Appendix 1 – Statement of Proposal

STATEMENT OF PROPOSAL TO AMEND WELLINGTON CITY COUNCIL'S LONG-TERM COUNCIL COMMUNITY PLAN 2009-19 TO ENABLE COUNCIL TO PARTIPATE AS A SHAREHOLDER IN THE ESTABLISHMENT OF THE NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY LIMITED

Introduction

Wellington City Council ("**Council**") proposes to participate as an establishment shareholder in the New Zealand Local Government Funding Agency Limited ("**LGFA**").

The LGFA will be a Council Controlled Trading Organisation owned by local authorities and the New Zealand Government, who will have a 20% shareholding. The aim of the LGFA will be to consolidate a large proportion of the borrowings of the local authority sector to provide lower cost funding, and another debt funding alternative, for local authorities.

The Council wants to hear the views of the community before making a final decision on the proposal.

Details of the Proposal

Council proposes to participate in the LGFA as an establishment shareholder. To do so will require amendments to Council's Investment and Liability Management Policy contained in the 2009-19 LTCCP. The proposed amendments are attached in Appendix A of this Statement of Proposal.

Consultation on the proposal is required due to:

- Section 56 of the Local Government Act 2002 (LGA 2002) which provides that a proposal to establish a Council Controlled Organisation (CCO) must be adopted by special consultative procedure before a local authority may establish or become a shareholder in the CCO.
- Section 102(6) of the LGA 2002 requires any amendment to a Liability Management policy or Investment Policy to be by way of an amendment to the Long Term Council Community Plan.

Reasons for the Proposal

Given the size of Council's borrowing requirement, greater than $300m, it is important that Council seek to diversify its funding options, achieve a lower borrowing cost and reduce refinancing risk so that is not reliant on a small group of lenders. Central government has also recognised these risks and has provided significant support for the development of the LGFA.

LGFA

Council has agreed in principle to participate in the LGFA as an establishment shareholder because it believes that through the LGFA Council will be able to borrow funds at significantly lower interest margins and have access to greater long term funding options, and that these benefits outweigh any costs associated with the LGFA. A discussion on the benefits and costs is included within the Information Memorandum.

Council has agreed in principle that its participation in the LGFA be as an establishment shareholder for the following reasons:

- A return on the investment will be paid by the LGFA which will cover the cost of capital for the investment;
- A certain amount of invested capital (expected to be around $20 million) will be required from local authorities for the LGFA scheme to be viable. As an establishment shareholder Council will be contributing up to $2.325m. Council's investment as an establishment shareholder increases the probability that the LGFA scheme will be viable, and therefore Council will be able to gain the benefits from participating in the scheme. Council understands that at least eight other significant councils are currently undertaking consultation processes to participate as establishment shareholders in the LGFA; and
- Council will continue to play an important role in developing the constitution and controls necessary to ensure that the LGFA is structured robustly and well placed to achieve its objectives.

The proposal will lead to a material reduction in Council's cost of borrowing of between $370k and $740k per annum by 2018. By this time the aggregate savings to Council would total between $1.386m and $2.772m. The annual savings peak in 2018 and continue at the same level each year thereafter. These savings are only available if the LGFA is established and reaches a critical mass with the support of the major local authorities.

In addition to the lower cost of funding, Council believes that the increase in long term funding options that the LGFA provides is a significant benefit to Council. One of the important lessons of the global financial crisis was the importance of long-term access to funding and liquidity. The LGFA increases the options available to Council for access to secure long term funding.

Reasonably Practicable Options

The reasonably practicable options are as follows:

Option 1. Participate as an establishment shareholder

Option 2. Participate as a non-establishment shareholder
Option 3. Participate as a guarantor
Option 4. Participate as a borrower
Option 5. Do not participate in the LGFA

Option 1. Participate as an establishment shareholder

If the LGFA reaches its potential then it will provide meaningful and long term benefits to Council through lower borrowing costs and reduced liquidity risk through an increase in available funding options.

In order for the LGFA to reach its potential it requires support from the sector and in particular establishment capital and the continued support of its establishment shareholders to enable it to reach sufficient scale to deliver the pricing benefits.

The initial capital investment is expected to be cost-neutral, at worst, as the LGFA will pay a return to shareholders based on their investment at cost of funds plus a margin of 2%, which is above the Council's cost of borrowing.

As an establishment shareholder, Council will continue to play an important role in developing the constitutional framework, policies and controls necessary to ensure the LGFA is robust, has strong governance and monitoring, and is well placed to achieve its potential.

Importantly, with Council participation as an establishment shareholder, together with the other large councils, the chances of the LGFA scheme being established and viable are substantially increased and the benefits from the LGFA realised.

This option carries an equity risk should the LGFA not achieve sufficient scale to cover its fixed operating costs. However, offshore precedents indicate this is a low risk and with the level of support already shown by the local authority sector and central government, we consider this a low risk to Council.

Council recommends that it participate as an establishment shareholder in the LGFA.

Option 2. Participate as a non-establishment shareholder

As a non-establishment shareholder, Council will not have a role in the formation of the LGFA's constitutional framework, policies and controls.

Future control and influence of the LGFA will be managed by individual shareholdings and voting rights. Non-establishment shareholders will have significantly less voting control than establishment shareholders. Council believes it is better placed to manage its contingent liability by holding a meaningful shareholding and voting right in the LGFA.

Importantly, if Council does not maintain its commitment to LGFA as an establishment shareholder and the rest of the establishment shareholders take the same approach, the LGFA would be at risk of not raising sufficient capital to make it viable. Without this critical mass the LGFA may not achieve its target credit rating needed to deliver the pricing benefits.

Council does not recommend participating as a non-establishment shareholder in the LGFA.

Option 3: Participate as a guarantor

Council is able to participate in the LGFA as simply a guarantor and borrower. Under this option Council would still be able to access most of the savings outlined in option 1 and also the benefits of increased liquidity resulting from an increase in the funding options the LGFA provides. This option also carries none of the equity risks associated with option 1. It is noted that the cost of the equity investment is expected to be neutral as a result of the return paid on shareholders capital. However, without being a shareholder with the associated voting rights and involvement in the establishment of the LGFA, Council would have no control or visibility over the management of the LGFA. Given that Council would still be subject to the same risk exposure through the guarantee and security arrangements it is beneficial to have visibility and control over this exposure. Participating as simply a guarantor Council would have no control and limited visibility over this contingent exposure.

Council's role in developing the LGFA scheme to date and its place on the steering group has helped to give the scheme the collective support and momentum required to reach this point. The LGFA, if it is to succeed, requires sufficient capital to get established and give it the opportunity to reach its potential and deliver on the expected benefits.

Council does not recommend participating as a guarantor only in the LGFA.

Option 4. Participate as a borrower

It is possible under the LGFA scheme to participate only as a borrower. This option, however, is subject to a cap of $20m of aggregate borrowings through the LGFA. The LGFA will operate a pricing matrix which provides pricing benefits to shareholder borrowers and guarantor borrowers. Consequently the pricing benefit from the LGFA for those councils that are only borrowers will be less.

From Council's perspective, access to another funding option capped at $20m does not materially reduce our liquidity risk when compared to Council's total borrowing programme which exceeds $300m.

Council's role in developing the LGFA scheme to date and its place on the steering group has helped to give the scheme the collective support and momentum required to reach this point. The LGFA, if it is to succeed, requires sufficient capital to get established and give it the opportunity to reach its potential and deliver on the expected benefits.

This option has none of the equity and guarantee risks associated with options 1 and 2 however these risks are expected to be very low anyway.

Council does not recommend participating as a borrower only in the LGFA.

Option 5. Do not participate in the LGFA

This is effectively the status quo option and is inferior to option 3. If the LGFA is established, even if Council does not participate as a shareholder or guarantor, the benefits of borrowing from an established LGFA are still available to Council and the LGFA would be able to be used as an additional source of funding (albeit relatively small) when its pricing was better than the next best funding alternative.

Council does not recommend not participating in the LGFA.

The table below provides a comparison of the main structural differences between the options.

Options Summary	**Option 1**	**Option 2**	**Option 3**	**Option 4**
	Establishment Shareholder + Guarantor + Borrower	-- Shareholder Guarantor + Borrower	-- -- Guarantor + Borrower	-- -- -- Borrower
Establish the LGFA and Board	yes	--	--	--
Subscribe for equity	yes	yes	--	--
Purchase one share	yes	yes	undecided	--
Subscribe for uncalled capital	yes	yes	--	--
Commit to further equity	yes	yes	yes	--
Commit to minimum borrowings	yes	undecided	--	--
Enter into the guarantee	yes	yes	yes	--
Borrow from the LGFA	yes	yes	yes	max $20m
Subscribe for borrower notes	yes	yes	yes	yes
Provide a rates charge	yes	yes	yes	yes

How this Proposal will Amend the LTCCP

In order to proceed with this proposal, Council is required to amend the Council LTCCP 2009-19 by amending the Investment and Liability Management Policy to allow for Council participation in the LGFA as an establishment shareholder. The proposed amendments to these policies are attached as Appendix A of this Statement of Proposal, and discussed briefly below:

Changes to the Investment Policy

It is proposed that the investment activity component of the Investment Policy be amended to make it clear that the Council's investment activity includes participating as a shareholder in the LGFA.

It is acknowledged that there will be a return on this investment that may be less than might be achieved by alternative equity investments.

There are no consequential material changes to the LTCCP from the proposed amendments to the Investment Policy.

Changes to the Liability Management Policy

It is proposed that the liability management component of the Liability Management Policy be amended to make it clear that the Council may participate in the LGFA scheme, including borrowing from the LGFA and entering into the transactions relating to that borrowing.

There are no consequential material changes to the LTCCP from the proposed amendments to the Liability Management Policy.

Auditor's Report[3]

The proposed changes to the Council's LTCCP have been reviewed by Audit New Zealand and they have raised no issues with the proposal. A copy of the Auditors report in relation to the proposed changes is attached as Appendix C.

Opportunity to Make Submissions and Have Your Say

Council is requesting public feedback on this proposal prior to making a final decision in August 2011. To make a submission, read the Summary of Information and/or the Statement of Proposal and complete the submission form online in the Have Your Say / Public Input section of www.wellington.govt.nz. The deadline for feedback is 5:00pm on 22 July 2011.

Alternatively, the Statement of Proposal, Summary of Information and submission forms are available:

- at the Council Service Centre at 101 Wakefield Street
- from Council Libraries
- at the Michael Fowler Centre
- by post and email – phone the Council on (04) 499 4444 or email lgfa@wcc.govt.nz

---

[3] The wording of this section anticipates the Audit New Zealand's report which is not available at the time of writing but is expected prior to the consultation process.

Appendix A of Statement of Proposal

LTCCP Amendments

The following amendments are proposed to the LTCCP.

Proposed 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."

Proposed 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 of Statement of Proposal

Information Memorandum

The New Zealand Local Government Funding Agency Ltd
("LGFA")

1. SUMMARY

Following the February 2009 Jobs Summit, the idea of a local government debt vehicle gained a lot of momentum. From the 2009-19 LTCCP's it is estimated that local authority debt would increase to around $11 billion by 2019. This scale of borrowings coupled with the global financial crisis' effect on liquidity and borrowing margins added impetus to the idea of a local government debt vehicle.

In July 2009 and in response to a selection process, Cameron Partners Limited ("**CPL**") and Asia-Pacific Risk Management Ltd ("**APRM**") were engaged by Local Government New Zealand and Treasury to provide scoping studies for a local government debt vehicle. A steering group which includes Wellington City Council ("**Council**") was set-up to help advance the proposal. The steering group is chaired by Local Government New Zealand and includes representatives from Auckland, Hamilton, Wellington and Christchurch councils, Treasury, The Reserve Bank and the Minister of Finance's office.

The scoping study was completed in December 2009 and its findings have resulted in further development of the local government debt vehicle concept to the point that commitments are now being sought to invest in the establishment of the LGFA from the following local authorities (collectively referred to as the establishment shareholders):

1. Auckland Council (representing the former Auckland City, Waitakere City, North Shore City, Manukau City, Rodney District, Franklin District, Papakura District, & Auckland Regional Councils)
2. Christchurch City Council
3. Hamilton City Council
4. Tasman District Council
5. Tauranga City Council
6. Wellington City Council
7. Greater Wellington Regional Council
8. Western Bay of Plenty District Council
9. Whangarei District Council

The establishment shareholders represent 62% of the total local authority sector borrowings[4]. This group was formed to give focus and commitment to the establishment of the LGFA, rather than try to organise over 70 local authorities.

The aim of the LGFA is to consolidate a large proportion of the borrowings of the local authority sector to provide another long term debt funding alternative, and achieve significant interest cost savings to participating local authorities. To be successful, the LGFA requires a number of local authorities to provide capital for the LGFA's establishment and to enter into guarantees in support of the obligations of the LGFA and other local authorities, and a commitment to utilise the LGFA for future funding requirements.

Effectively, the LGFA will issue debt on behalf of all participating local authorities. If the co-operation and support from councils is sufficient, the LGFA is expected to achieve the credit rating, scale, and specialisation to yield significant savings for the participating local authorities.

Currently, most local authorities including Council are restricted by legislation or scale from accessing overseas debt markets or local retail debt markets. The LGFA will have the power to borrow offshore and will have the necessary scale to issue debt in the domestic retail market. 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.

If Council agrees to be an establishment shareholder then there will be a requirement to invest called capital of up to $2.325m plus there will be an equivalent amount of uncalled capital. Council would need to borrow these funds to invest in the LGFA, and the cost of the borrowings would be met from a return to shareholders which will be set at a level marginally above Council's cost of borrowing. The investment would be cost-neutral to Council.

The financial benefits to Council from the LGFA are expected to result from lower overall borrowing costs. Initially these benefits are modest and begin relatively slowly due to Council's current debt maturity profile, but over time the savings are expected to grow to between $370k per annum and $740k per annum by 2018. At this point, the aggregate savings will total between $1.386m and $2.772m. Once established, the savings will accrue every year commensurate to Council's borrowings and, as such, represent a growing and very passive form of significant cost saving to Council.

Legislation to facilitate the LGFA is advanced with a dedicated Bill (Local Government Borrowing Bill) having been tabled in Parliament, awaiting its first reading. The Bill addresses key areas of legislation that will allow the LGFA to achieve the expected credit rating, scale, and specialisation to yield savings for the participating local authorities. The Local Government Borrowing Bill is expected to be passed by September 2011.

The LGFA will be a limited liability company supported by a joint and several guarantee. This structure effectively dilutes the limited liability protections afforded by a limited liability company, but is fundamental to achieving its

[4] Based on councils' LTCCPs.

required credit rating. As such, the LGFA (despite being a limited liability company) is best considered as being similar to a partnership.

The ‘partners’ in the LGFA will be all those local authorities that borrow more than $20m from the LGFA and in doing-so are effectively a guarantor group. The guarantor group underwrites the trading activities and ongoing viability of the LGFA by way of a joint and several guarantee of the LGFA. The guarantee exposure will be spread across all guarantors on a pro-rata basis in direct relationship to their rate-payer base.

Whilst the guarantee appears to be a prima-facie risk, the structure of the LGFA provides substantial protections which are designed to minimise the financial risks to all parties. The nature of the local authority sector is one of high credit quality and very low financial risk. The financial risks to Council of participating in the LGFA scheme as an establishment shareholder are considered low.

It is recommended that Council participate in the LGFA as an establishment shareholder which will require an investment up to $2.325m.

Any further investment in the LGFA will only occur if trading events trigger Council’s contingent liabilities related to the investment – but the risk of these events happening are considered low and are discussed in the body of this Information Memorandum.

2. THE LGFA

Council is considering a proposal to participate in the establishment of a Council Controlled Trading Organisation called the New Zealand Local Government Funding Agency Limited, as an establishment shareholder.

The LGFA will be established solely for the purposes of providing debt funding to local authorities.

The proposal to create the LGFA is motivated by an expectation that a *credit arbitrage*, a *regulatory arbitrage* and *critical mass* will be created by its establishment. These terms are defined below:

- *Credit arbitrage*. This is achieved when the LGFA attains a credit rating higher than the underlying assets by applying credit enhancements. The LGFA has been structured in a way to achieve a credit rating equal to New Zealand’s sovereign rating (currently AAA). The highest credit rating currently held by any of the individual local authorities is AA+ (held by New Plymouth, Christchurch and Wellington councils)

- *Regulatory arbitrage*. The LGFA will be able to borrow offshore, whereas local authorities are currently restricted by legislation from borrowing offshore.

- *Critical mass.* The establishment shareholders account for over 60% of the debt within the local authority sector. Pooling their borrowing requirements will create an economy of scale and enable the LGFA to undertake larger debt issues at a lower cost.

These factors are expected to allow the LGFA to borrow, on average, more cheaply than any of the individual local authorities. The benefits of the lower average borrowing costs will be passed-on to all participating local authorities with an expected return on capital for all shareholders.

There are precedents globally of similar vehicles that successfully pool local authority debt. The offshore precedents are typically owned by the local authorities in the relevant jurisdiction (often with central government involvement), as is proposed here.

3. THE INVESTMENT

If the LGFA is created as planned, the New Zealand Government will become a 20% cornerstone shareholder and local authorities will own the remaining 80%, with the establishment shareholders holding 50% and other local authority shareholders (yet to be identified) holding the remaining 30%.

The Government will provide $5m of paid up capital and local authorities will subscribe for $20m of paid-up capital and an equivalent amount of uncalled capital. The table below shows the expected make up of the respective shareholdings:-

$5.0m	20%	New Zealand government
$12.5m	50%	Establishment shareholders
$7.5m	30%	Other local authority shareholders
$25.0m	**100%**	**Total**

At the time of writing, 8 of the 9 proposed establishment shareholders have approved Statements of Proposal for public consultation. There is also a reasonably high level of interest among local authorities outside this group for the 30% share allocation.

For Council to participate as an establishment shareholder the investment required is expected to be between $1.389m and $2.325m. At this stage, we are not able to be more precise because it is contingent on the level of investment by other local authorities.

3.1. Return on Investment

The LGFA intends to pay discretionary dividends to shareholders, expected to be approximately cost of funds plus 2%. The proposed return on equity will enable local authorities to borrow to invest in the LGFA and cover the funding cost of the investment.

Council will need to borrow to invest in the LGFA and the expected return on equity should mean this investment cost is, at least, neutral to the Council.

4. CAPITAL STRUCTURE

The LGFA will be a limited liability company with shares allocated to central government and local authorities. At this stage, the exact percentage of shares to be held by central government has not been finalised, but it will be less than or equal to 20% meaning that 80% or more of the shares will be held by local authorities.

4.1. Types of Shareholder

Once established it is expected that the New Zealand government will be a 20% cornerstone shareholder, establishment shareholders will hold 50% of the shares and other local authority shareholders will hold the remaining 30%.

Despite the references here to the different shareholding classes (establishment and other) it is proposed that all issued share capital will be ordinary voting shares. The only material distinction between establishment and other shareholders will relate to the minimum utilisation requirements (refer section 9.3 for details) which requires that establishment shareholders commit to borrowing 80% of their needs from the LGFA for 5 years following its establishment. This is designed to ensure its viability through the start-up phase and assist LGFA to reach critical mass as soon as possible.

Share capital is intended to be perpetual in nature and therefore not readily liquidated. Following establishment, trading of shares will only be permitted to replace one local authority shareholder with another local authority to maintain the stability of ownership. The stability of shareholding among the local authority sector will be required to maintain LGFA's credit ratings (refer section 10).

There are a range of credit enhancements that underpin the credit arbitrage including subordinated debt arrangements, uncalled capital, joint and several guarantee and a stand-by liquidity facility. The credit enhancements are critical to the LGFA achieving a credit rating equal to the NZ sovereign debt rating. The credit enhancements are discussed separately (refer section 6).

4.2. Paid-up Capital ($25m)

There will be $25m of paid-up capital and all local authority shareholders will be committed to uncalled capital of a further $20m (in total) i.e. uncalled capital will match dollar for dollar local authority shareholders' called capital.

The table below outlines the expected shareholding of the LGFA.

$5.0m	20%	New Zealand government
$12.5m	50%	Establishment shareholders (Tight 9)
$7.5m	30%	Other shareholders (other local authorities)
$25.0m	**100%**	**Total**

At the time of writing, 8 of the 9 proposed establishment shareholders have approved Statements of Proposal for public consultation. There is also a reasonably high level of interest among local authorities outside this group for the 30% share allocation.

4.3. Cost of Shareholding

Establishment shareholders are expected to invest between $1.389m and $2.325m each to launch the company. Central government will invest $5.0m.

At this stage the actual investment required by Council is unknown because it will be affected by:

1. The shareholding take-up by other shareholders of their 30% allocation.
2. Any shareholding cap among the establishment shareholders which places greater onus on the subscriptions required by those uncapped establishment shareholders for their 50% allocation.

4.4. Establishment Shareholders

The proposed establishment shareholders are:

- Whangarei District Council
- Auckland Council
- Hamilton City Council
- Tauranga City Council
- Western Bay Of Plenty District Council
- Wellington City Council
- Greater Wellington Regional Council
- Tasman District Council
- Christchurch City Council

4.5. *Other Shareholders (30%)*

The minimum subscription for other shareholders is $100k.

The LGFA ordinary shareholders that could hold up to 30% are broadly defined as those local authorities that have total borrowings in excess of NZ$20m. The following local authorities[5] are expected to have borrowings of $20m or more and are potential shareholders:

Palmerston North City
Taupo District
Rotorua District
New Plymouth District
Queenstown-Lakes District
South Taranaki District
Nelson City
Far North District
Kapiti Coast District
Hastings District
Selwyn District
Wanganui District
Kaipara District
Thames-Coromandel District
Timaru District
Marlborough District
Horowhenua District
Gisborne District
Lower Hutt City
Waitomo District
Invercargill City
Waipa District
Porirua City
Waimakariri District
Ashburton District
Waikato District
Masterton District
Matamata-Piako District
Canterbury Region
Ruapehu District
Whakatane District
Hauraki District
Otago Region
Dunedin City
Manawatu District
Buller District
Upper Hutt City

4.6. *Non-shareholder Borrowers*

All other local authorities that are not expected to become shareholders (at the LGFA's establishment) are broadly defined as those with borrowings less than $20m. While there is nothing that will prevent these local authorities from subscribing for capital, it is not expected that all local authorities will invest.

The following local authorities had total debt up to $20m:

Southland District
Manawatu-Wanganui Region
Hawke's Bay Region
Tararua District
Grey District
Otorohanga District
Central Hawkes Bay District
South Wairarapa District
Napier City
Westland District
Gore District
Hurunui District
Rangitikei District
South Waikato District
Kaikoura District
Stratford District
Central Otago District
West Coast Region
Carterton District
Waitaki District
Opotiki District
Waimate District
Wairoa District
Chatham Islands Territory

[5] Some of these local authorities may not participate in the LGFA.

Mackenzie District	Bay of Plenty Region
Northland Region	Southland Region
Clutha District	Taranaki Region
Kawerau District	Waikato Region

5. CAPITAL ADEQUACY

The LGFA scheme is structured to maintain adequate capital relative to its asset base. It is important that this is achieved cost-effectively and in a way that keeps pace with balance sheet growth. The key design features that achieve this are discussed below:

5.1. Uncalled Capital

The LGFA will have $20m in uncalled capital which will be owned by the establishment and other shareholders (excluding central government). Uncalled capital can be called by the LGFA at any time, but is most likely to be called if there is a liquidity event (e.g. a loan default) which threatens to cause the LGFA to default on its commitments.

Council's uncalled capital is proposed to match dollar for dollar its paid-up capital. As such, Council will have a contingent liability for uncalled capital of between $1.389m and $2.325m.

5.2. Further Equity

In the event that the LGFA faces a loan default, it is expected that the LGFA will raise equity for the business in preference to making a call on the guarantee.

This mechanism is intended to protect the LGFA from ever defaulting on its commitments by allowing it to raise capital before it needs to call on its guarantee (which will require a default to have occurred). In other words, it allows pre-emptive balance sheet protection by raising capital before it is needed, rather than correcting it after the damage is done.

This would involve issuing additional capital to the guarantor group pro-rata to their individual rates revenue base.

5.3. Subordinated Borrower Notes

Subordinated Borrower Notes[6] ("**Notes**") are designed to be a cost effective mechanism to enable the LGFA to maintain appropriate capital adequacy ratios without the shareholders having to inject additional capital as the assets of the LGFA grow over time.

[6] The Notes will be subordinated debt and as such will rank behind the LGFA's other lenders and creditors.

The Notes will be funded from a local authority's borrowings such that, when a council draws down a loan from the LGFA an amount of the loan equal to 1.6% will be retained by the LGFA and the borrowing local authority will receive Notes to that value. When those borrowings are repaid the Notes held by the borrower are concurrently redeemed.

Returns will be payable on the Notes at the discretion of the LGFA. At this stage, the proposed return is expected to be based on an equivalent cost of capital. As such, the Notes are intended to be 'cost-neutral' to the local authority when it borrows from LGFA.

6. CREDIT ENHANCEMENTS

In order to succeed, the LGFA is required to achieve and maintain the same credit rating as New Zealand sovereign debt. This requires the LGFA scheme assets to be enhanced so they become equivalent to New Zealand government risk and this is achieved with credit enhancements. The Rates Charge and the Joint and Several Guarantee are critical credit enhancements that underpin the LGFA scheme and are discussed below:

6.1. Registered Charge over Rates

All local authority borrowers will pledge their rates revenues as tangible security for their borrowings from the LGFA. This security mechanism already underpins Council's and other local authorities existing borrowing arrangements that operate under a Debenture Trust Deed.

6.2. Joint and Several Guarantee

The guarantors will include all local authority shareholders and those local authorities with LGFA borrowings greater than $20m ("**the guarantor group**").

The guarantee will be in favour of the obligations of:

- The LGFA ("LGFA guarantee")
- All parties to the LGFA guarantee ("cross guarantee")

A call under the cross guarantee will occur only after a local authority loan default has occurred and loan recovery action has begun and the LGFA Board is concerned that the LGFA is at risk of imminent default.

The guarantee will be unconditional but is not irrevocable. Parties to the guarantee will be able to exit after:

- All the exiting local authorities borrowings are repaid
- All the LGFA's advances/borrowings, current at the time the local authority notifies of its withdrawal from the guarantee, are repaid

Council cannot quantify its potential guarantee exposure because it is dynamic and depends upon the size of the LGFA and on the financial capability of the other parties to the guarantee.

Among the guarantor group, there will be a mechanism to pro rata each guarantor's exposure under the guarantee based on relative rates revenue base.

6.3. Liquidity

Multiple sources of liquidity are required to secure and maintain the required high credit ratings for the LGFA. The primary sources of liquidity are discussed below:

6.3.1. Stand-by Line of Credit

The New Zealand government via the New Zealand Debt Management Office ("**DMO**")[7] will provide the LGFA with stand-by facilities of $500m initially, increasing to $1.0 billion.

6.3.2. Pre-funding Cash and Equivalents

LGFA will hold 20% of its assets in cash and cash equivalents for liquidity management purposes which is in-line with best practice for this type of funding vehicle.

6.3.3. Repo-eligible Assets

The Reserve Bank conducts repurchase ("**repo**") transactions with counterparties in which the Bank buys securities for cash with a commitment to sell the securities back to the counterparty at a pre-determined time and interest rate.

Local authority notes are repo-eligible assets and represent highly liquid assets. Given that the LGFA will be lending solely to local authorities it will hold a portfolio of highly liquid assets able to be repurchased with the Reserve Bank if the need for liquidity ever arose.

7. LGFA Operational Considerations

Operational considerations are relatively high-level at this stage. The detail will be worked on prior to the establishment of the LGFA. The main areas are discussed below.

7.1. Lending Policies

LGFA will only lend to local authorities.

---

[7] This is an operating unit of the New Zealand Treasury responsible for managing the Crown's debt, overall cash flows and interest-bearing deposits.

All borrowers will be required to comply with financial covenants similar to those outlined in the following table, except that local authorities with independent credit ratings above “A” may negotiate bespoke financial covenants. Council has a credit rating of AA+ and would negotiate financial covenants directly with the LGFA.

FINANCIAL COVENANT	THRESHOLD
Net Debt / Total Revenue	<250%
Net Interest / Total Revenue	<20%
Net interest / Annual Rates income (debt secured under debenture)	<30%
Liquidity (external debt + committed loan facilities + liquid investments to current external debt)	>110%

Revenue is defined as earnings from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue.

Revenue excludes non government capital contributions (eg developer contributions and vested assets).

Net debt is defined as total consolidated debt less liquid financial assets/investments.

Non-compliance with the financial covenants will either preclude a local authority from borrowing from the LGFA or, in the case of existing borrowers, trigger an event of review.

To avoid concentration risks, no more than the greater of $200m or 20% of any single local authority’s borrowings from the LGFA can mature in any 12 month period. Also, the exposure of the LGFA to Auckland City will be limited to a maximum of 40% of the LGFA total assets.

7.2. Investment Policies

The LGFA will maintain pre-funding (cash or near cash) equivalent to 20% of total assets. In effect, the LGFA will raise 20% more than is on-loaned to its borrowers which will be held in cash or near cash as part of the liquidity management tools for the LGFA.

7.2.1. Counterparty Concentration Risk Management

LGFA aggregate exposure and individual counterparties will be limited based on credit ratings along the following lines.

	NZ GOVERNMENT	‘AAA’ / ‘A1+’	‘AA+’ TO ‘AA-’ / ‘A-1’	‘A+’ TO ‘A’ / A-2	UNRATED LG
Maximum LGDV investment	100%	100%	50%	20%	20%
Maximum individual counterparty limit	100%	20% or $200m	10% or $100m (but $150m if NZ registered bank)	5% or $50m	5% or $50m

7.3. *Pricing Policies*

A differential pricing policy will apply so that higher credit quality local authority borrowers are rewarded with lower priced borrowing. Council's credit rating of AA+ is among the highest of all local authorities in New Zealand.

To help build scale in the LGFA, the size of borrowings by individual local authorities will also influence price.

7.4. *Borrowing Policies*

The LGFA will seek to minimise risk through broadly matching the maturity profiles and quantum of its assets and liabilities. It intends to source funding from the most price effective domestic or international capital markets (NZD and foreign currency).

7.5. *Treasury Policies*

During its establishment, the funding needs of local authorities will require at least 3 months notice to LGFA. Anything less than 3 months notice will be funded on a best endeavours basis. This will enable the LGFA to manage the risks around having a mismatch in its maturity profile during the start up phase when demand is growing.

7.6. *Treasury Function, Systems and Management*

Many of the operational functions required by the LGFA will be outsourced to the DMO. The DMO would act as agent for the LGFA in carrying out the functions described below.

- Back office systems – the DMO will provide back office services including managing the settlements processes.
- Investing pre-funding - the DMO will invest any funds held for liquidity or pre-funding purposes.
- Hedging – the DMO will execute hedges on behalf of the LGFA and be the counter-party to NZD interest rate swaps and cross currency/interest rate swaps.
- Borrowing – the DMO will manage domestic and offshore debt issues and any other borrowing e.g. retail public issues, and private placements.

The contractual arrangements with the DMO will be contained in Service Level Agreements to be negotiated. The pricing of the DMO arrangements are expected to be no greater than the costs currently estimated for the LGFA to undertake these operational functions in-house.

7.7. Governance

The LGFA will have a five member board appointed by its establishment shareholders:

- 2 local authority representatives
- 1 central government representative
- 2 independent directors

The mechanism for how the board will be appointed is yet to be determined.

The Minister of Finance and Minister of Local Government will be the shareholding ministers and will agree LGFA's constitution with the other shareholders.

As a CCTO, the LGFA will be subject to monitoring, reporting and disclosure requirements under the Local Government Act 2002.

Appropriate prudential provisions will be outlined in the LGFA's constitution and other internal policies as set by the LGFA Board and establishment shareholders.

Monitoring of the LGFA's compliance, conduct and performance will be by the Board, shareholders (including Crown Ownership Monitoring Unit and Department of Internal Affairs in relation to the government's shareholding) and trustees.

Investors (who will be purchasing LGFA debt) will also require a high level of transparency and information disclosure. Audit of the LGFA will be carried out by Audit New Zealand. Financial statements will be prepared six monthly.

8. Financial Considerations and Risks

The main financial considerations are discussed below. In addition to the pure financial benefits, the LGFA will provide Council with significant liquidity benefits from increasing the range of long term funding alternatives available to Council. This benefit should not be under estimated, as a borrower more than $300m, Council requires secure long-term access to a range of debt funding sources.

8.1. Cost of Shareholding

Establishment shareholders are expected to invest up to $2.325m each to launch the company. Central government will invest $5.0m.

8.2. *Forecast Financial Returns*

The financial modelling by CPL and APRM predicts that the LGFA scheme will be viable if it meets 2 key benchmarks.

- A credit ratings equivalent to NZ government debt
  Discussions with ratings agencies have been held. The shadow credit rating is not yet assigned but CPL expects that it will mirror the NZ government sovereign debt ratings.
- Sufficient utilisation by local authorities to achieve economies of scale. According to the financial modelling provided by CPL, the LGFA scheme will reach its 'steady state' when it reaches a scale of $2 billion of local authority debt.

The potential cost savings for Council in terms of lower funding costs will depend on the difference between the funding cost to Council when it borrows from the LGFA and the funding cost to Council when it borrows from alternative sources.

Financial modelling by CPL and APRM indicates expected interest rate savings of 0.40% per annum across the sector through the use of the LGFA once the LGFA is fully established.

For our own modelling we have assumed:

- the LGFA is operational in early 2012 (as planned);
- that Council's first available debt maturities able to be refinanced through the LGFA will be in July 2012;
- The expected interest savings fall between 0.20% (expected) to 0.40% (upper per the CPL and APRM modelling); and
- Council utilises the LGFA for 80% of its debt maturity refinancing[8].

Based on these assumptions, the table below sets out the range of potential annual savings for Council from the LGFA.

	Data	
Year	Sum of 20bp (Expected)	Sum of 40bp (Upper)
2012	$16,215	$32,430
2013	$54,027	$108,055
2014	$130,372	$260,743
2015	$183,321	$366,641
2016	$280,706	$561,412
2017	$351,562	$703,123
2018	$369,600	$739,200
Grand Total	$1,385,802	$2,771,603

Based on Council's current debt maturity profile the savings are initially modest. The benefits begin to accelerate after several years as more debt matures and requires refinancing. The expected savings benefits to Council in 2012 are $16k increasing to $370k in 2018, at which point the aggregate savings total $1.386m. If the savings benefits are per the CPL and APRM modelling of 0.40%, the annual savings benefits increase to $740k by 2018, at which point

[8] This excludes bank facilities held for liquidity purposes and bank stand by lines that underpin the Council's commercial paper programme.

the aggregate savings would total $2.772m. These savings then continue on an annual basis beyond 2018.

8.2.1. Return on Equity

The LGFA intends to pay a dividend to shareholders matching the cost of funds plus 2%. This is intended to enable local authorities to invest in the LGFA and fully cover the funding cost of the investment.

Council will borrow to fund its investment in the LGFA so the proposed return on equity will offset the cost of borrowing and is expected to be cost-neutral to Council.

8.2.2. Contingent Liabilities

Council's contingent liabilities with regard to the LGFA are only partially quantifiable due to their uncertain nature. With the exception of uncalled capital which is known, Council's other contingent liabilities will depend on:

- the trading performance of the LGFA and its underlying asset base (i.e. its local authority borrowers), and
- the financial strength of the wider pool of other local authority shareholders (i.e. the guarantor group).

8.3. LGFA Risks

Council's risks are assessed as low and are tied directly to the LGFA by virtue of Council's proportionate liability for the LGFA commitments.

Council has both quantifiable financial risks (paid-up capital, uncalled capital, and borrower notes) and unquantifiable financial risks (contingent liabilities relating to the guarantee and further equity commitments) together with operational risks in relation to the LGFA scheme.

The nature of the contingent liabilities that underpin the LGFA scheme mean that it is not possible to quantify Council's total potential financial risks. However, the risk of Council being required to contribute significant financial sums in relation to its contingent liabilities are considered to be very low due to

- The rates charge security over the rates revenues of its borrowers that underpin the LGFA lending.
- The high quality of the LGFA's assets (being a mix of solely local authority debt).
- $20m uncalled capital.
- $500m to $1.0 billion standby borrowing facilities from central government to assist the LGFA manage any liquidity events.

The main risks are discussed further below:

8.3.1. *Management Risk*

The treasury related activities of the LGFA will be outsourced to the DMO. This is considered a significant mitigation to any potential mismanagement risk. The main management risks are:

Operational management

- The risk of mismanagement (e.g. rogue trading) this is mitigated by DMO outsourcing.
- DMO will manage the borrowing and investing functions and undertake the back-office and hedging functions.
- DMO will be the hedge counterparty for LGFA.

Lending risks

- The LGFA will only lend to local authorities.
- There is no history of any loan default by a local authority in New Zealand. This does not mitigate future risk but offers some understanding of the historic risk profile of local authority debt.
- LGFA's borrowers will need to comply with financial covenants.

Investment policies

- Borrowing – LGFA will seek to match its assets and liabilities
- Lending – local authorities must meet financial criteria (financial ratios) and spread maturities so that exposure in any 12 month period is limited.
- Investing – any cash invested by the LGFA must be in very high quality securities.

8.3.2. *Default Risk*

LGFA's risk of default is both short term and long term based on the underlying loan assets.

- Short term default is where a payment obligation is not met on time. This could be a liquidity event but may not be a business failure.
- Long term default is where a payment obligation is never met. This level of default would indicate a complete failure of the local authority borrower.

There are two principal safeguards that the LGFA will put in place to manage short term default (liquidity) risk:

- It will hold a certain amount of cash and other liquid investments which can be quickly turned into cash.
- It will have a committed borrowing facility with the government of between $500m and $1.0 billion which allows it to borrow funds to manage a liquidity event if required.

Long term default risk will be managed by:

- A registered charge over all borrowers' rates revenues that will allow the LGFA to appoint a receiver that can then levy a special rate to remedy any loan default.
- The LGFA will have full shareholder support by way of uncalled capital (first) then commitments by shareholders to subscribe for further capital, and also a joint and several guarantee of all of the obligations and commitments of the LGFA.

8.3.3. *LGFA Guarantee Risk*

The LGFA guarantee will be called by investors if the LGFA defaults on its commitments to its lenders.

If any such default did occur and the guarantors (including Council) were called on under the LGFA guarantee they could potentially be called on to cover any payment obligation of the LGFA. Such payment obligations may (without limitation) include obligations under the following transactions:

- A failure by the LGFA to pay its investors and/or principal lenders.
- A failure by the LGFA to repay drawings under the liquidity facility with the New Zealand government.
- A failure by the LGFA to make payments under interest rate and foreign exchange hedging transactions.

The mitigation strategies to minimise the risk of the LGFA facing a call in its guarantee are the fundamental building blocks of its structure, being

- The rates charge security over the rates revenues of its borrowers that underpin the LGFA lending.
- The high quality of the LGFA's assets (being a mix of local authority debt).
- $20m uncalled capital.
- $500m to $1.0 billion standby borrowing facilities from the government to assist the LGFA manage any liquidity events.

The systemic failure of the LGFA's foundations is difficult to forecast other than by way of complete political and local government melt-down in New Zealand. It is meaningless to attempt to discuss risks of this magnitude here, other than to say these are considered very low.

8.3.4. *Cross Guarantee Risk*

The detail of when the LGFA will be able to call upon the cross guarantee is not yet finalised, but it is likely that it will be restricted to situations in which there is a risk of an imminent default by the LGFA.

There are five factors which mitigate the risk to the guarantor group under the cross guarantee:

1. The risk only materialises if another local authority defaults on its debt obligations. It is believed that no such default has ever occurred, which suggests that the risk of a local authority default is very low.
2. If a local authority defaults, but it is because of temporary liquidity problems only, the safeguards in place to cover temporary liquidity shortages may be sufficient for the LGFA never to have to call upon the cross guarantee.
3. It is anticipated that the guarantee will only be called if a call on the uncalled capital does not generate sufficient funds to eliminate the risk of an imminent default by the LGFA.
4. If a local authority defaults, the burden will be shared by the guarantor group on a pro-rata basis.
5. If a local authority defaults, the LGFA will exercise its rights under the Rates Charge to recover the payments defaulted on. The funds recovered through

that exercise will be passed on to the local authorities who have made payment under the cross guarantee, so they should, in the long term, be reimbursed for a significant portion, if not all, of the amount they have paid under the cross guarantee. The statutory processes involved in exercising these rights suggest that funds will be able to be recovered within 18 months of default.

8.3.5. Guarantee Risks Shared

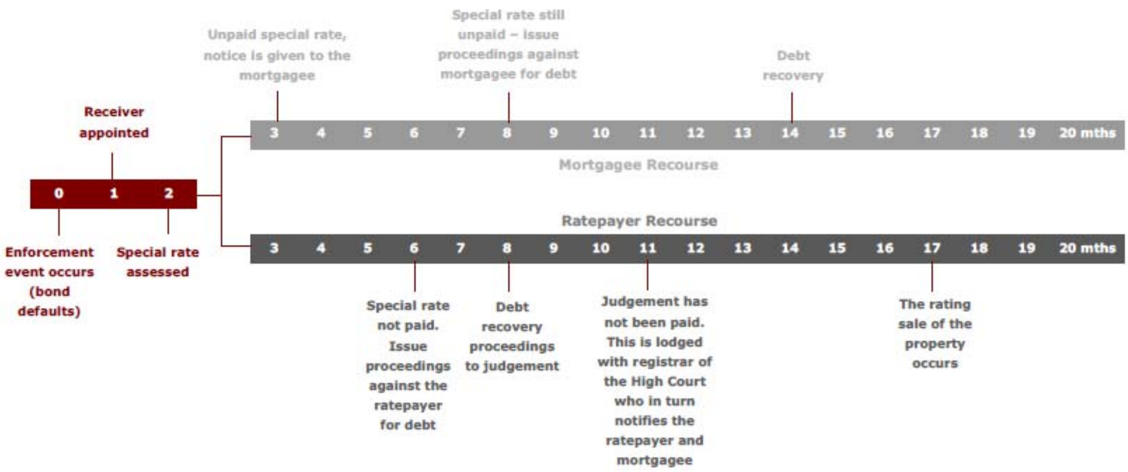
Although the detail is not yet finalised, there will be a mechanism to ensure that payments made under the guarantee are shared across the guarantor group. It is likely to be levied between local authorities based on rates revenues.

8.3.6. Managing any Loan Default Event

In the unlikely event of loan default by a local authority, the LGFA will manage the liquidity impacts using the mechanisms discussed, and will then exercise its rights in terms of its loan securities to recover its lending to the local authority.

Receivership

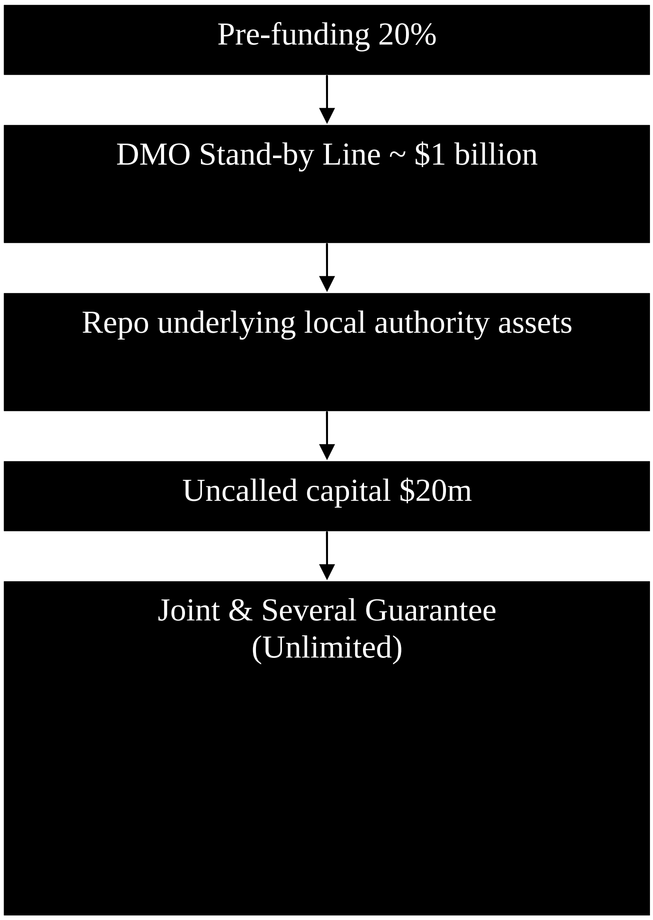
The proposed loan security structures will provide, in the first instance, for the LGFA to appoint a receiver to remedy the default by levying a special rate on the local authority rating base. The diagram below sets out the broad process:



Liquidity Management

In the event of a loan default, then during the expected 17-18 months required to remedy any default via the Rates Charge, the LGFA will need to manage the cash flow implications of the default so it does not default on its own commitments.

The tools to manage such a liquidity event at LGFA include the 20% pre-funding (cash deposits), DMO's standby liquidity facility, the repo-eligible longer term assets on LGFA's balance sheet, uncalled capital and the guarantee. Below is an example of the likely payment waterfall under the liquidity management measures.



9. THE LOCAL AUTHORITY DEBT MARKET

This is a relatively mature sector and modest growth across the sector is expected. A brief discussion of the sector follows:

9.1. Total Sector Debt

Based on CPL models, local authority borrowings in 2011[9] are expected to total $8.4 billion.

There are 78 local authorities and the 10 largest (in terms of debt) account for 68% ($5.7 billion) of the total sector debt of $8.4 billion.

Establishment shareholders represent 62% of the sector debt with a total of $5.2 billion.

LTCCP projections estimate the sector debt will increase to $11.1 billion in 2016/17 reducing to $10.8 billion in 2019.

[9] Source: LTCCP total borrowings for individual local authorities per CPL financial models.

The forecast growth in sector debt of 2.4bn (between 2011 and 2019) is approximately 30% in nominal (i.e. non inflation adjusted) terms.

9.2. Economy of Scale

CPL modelling indicates that the LGFA will operate profitably from its core activities from year one onward. Set-up costs will be met from establishment capital.

Overheads are largely fixed (premises, payroll etc) with the exception of issuance costs (the cost of raising capital) which are variable. The LGFA will operate most efficiently when its assets exceed $2 billion.

9.3. Minimum Utilisation

On the basis that the LGFA can provide debt funding at equal or better than market rates, establishment shareholders (including Council) are expected to commit to using the LGFA for a minimum of 80% of its new borrowing requirements (including replacing existing debt as it matures) for 5 years from the commencement of LGFA's operations. The case of Auckland Council is separate the LGFA will be limited to a maximum of 40% exposure to Auckland Council to avoid concentration risk.

10. CREDIT RATINGS

A fundamental driver behind the LGFA is that its credit ratings match New Zealand government's sovereign credit rating.

CPL have held discussions with the various rating agencies to ensure that LGFA's capital structure, credit enhancements and liquidity tools will support the required credit rating.

At this stage CPL do not have a shadow credit rating for LGFA but their discussions with the ratings agencies are encouraging and CPL expects the LGFA to achieve the required ratings with at least 2 of the 3 major credit rating agencies (Fitch Ratings, Moody's and Standard & Poor's).

11. LEGISLATION AND LGFA

The LGFA scheme has strong political support both from local government and central government. Some of the more significant interactions are set out as follows:

- The steering group has met with the Minister of Finance and the Minister of Local Government and been heavily engaged with officials.
- The Treasury, Department of Internal Affairs, RBNZ and DMO have undertaken significant work reviewing the LGFA and facilitating Central Government's involvement.

- On 8 December a Cabinet Committee agreed to all recommendations put forward in a cabinet paper prepared by the Treasury and Department of Internal Affairs (plus RBNZ, DMO and Ministry of Culture and Heritage).

New legislation (Local Government Borrowing Bill) is now before parliament and is designed to facilitate the establishment and operation of the LGFA so it can achieve its aims.

The Bill provides the LGFA with certain legislative entitlements and exemptions that allow for the LGFA to be treated as if it were a local authority. The guiding principle behind this approach is that the LGFA will be a conduit for local authorities to achieve collectively what they could also do individually and therefore the LGFA should have the same regulatory environment as that of its participating local authorities.

The Bill authorises local authorities to give guarantees, indemnities, or securities to the LGFA and to lend money or provide other financial accommodation to the LGFA on more favourable terms than those that would normally apply.

The Bill provides that the Minister of Finance may lend money to the Funding Agency if it appears to be necessary or expedient in the public interest to do so and the lending is for the specific purpose of meeting an exceptional and temporary liquidity shortfall. Any money lent will be subject to a permanent legislative authority. However, the permanent legislative authority will expire 10 years after the commencement of the Bill.

The Bill specifically provides that the Crown does not guarantee the obligations of the Funding Agency.

Cabinet approvals and the Bill address the following key areas:

Deeming for tax purposes
- Local authorities are specifically exempted from the Income Tax Act 2007 and the LGFA will be treated as a local authority for tax purposes (i.e. tax exempt).

Securities Act
- Local authorities are, subject to conditions, exempted from the requirement to prepare a prospectus under the Securities Act 1978 and the LGFA will receive similar treatment to local authorities.

Local Government Act 2002
- Local authorities will be able to guarantee other local authorities debt and the debt of the LGFA.
- Guarantees of indebtedness of the LGFA and commitments to contribute additional equity to the LGFA by local authorities will be “protected transactions” under the Local Government Act 2002.
- Local authorities will be exempt from the application of sections 62 and 63 (which prevent local authorities from guaranteeing or providing concessional funding to any CCTO) in relation to the LGFA

- Guarantees of debt owing by local authorities to the LGFA, guarantees of indebtedness of the LGFA and commitments to contribute additional equity to the LGFA may be secured by a rates charge

Crown Equity in the LGFA

- The Crown will become a founding shareholder with a maximum contribution of $5m (as appropriated in Budget 2010) and maximum share of 20%.
- $450,000 of the Crown’s $5 million capital contribution may be used to help co-fund establishment expenses.

Debt Management Office role

- The DMO will provide the LGFA with a standby credit facility (Minister of Finance to give initial approval and also grant the DMO a standing delegation to continue the same)
- The DMO will provide the LGFA with certain outsource financial services

Governance and monitoring

- The Minister of Finance and Minister of Local Government will be the shareholding ministers.
- The shareholding ministers will agree LGFA's constitution with the other shareholders.