayer ability to pay is a reflection of the ratepayer incomes (including Commercial profitability) and the level of cost of all expenditure items. Ratepayer affordability of rates is, for example, affected by increases in non-rates expenditure. Current economic conditions have restricted household and commercial incomes, as well as increasing some expenditure items e.g. fuel, which is putting pressure on budgets across the sectors which impacts rates affordability.
Although a recent ratepayer survey indicated that for most, rates approximating 2.2% of average household income was regarded as affordable, we recognise that household costs are rising and that, for some residents, rates and the fees we charge for the use of some of our facilities are becoming less affordable.

5.4.5 *Ratepayer willingness to pay*

Willingness to pay is influenced by ratepayer perceptions of the value they get for the rates they pay and their attitudes towards the Council's decision making and ratepayer consultation. It may also be influenced by *private good* versus *public good* issues (ratepayers being asked to contribute through rates to the cost of services that directly benefit others and not the ratepayers themselves).

60% of residents surveyed indicated that a rate at or below 3% of household income was a fair amount to pay for rates. 51% of ratepayers did not want an increase in the current level of their rates, preferring a reduction in services or service levels, with a further 30% only prepared to pay for inflationary increases.

As the councils rate of inflation is forecast to be greater than household inflation over the next ten years this will increase pressure on the council's ability to keep within the band that is considered 'fair' by most ratepayers.

5.4.6 *Increasing asset ownership and replacement costs*

The cost of building or buying new assets and replacing old assets (the capital cost of a new swimming pool or playground or new water pipes, for example) is only the beginning of the costs we have to meet if the community is to have continuing benefit from them.

Owning assets also has a significant impact on our annual operating costs in two ways -

- *Direct asset ownership costs* – depreciation, insurance and interest on assets account for up to 33% of our annual operating expenditure.

- *Indirect asset ownership costs* – these include the annual maintenance, staffing, utility and other costs necessary for the assets to be used.

These costs are locked in for the life of the asset and add a significant amount to the operational costs that need to be funded.

5.4.7 Weather-tight homes liability
The Council has a liability of around $61m which will require settlement over the next 7 years. This will require Council to borrow in the first instance to meet liabilities, with the borrowing subsequently being repaid through rate funding.

5.4.8 Shift of responsibility for services from central to local government
The continued devolution of responsibilities from central government to local government, a reduction in social investment, and increasing of standards by the government are also anticipated to have an impact on the Councils expenditure. Key impacts include:

- Costs of implementing new legislation
- Costs of meeting increased environmental standards
  - Discharge standards for water quality, wastewater and stormwater
  - National policy for managing increasing demand for water and compliance monitoring
  - Meeting proposed drinking water standards
  - Flood risk management
- Costs of community programmes where the government has reduced funding and shifted costs for community wellbeing to local government:
  - Community safety patrols
  - Civil defence
  - Creative sector funding cuts
- Risk of reduced capital funding for our roading network

5.5 Consultation an Engagement
The Financial strategy is required to be consulted on through the special consultative procedure as part of the Long Term Plan consultation.

5.6 Financial Considerations

The main impact of the Financial Strategy on the overall council budget is to demonstrate financial prudence and set limits on council's funding.

5.7 Climate Change Impacts and Considerations

N/A.

5.8 Long-Term Plan Considerations

The Financial Strategy Forms part of the Long Term Plan.

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Supporting Information

1) Strategic Fit / Strategic Outcome
The policy supports Council's overall vision of Creative Wellington – Innovation Capital. The Financial Strategy forms part of, and contributes to, the Long Term Plan by facilitating and demonstrating prudent financial management. Agreement to the strategy will contribute to Council meeting its obligations under the local Government Act (2002), see Appendix 2.

2) LTP/Annual Plan reference and long term financial impact
The Financial Strategy will be contained in the Councils Long Term Plan. The changes indicated here will facilitate prudent financial management and transparent decision making. There is not direct cost of the strategy, other than the self imposed funding limits and financial management measures discussed in the strategy.

3) Treaty of Waitangi considerations
N/A.

4) Decision-Making
The setting of the Financial Strategy is a significant decision.

5) Consultation

The Draft Long Term Plan, including the proposed financial strategy will be consulted through the special consultative procedure, in which the draft.

6) Legal Implications
There are legal implications of this report, namely the Financial Strategy must comply with the Local Government Act (2002) and this will be audited as part of the Long Term Plan audit. Council's lawyers have been consulted during the development of this report.

7) Consistency with existing policy
This report recommends certain measures which will inform policy making and council decision making.

APPENDIX 1

Appendix 1

Local Government Act 2002, section 101A Financial strategy

"(1) A local authority must, as part of its long-term plan, prepare and adopt a financial strategy for all of the consecutive financial years covered by the long-term plan.

"(2) The purpose of the financial strategy is to facilitate—

- "(a) prudent financial management by the local authority by providing a guide for the local authority to consider proposals for funding and expenditure against; and
- "(b) consultation on the local authority's proposals for funding and expenditure by making transparent the overall effects of those proposals on the local authority's services, rates, debt, and investments.

"(3) The financial strategy adopted under this section must—

- "(a) include a statement of the factors that are expected to have a significant impact on the local authority during the consecutive financial years covered by the strategy, including—
    - "(i) the expected changes in population and the use of land in the district or region, and the capital and operating costs of providing for those changes; and
    - "(ii) the expected capital expenditure on network infrastructure, flood protection, and flood control works that is required to maintain existing levels of service currently provided by the local authority; and
    - "(iii) other significant factors affecting the local authority's ability to maintain existing levels of service and to meet additional demands for services; and
- "(b) include a statement of the local authority's—
    - "(i) quantified limits on rates, rate increases, and borrowing; and
    - "(ii) assessment of its ability to provide and maintain existing levels of service and to meet additional demands for services within those limits; and
- "(c) specify the local authority's policy on the giving of securities for its borrowing; and
- "(d) specify the local authority's objectives for holding and managing financial investments and equity securities and its quantified targets for returns on those investments and equity securities."

APPENDIX 2

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