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**REPORT 2**  
*(1215/52/IM)*

## **2012-2022 DRAFT LONG-TERM PLAN: FINANCIAL STRATEGY**

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### **1. Purpose of Report**

To agree the Financial Strategy for Council as required under the 2010 amendment to the Local Government Act (LGA) 2002 to be included for into the draft Long Term Plan.

### **2. Recommendations**

Officers recommend that the Strategy and Policy committee

1. *Receive the information.*
2. *Recommend to Council for the Financial Strategy as attached in Appendix 1 to be included in the Draft Long Term Plan for consultation.*

Contact Officer: *Martin Read, Manager Financial Planning*

## 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.*

## Draft Financial Strategy

### 1.0 Introduction

The *Local Government Act 2002* requires the Council to adopt a financial strategy that covers every year of the long-term plan.

Our financial strategy is intended to guide the decisions we make now and in the future to ensure they contribute to our Community outcomes and the vision and strategic goals of *Wellington Towards 2040: Smart Capital* so Wellington can continue to grow as a creative, inclusive and vibrant city where people choose to live, work, study and play. 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

It also will help us consult with you about what we plan to do by making it clear how those plans will affect our services, rates, borrowings and investments.

### 2.0 Current Financial Situation and forecast

The council is in a strong financial position. We have assets of \$6.7bn and long term debts of \$350m. While a lot of our assets have a low market value (underground pipes, for example), we maintain a portfolio of investments with a current market value of \$363m, which is around the level of our net borrowings.

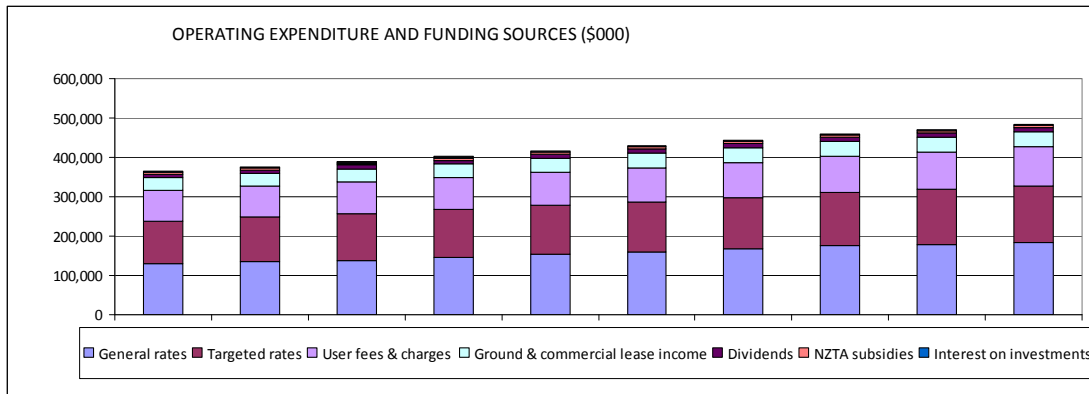
In the past, the proceeds from rates increases and borrowings increases as well as asset sales have allowed us to fund significant expenditure on new projects, assets and services. The next five years, at least, will be much more challenging and it is unlikely we will have funds to spend from these sources.

Over the last 10 years, our expenditure on meeting demand for new capital assets has increased our borrowings. This level of capital expenditure is unsustainable in the long term, especially if it is increasing faster than the growth in our ratepayer base and the growth in our ratepayers' disposable incomes.

#### Operational Expenditure

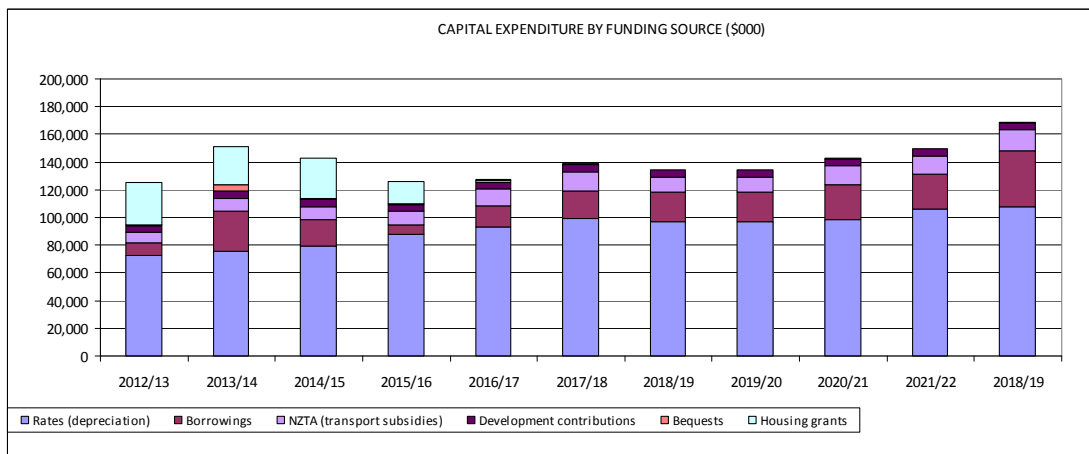
The Council's forecast Operational Expenditure is shown in the graph below. This level of expenditure shows the cost of continuing with councils programme to prioritise spend based on the *Wellington Towards 2040: Smart Capital*, and also taking into account a number of items, other than inflation, that are impacting on councils budget which are explained in section 4 below. The two most immediate and significant of these pressures is the operational impact of funding for weathertight homes and earthquake strengthening Councils assets to improve the cities resilience.

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## Capital Expenditure

The Council is forecasting a capital expenditure programme of \$1.4bn over the next ten years. The cost of this programme and the funding sources are shown in the graph below. This expenditure includes the cost of renewing existing assets that are coming to the end of their useful lives, as indicated by asset management plans. It also includes the cost of improving existing assets and investing in new assets.



## 3.0 Guiding principles

The following Principles form the basis which guides the councils funding of expenditure. These principles are already 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. The Financial Strategy clarifies the meaning of these principles and how they should be applied in decision making and policy:

### 3.1 Fairness and Equity

Fairness and equity relates primarily to ensuring that the funding of expenditure is fair, both across present ratepayers and to future ratepayers (intergenerational equity).

#### 3.1.1 Ability to pay

Ratepayers ability to pay rates means they have sufficient income to pay for rates expenditure without unreasonably compromising other expenditure

Determining affordability requires consideration of a number of factors including:

*Officer advice awaiting Council / Committee decision. Refer minutes for decisions.*

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The cost of rates relative to income and also relative to wealth (to the extent that wealth can be converted into income)

The potential for ratepayers to earn greater income as a result of council investment in infrastructure, services and economic development.

The impact of changes in other household costs, electricity, fuel and food for example.

Where a service is deemed to be essential or very important in terms of contributing to wellbeing, consideration is given to ensuring that people are not excluded from using a service because they cannot afford to pay.

## 3.1.2 Intergenerational equity

The principle of intergenerational equity is that ratepayers should not be required to pay the costs until they enjoy the associated benefits of an activity. This is reflected in matching capital repayment to asset lives, which then allows future Councils to more easily fund the replacement of those assets, as it is assumed that the debt principal incurred in the initial purchase has been repaid through the depreciation charge.

### 3.1.2.1 Balanced Budget

Council maintains the practice that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses. This ensures the current ratepayers are paying the right amount of costs for the service they receive and are neither subsidising future ratepayers or transferring current operating costs to future ratepayers.

### 3.1.2.2 Borrowings funding

Council's debt is used to fund the purchase of assets that Council has agreed, after consultation with the public, will add sufficient value to the city to more than compensate for the expenditure incurred on that asset. Council's financial policies require that new assets are to be funded by debt, with assets being replaced to be funded from depreciation. This is consistent with the intergenerational equity principle.

### 3.1.2.3 Depreciation funding

The depreciation funding principle is reflected in matching capital repayment to asset lives, which then allows future Councils to more easily fund the replacement of those assets, as it is assumed that the debt principal incurred in the initial purchase has been repaid through the depreciation charge.

### 3.1.2.4 Asset Management Planning

If depreciation funding is a means of ensuring today's ratepayers meet the cost of their 'consumption' of the asset, then Asset Management Planning and considering the useful lives of assets effectively plans for the period over which the consumption occurs.

This will be crucial over the next 30 years, particularly as key infrastructure assets near the end of their life cycles.

## 3.1.3 Distribution of benefits

Consideration is given to each activity of the distribution of the benefits (of the activity) over identifiable parts of the community, the whole community or individuals (users). This then informs the consideration of who should pay for the activity. The distribution of benefits is explained in detail in the Revenue and Financing policy.

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## 3.1.5 Development Contributions

The Development contributions policy provides the Council with a method to obtain aims to recover funding for additional infrastructure required for growth in the city.

## 3.1.6 'polluter' and 'exacerbater' pays

'Exacerbater' pays and 'polluter' pays principles can be explained as 'those whose actions or inactions give rise to a need to undertake a particular activity should meet part of the cost of that particular activity'. In other words, where those creating a need for a service should pay for the cost of providing it.

## 3.1.7 Market Neutrality

The impact of councils funding mechanisms on commercial markets should be neutral where possible, and where appropriate.

## 3.2 Willingness pay

Ratepayer concerns often reflect unwillingness rather than inability to pay.

This reflects relative satisfaction with perceived value for money from rates or with council decision making/consultation. Willingness to pay may reflect the real or perceived benefit from rates and may reflect private v public good issues (ratepayers may perceive that they are paying for services that largely benefit others, for example). The following are factors of willingness to pay:

### 3.2.1 limits on rates

The limits on rates is the amount of rates income forecast to be collected by Council based on the increase set by Local Government Cost Index (LGCI) annually. As an indication based on the 10 year forecast of the LGCI, this would equate to:

Rates vs proposed limit	2012/13 (\$000)	2013/14 (\$000)	2014/15 (\$000)	2015/16 (\$000)	2016/17 (\$000)	2017/18 (\$000)	2018/19 (\$000)	2019/20 (\$000)	2020/21 (\$000)	2021/22 (\$000)
Rates Limit	239,010	247,307	255,100	263,400	272,363	281,197	290,657	301,304	313,011	319,407

### 3.2.2 limits on rates increases <sup>1</sup>

We have set a limit and a target for rates increases to be clear about our intentions.

Limits should not be confused with targets. Targets are a level that is intended to be achieved. 'Limits' are a level that is not intended to be breached

Limits on rates increases are:-

The limits on rates increases are set as an indexation based on the Local Government Cost Index (LGCI)<sup>2</sup>. The base year is the 2011/12 rates income<sup>3</sup>.

#### Target on Rates Increases:

The target for 2012/13 equates to the increase of the local Government Cost index (LGCI). The 2013/14 target is the average of the Local Government Cost Index and the Consumer

<sup>1</sup> Please note the limits will be the amount published as a forecast for the year prior to the striking of the rates.

<sup>2</sup> Local Government Cost Index as Published by Business and Economic Research Limited (BERL) for the Society of Local Government Managers (SOLGM) and Local Government NZ.

<sup>3</sup> It will be set annually with the updated LGCI forecast for the subsequent year, and will be expressed as the impact on the average rates paid so is considered 'net' of forecast growth in the ratepayer base.

*Officer advice awaiting Council / Committee decision. Refer minutes for decisions.*

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Price index<sup>4</sup>. From 2014/15 to 2021/22 the target is based on the Consumer Price index (CPI)<sup>5</sup>

It will be set annually with the updated forecast of the relevant indexation for the subsequent year, and will be net of growth in the ratepayer base.

An indication based on the current year on year forecasts for these increases are:

	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. These limits are not intended to be breached.

The rates increase limits only apply to average rates increases, and not rates increases for individual properties, as these depend on a number of factors outside the council's control, like changes in property valuations or remission status changes, for example.

### 3.3 Value for money

Value for money considers:

- The contribution of a proposal to the community
- The degree of outcome contribution per dollar of cost
- That the total cost is reasonable

It also considers the means chosen to fund the expenditure is the most cost effective. This analysis includes the cost of financing an initiative, market maturity and demand analysis, an assessment of risks, and ensuring market neutrality where appropriate.

### 3.4 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. In a financial context this can include insurance and provisions.

### 3.5 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:

- assets are not rundown for future generations to pay for;
- debt is not used to fund operating expenditure other than specific exceptional circumstances;
- 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 restrict a future Council's ability to fund new assets through debt

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<sup>4</sup> Average of LGCI and CPI, as published by Business and Economic Research Limited (BERL) for SOLGM and Local Government NZ

<sup>5</sup> As published by Business and Economic Research Limited (BERL) for SOLGM and Local Government NZ

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- the operational expenditure implications of capital expenditure decisions are considered

## 3.5.1. Borrowing limits

We control our borrowing levels by self imposed ‘*prudential borrowing limits*’. These limits are consistent with the liabilities management policy.

There are five measures which are set to control both the cost of borrowings and level of borrowings.

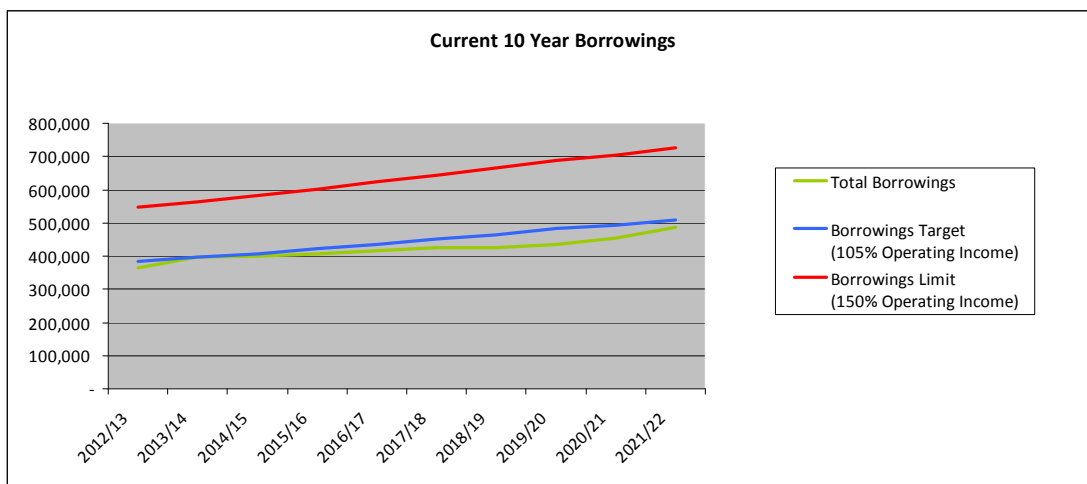
Ratio	Limit
Net borrowing as a percentage of equity	<10%
Net borrowing as a percentage of income	<150%
Net Interest as a percentage of income	<15%
Net Interest as a percentage of annual rates income	<20%
Liquidity (Term borrowing + committed loan facilities to 12 month peak net borrowing forecast)	>110%

### Operational borrowing target

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

This is closely aligned with the council’s independently assessed credit rating. These will help ensure that we are able to maintain a strong externally assessed credit rating

As an indication the *operational borrowing limit* is shown as a forecast below for the next 10 years.



### Capital Investment Limit (funded by borrowings)

A ‘*Borrowings funded Capital Investment Limit*’ will limit the cost of new capital expenditure funded by the Council to **\$20m** a year for the next 10 years.

Living within this *Capital investment limit* will require the Council to prioritise its investment decisions.

*Officer advice awaiting Council / Committee decision. Refer minutes for decisions.*



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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.

[Needs agreement]

## 3.5.2 Security for borrowings

[Our borrowings are secured by a Debenture Trust Deed which creates a charge over our rates revenue (something akin to a mortgage security). This security relates to any borrowing and to the performance of any obligation we have that relates to the borrowing.]

## 3.5.3 Investment Management

Council holds and manages a range of investments. These are broadly:

- Cash and Cash Equivalents;
- Income generating debt instruments;
- Income generating equity investments;
- Income generating property investments; and
- Non-income generating investments.

### 3.5.3.1 Objectives

The primary objective of holding and managing investments 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.

### 3.5.3.2 Targets for returns

For those investments held for other than primarily strategic reasons the target return for investment is to achieve an average return on investment over time greater than Council's long term cost of funds. This is currently forecast to be 6.75% per annum.

The Council's Investment Policy sets out in greater detail the mix of investments, strategies and other policy considerations.

## 4.0 Operating environment and financial challenges

We are forecasting a challenging operating environment over the next ten years. The following are the key factors expected to have a significant impact on our operating environment and on the management of our finances over the next decade –

- The global debt crisis
- Earthquake strengthening costs and city resilience
- Population and workforce growth, and changes in land use
- Rates affordability and willingness to pay
- Increasing asset ownership and replacement costs
- Weathertight homes liability
- Central government budget reductions, shift of responsibility for services from central to local government and increased regulation.

*Officer advice awaiting Council / Committee decision. Refer minutes for decisions.*

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## 4.1 The global debt crisis

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.

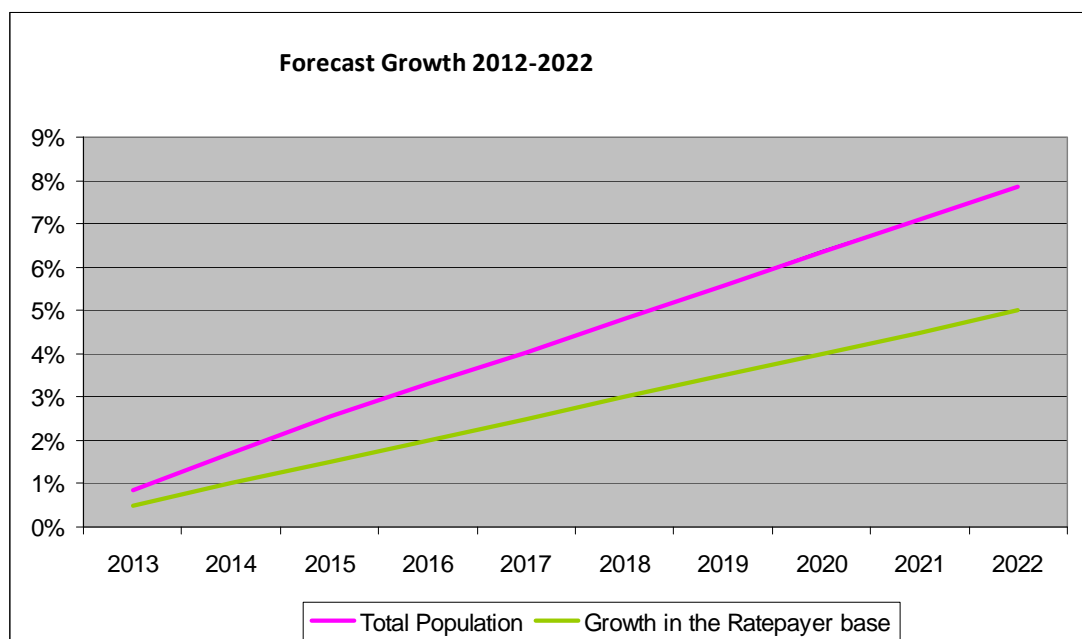
## 4.2 Earthquake strengthening and city resilience costs

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. This includes the cost of strengthening Council owned buildings and improving network infrastructure with more resilient materials, and including automatic shut off valves for water reservoirs for example.

## 4.3 Population and workforce growth, and changes in land use

The 2012 resident population of Wellington City is estimated to be 200,212<sup>6</sup>. This is forecast to grow at a rate of 0.76% per annum<sup>7</sup> on average to reach 216,476 in 2022.

This limited population growth will make continuing economic growth more difficult. However, the Council must deliver 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 and related changes in land use. The Northern Growth Management Plan provides for the limited amount of change in land use that is expected to occur over the next 10 years.



## 4.4 Rates affordability

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 2.3% of average household income was regarded as affordable, we recognise that household costs are

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rising and that, for some residents, rates and the fees we charge for the use of some of our facilities are becoming less affordable.

The median annual household income in Wellington is \$76,804<sup>8</sup>. This is 15% higher than the national median at \$64,272. Our aim is to keep rates at a level that does not exceed 3% of average household income. This will ensure that, through rates, our costs do not become a larger part of household expenditure.

Affordability for Wellington’s commercial sector is a factor of the economy and profitability of the businesses. The sector is made up of around 24,915 businesses and it employs around 152,930 people. The sector generates around \$46.5 billion a year in total income, which is about 9% of total business income in New Zealand.

Its annual net profit of \$6.138 billion represents 12% of the net profit of the whole New Zealand commercial sector even though Wellington has only 4.5% of the national population.<sup>9</sup> Our aim is to keep rates at an affordable level when compared to profitability of the sector.

## 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. Research shows that there is a reduction in the willingness to pay more for Council services.

## 4.5 Increasing asset ownership and replacement costs

A significant portion of Council’s operating costs are fixed because they relate to the cost of owning assets (eg depreciation, interest and maintenance costs). 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.

Another factor that is increasingly impacting the operating expenditure is the timing of the replacement of assets. These costs relate to the timing of periods of development in the city and the useful lives of those assets.

### 4.5.1 Capital Expenditure on network infrastructure

The proportion of assets that are at the end of their useful life that need to be replaced is increasing over the next ten years. The table below highlights the forecast expenditure on network infrastructure.

Activity Area	Activity Grouping	2012/13 (\$000)	2013/14 (\$000)	2014/15 (\$000)	2015/16 (\$000)	2016/17 (\$000)	2017/18 (\$000)	2018/19 (\$000)	2019/20 (\$000)	2020/21 (\$000)	2021/22 (\$000)
Environment	Open spaces and conservation	2,650	1,794	2,103	1,827	2,026	2,641	2,627	2,311	2,829	7,290
	Stormwater management	3,443	4,012	4,612	6,560	6,966	7,535	8,140	9,315	10,946	14,418
	Waste reduction, recycling and energy conservation	1,052	9,270	7,298	1,215	1,793	822	1,743	793	970	3,882
	Wastewater and storm water	7,930	8,093	9,098	10,480	12,167	15,477	17,038	18,555	17,488	19,116
	Water	14,164	22,980	17,056	16,749	19,577	22,604	24,957	24,696	25,991	27,876
Transport	Transport	27,371	28,524	29,470	34,540	39,237	42,068	42,309	48,308	53,625	59,170

<sup>8</sup> 2006 Census adjusted for CPI.

<sup>9</sup> Statistics New Zealand

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## 4.6 Weather-tight homes liability

The Council has provided for a significant liability of around \$61m to settle claims associated with weather-tight homes issues. The funding of this liability will take place progressively over the next 8 years. This will require Council to increase borrowings in the first instance to meet these costs, with the associated borrowing subsequently being repaid through rate funding.

## 4.7 Central government budget reductions, shift of responsibility for services from central to local government and increased regulation.

Central Government budget reductions, the continued moving of responsibilities from to local government and increasing of standards by the government are also anticipated to have an impact on the Councils expenditure. Key impacts include<sup>10</sup>:

- Costs of implementing new legislation
- Costs of meeting increased environmental standards (one in 50 year flood protection, for example)
- Costs of community programmes where the government has reduced funding and shifted costs for community wellbeing to local government (building regulations standards earthquake strengthening and reduced funding to creative sector, for example).
- Risk of reduced capital funding for our roading network.

## 5.0 Impact of Our Strategy on Services

The financial strategy will enable the transition to the strategic outcomes of *Wellington towards 2040: Smart Capital*, rather than a limit change in the city, by guiding the financial impact of the Council's decisions. Decisions requiring significant investment will require prioritisation of services and levels of service in order to maintain the sustainable and affordable levels of rates and borrowings outlined within the strategy.

No significant changes in our services or levels of service are proposed for 2012/13. Where prioritisation decisions require some lower priority services and/or service levels to be reduced, the Council will consult with the public through our Annual Plan process.

Over the next 10 years Council faces significant challenges around funding prioritisation because the costs of earthquake strengthening, leaky homes and insurance specifically are rising at a rate higher than average Council inflation. Council feels that in order to ensure we also deliver on our strategic outcomes and continue to invest in Wellington's future some focused effort needs to take place.

We are proposing to set a working party with Councillors and staff to develop options that will deliver financial sustainability into the future for Wellington City Council. These options will consider the future role of local government and the following key issues:

- Current service levels and alternatives to reduce, re-phase or discontinue
- Current assets, their strategic alignment and options for reduction or reconfiguration

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<sup>10</sup> Local Government Rates Inquiry – August 2007

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- Alternative governance and management options for services (these include regionalisation initiatives such as shared services, configuration of Council Controlled Organisations and partnership opportunities)
- Future revenue options including looking at the level of user charges received to fund each activity.
- Strategies for debt reduction
- Developing a balanced investment approach

In addition to this working party, Council will be focused on ensuring we minimise the effects of prioritization decisions on our services. Strategies we will use include:

- Every year Council will seek efficiencies and cost reductions
- Ongoing review and alignment of our future projects to our new Wellington 2040 strategic direction.
- Focus on growing Wellington's economy through our economic development strategy and continue to foster a creative educated workforce.
- Optimally managing income from our investments and looking for ways to increase our revenue from other sources.
- Smart asset management and use