Local Government: a financial snapshot

For Local Authorities as at 30 June 2013

19 May 2014

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Executive Summary

Background

Local Government New Zealand (LGNZ) engaged Grant Thornton to provide advice on a methodology for producing a proxy of council financial health and analyse this based on the publically available 2013 financial data. Within the terms of the methodology, councils judged to be in good financial health are described as "sound".

Consideration was given to identifying the most appropriate metrics and approach in order to mitigate the weaknesses identified in other approaches to analysing the financial health of the sector. To remedy the weaknesses, we

- Took into account the variable level of assets held by councils in relation to their differing debt levels i.e. taking a total balance sheet approach
- Allowed for differing forecast population growth
- Took into account the ability to service debt by calculating the surplus after allowing for all revenue and running costs instead of focusing just on rates revenue
- Grouped councils into sectors to enable comparison of like with like. That, is rural councils face different financial pressures to metropolitan councils

Summary of Conclusions

All but four councils were found to be Sound or higher on average across the five metrics. The metrics are debt levels relative to their asset base; debt levels relative to population; the ability to repay debt; the ability to cover interest obligations and population change.

The overall Sound benchmark was compiled by summing each of the five individual metrics. This means that in some metrics some councils scored much higher than they did in their overall score.

The analysis shows that almost all councils are in good or very good financial health. The four councils that narrowly fell below the rating line are there for very different reasons. Some have recognised financial challenges and have strategies in place in their Long Term Plans for addressing those issues. Others are there because of the nature of the methodology, which does not take into account income from non-rating sources or financial equity.

Summary of Methodology

Having examined possible methodologies Grant Thornton was comfortable a proxy for a snapshot of a council's financial strength could be achieved by using a modified version of the criteria that the Local Government Funding Agency (LGFA) employs when assessing a council.

These criteria include

1. Debt levels relative to asset base
2. Debt levels to population
3. Ability to repay debt
4. Ability to cover interest (finance cost) obligations
5. Population forecasts

Grant Thornton have expanded some of the metrics and applied our own experience to the methodology. This includes some inherent weightings, with debt levels per population having a slightly higher weighting and population forecasts a slightly lower weighting.

For Auckland, Christchurch and Dunedin, the Group financial data has been used given that those councils have significant holdings of core operations / assets in separate entities.

In effect, a commercial lending approach has been taken which asks, would a lender lend to this council given the normal factors a commercial lender would consider.

Scatter diagrams are used to illustrate the range of the overall results by type of authority and by metric.

About the LGFA

The LGFA is jointly owned by central government and participating local authorities. The primary objective of the LGFA is to optimise debt funding terms and conditions for participating local authorities.

As at 31 December 2013, of the 78 local authorities, 42 are eligible borrowers of the LGFA. These 42 eligible borrowers represent over 90% of total local government sector debt. At that time, the LGFA had made loan advances of over three billion dollars to the participating members.

Types of Authority

The councils are grouped into similar authorities. The definitions of these groups are

Rural	Populations less than 20,000 (includes Chathams Islands District Council as a unitary authority)
Provincial	Populations between 20,000 and 90,000 (includes the following unitary authorities - Gisborne District Council, Marlborough District Council, Nelson City Council and Tasman District Council)
Metropolitan	Populations exceeding 90,000 (includes Auckland Council as a unitary authority)
Regional	As defined by the Local Government Act 2002. Population varies based on the councils within the region

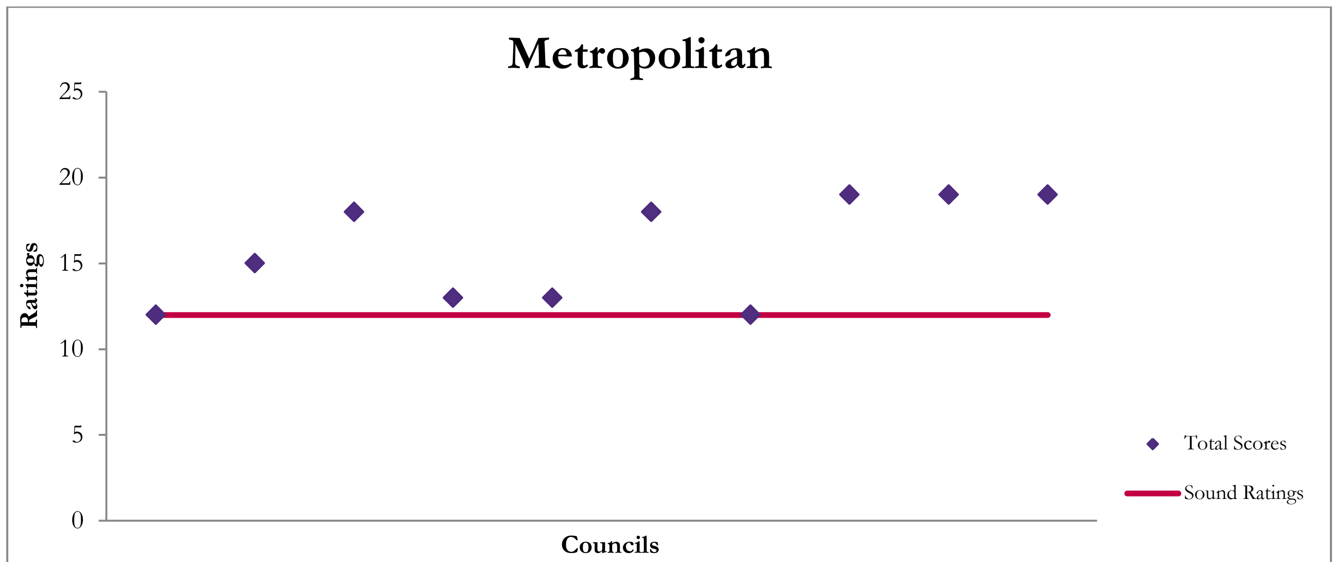
Scope & Limitations

It is important to read the results of this analysis while considering the following points

- This report and rankings should not replace an in-depth review of each individual council for financial stability, but is designed to be a proxy of financial strength.
- The lack of uniformity in the way some financial information is presented in council financial statements has given rise to judgement calls in gathering and analysing the underlying data.
- The data, ratings and trends would be strengthened by undertaking the exercise in future years and potentially using the ten year plan to estimate each council's position in five or ten years' time.
- The report provides a snapshot of a council's current financial health. It makes no comment on the degree to which councils may be required to make significant infrastructure investments in the future, which could have a major bearing on their future rating, or whether councils have only recently made those investments, thus impacting on their current position.

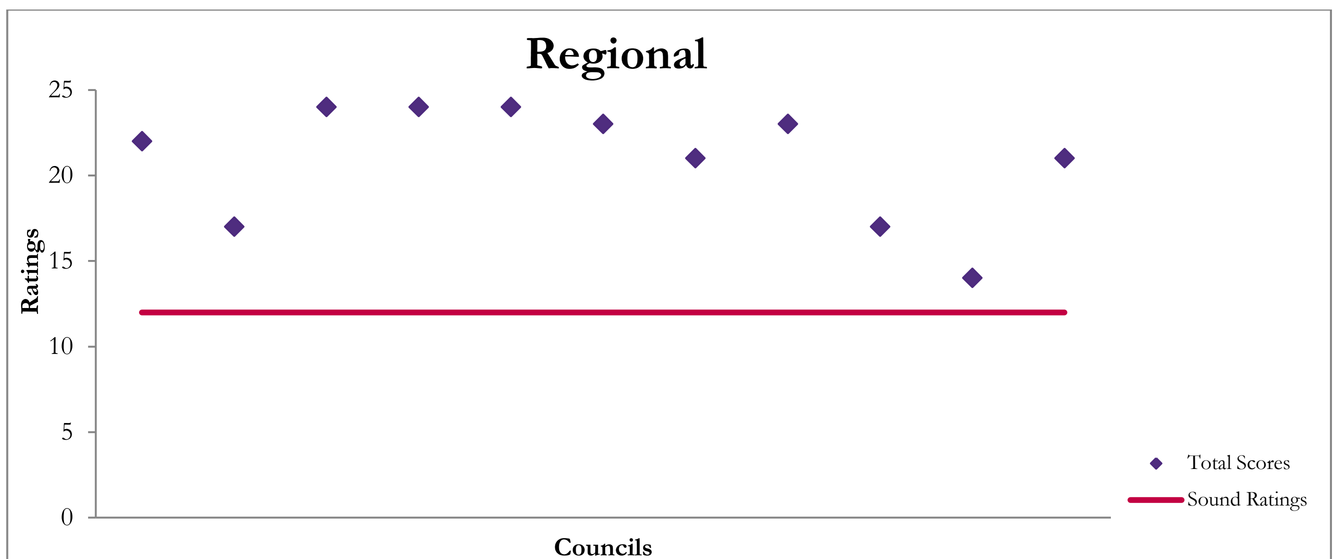
Overall summary by Group

Figure 1: Metropolitan councils



These are urban councils usually with resident populations greater than 90,000. Metropolitan councils are responsible for large scale urban infrastructure and amenities. Many are facing growth pressures and using debt to build and upgrade infrastructure to cater for future population growth and enhance the quality and capacity of existing assets and utilities. New regulatory responsibilities are also a cost driver, such as the earthquake strengthening of public buildings as well as the potential cost of earthquake inspection responsibilities. Extreme weather events and the risk of natural hazards are also forcing councils to upgrade and enhance the capacity of their underground infrastructure, frequently ahead of planned schedules.

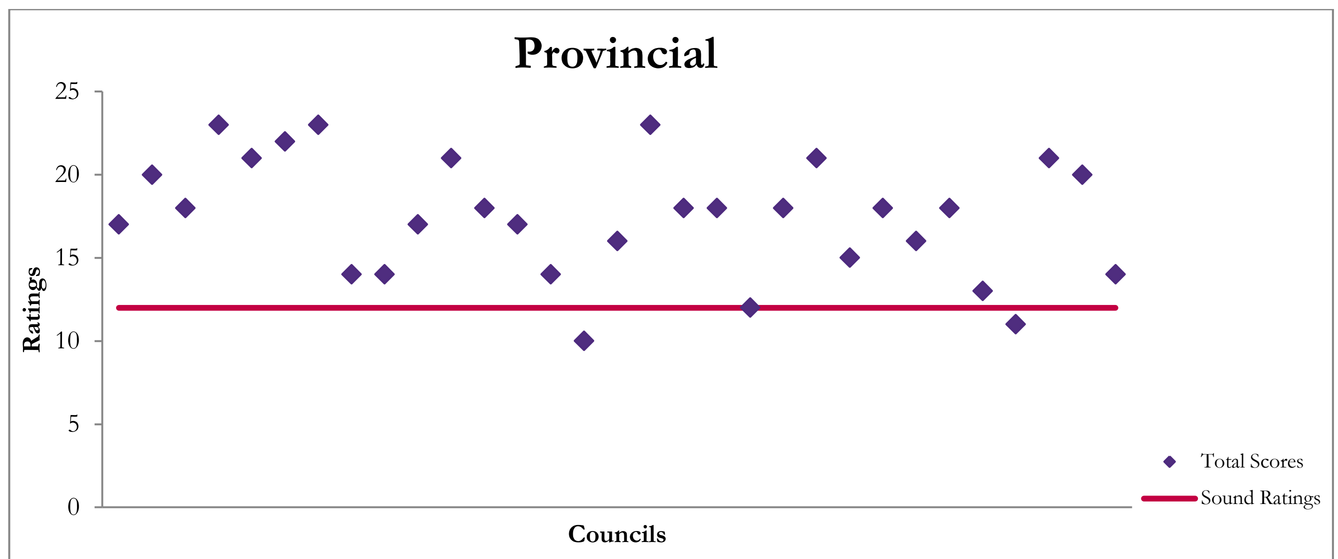
Figure 2 Regional councils



Regional councils are regional authorities as defined by the Local Government Act 2002. They are primarily responsible for environmental management and regulation, although responsibilities vary with Wellington Regional Council, for example, responsible for both the bulk water supply to the Wellington urban area and an extensive public transport network.

Cost drivers affecting regional councils include enhanced environmental standards, such as fresh water accounting standards, which have financial implications in terms of both their regulatory and service delivery functions. Extreme weather events are increasing pressure on flood prevention works and many councils are investigating water storage and irrigation initiatives in the light of facilitating stronger regional development.

Figure 3 **Provincial councils**



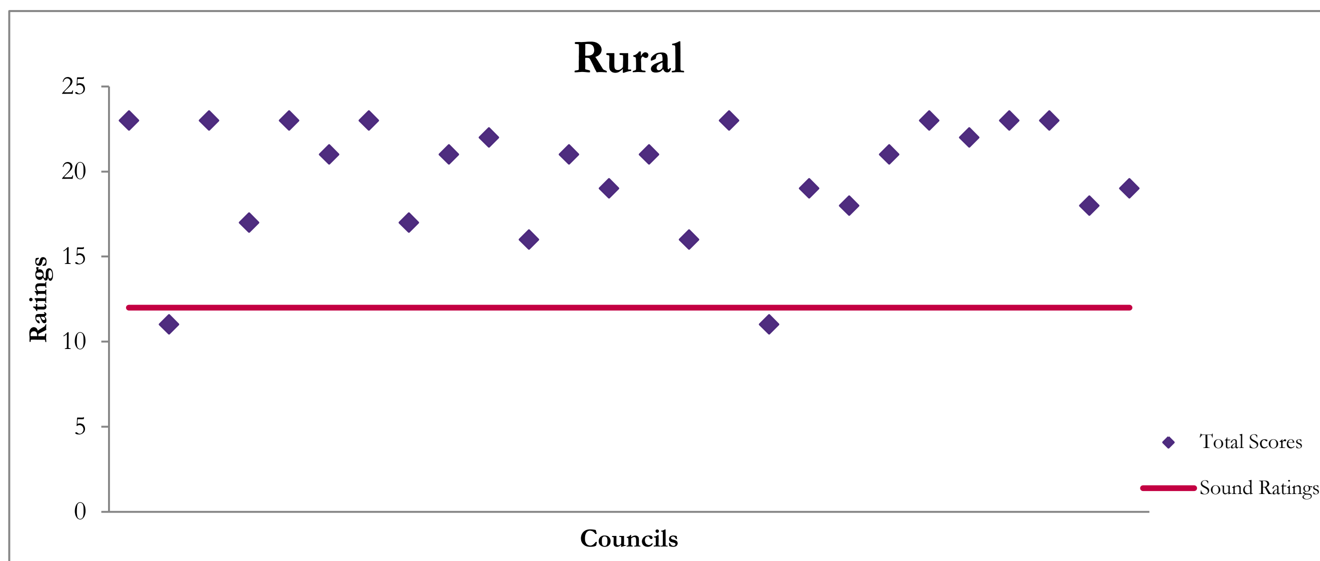
Provincial councils (those with populations between 20,000 and 90,000) which also include all unitary councils with the exception of Auckland Council, tend to face similar issues to both rural and metropolitan councils, depending upon whether their populations are growing or not. Many provincial councils have large rural hinterlands and face similar roading demands to rural councils while also dealing with expectations of urban dwellers for more and better amenities, which are also required to attract investment. Additional funding pressure is coming from the cost of new regulatory standards, such as earthquake strengthening, freshwater and drinking water standards as well as, in many councils, the cost of building infrastructure for growing populations. Extreme weather events are also putting pressure on council infrastructure.

The two councils marginally under the Sound rating line are Western Bay of Plenty District Council and Taupo District Council

- Western Bay of Plenty District Council has invested heavily in infrastructure upgrades to enhance capacity and new infrastructure to meet future population growth. The council has a policy of meeting the cost of infrastructure development caused by growth through financial contributions. This is not reflected in the final assessment as the criteria does not take into account any income from financial or development contributions. When this income is included Western Bay sits comfortably above the line and is in a sound position financially.

- Taupo District is below the line because of its gross debt figure and resulting high level of debt to population. However, as 42% of ratepayers reside outside of the district the debt to population measure does not account for this therefore understates comparative population. In addition the council's financial strategy combines a high level of debt with a high level of financial equity, that is, the council has a large investment fund. The council is below the line in this exercise as the LGFA criteria modified by Grant Thornton employs gross not net debt. When net debt is considered the council sits above the line and is financially sound which is a reflection of the AA- credit rating issued by Standard and Poors.

Figure 4 **Rural councils**



Rural councils are council with populations under 20,000. They are often characterised by large roading networks and small disaggregated settlements, meaning that it is difficult for these councils to achieve the same economies of scale as councils with larger and more concentrated populations. Disaggregated communities each require stand-alone water and waste water infrastructures, the cost of which are shared across a relatively small number of citizens without the benefit of economies of scale

Because roading accounts for such a major part of a rural council's expenditure any reduction in the share of the National Land Transport Fund allocated to rural roads can result in a major increase in local property taxes. An additional pressure is the damage to rural roads caused by forest harvesting, with the impact on local bridges being particularly problematic, especially with the shift to larger trucks. Over the last decade infrastructure upgrades to meet changes in fresh water and drinking water quality standards have been a major financial challenge. The two councils just under the Sound rating line are Kaipara District Council and Waitomo District Council

- Kaipara District Council is dealing with the financial impact of debt created by construction of the Mangawhai Community Wastewater scheme. The issues related to the council management of this scheme led to the appointment of Commissioners in September 2012. The Auditor-General also conducted an Inquiry into Council's management of the scheme during 2012 and 2013 and released a final report detailing her findings in December 2013. The Council has now adopted a new Long Term Plan with a financial strategy that will reduce debt and lift its financial position above the Sound rating line in the future.

- Waitomo District Council is addressing historic levels of debt. The District also required and has carried out crucial infrastructure upgrades for Water and Wastewater services, which is reflected in the debt figures. These investments are largely complete now. Since the adoption of its 2009 Long Term Plan, Waitomo District Council has implemented financial measures aimed at gradually reducing debt while providing essential services to the community.

Summary of Methodology, Approach and Assumptions

Background

Local Government New Zealand engaged Grant Thornton to provide advice on a methodology for producing a proxy of council financial health based on publically available 2013 financial data.

While an in-depth report of each council's financial health is a significant task, Grant Thornton was comfortable a proxy for a financial strength snapshot could be achieved by using a modified version of the criteria that the Local Government Funding Agency ("LGFA") use for assessing a Council.

These criteria include

1. Debt levels relative to asset base
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For Auckland, Christchurch and Dunedin, the Group financial data has been used given that those councils have significant holdings of core operations / assets in separate entities.

In effect, the overall approach has been to apply a commercial lending approach – would a lender lend to this council given the normal factors that would be considered.

About the LGFA

The LGFA is jointly owned by central government and participating local authorities. The LGFA is a council-controlled organisation as defined under section 6 of the Local Government Act 2002.

The primary objective of the LGFA is to optimise the debt funding terms and conditions for participating local authorities.

As at 31 December 2013, of the 78 local authorities, 42 are eligible borrowers of the LGFA. These 42 eligible borrowers represent over 90% of total local government sector debt. At that time the LGFA had made loan advances of over three billion dollars to the participating members.

Types of Authority

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Points of Interest in Methodology

To better understand the outcomes, the following points will provide context and support for the approach

- To produce a more readily even comparison between councils, population was used as the denominator in ratios as opposed to "ratepayers". Ratepayers is a problematic definition which generically focuses on "rateable units" and ignores the fact that rates are not weighted evenly between different classes of "ratepayers" (such as business or residential) and that a large part of the population effectively pay rates via rental accommodation.

- The use of EBITDA (Earnings before interest, tax, depreciation and amortisation) is a useful metric. As opposed to just rates as revenue, EBITDA reflects all revenue gathered and allows for the different services and structures (different costs / salary levels) by the individual councils.

- We have used LGFA's data for population growth which is based on the 2007 census as the 2013 data is not available until later this year.

- For Auckland, Christchurch and Dunedin, Group financial data has been used, given that these councils have significant holdings of "normal" core operations / assets held in separate entities.

- We have calculated a Saleable assets value for each council, being assets that are not heritage, restricted or infrastructure. This gives a more rigorous measure of the percentage of total debt to assets and acts as a proxy to compare the mix held of non-infrastructure assets and assets that could be considered more liquid.

Other Assumptions & Notes

- We have used the LGFA's definitions for the following:

  - Rates include metered water charges
  - Interest incudes all interest and financing costs
  - EBITDA excludes revenue from development contributions and financial contributions, vested assets, found assets and any unrealised gains.

- Restricted Assets includes heritage assets.

- Debt includes borrowings, term loans, public debts and bank overdrafts.

- We have assumed the current portion of the borrowings is an adequate estimate of the principal payment of borrowings.

- It has been assumed that Depreciation, Amortisation and Finance Costs shown at the bottom of the Statement of Comprehensive Income have been included as part of the Total Operating Expenditure, where it is not specified as separate items in the Operating Expenditure.

- The Criteria for Debt per head of population mirrors the LGFA approach, except we considered total not debt net of cash holdings is a better metric and have adjusted the ratings to reflect this.

- While we have used the LGFA's data and analysis in this report, any findings are based on our approach.

Approach

We detail the procedures we have undertaken in completing this report;

1 Consideration was given to the most appropriate metrics and approach to mitigate the weaknesses identified in other sector analysis. To remedy the weaknesses, we:

   - Took into account the variable level of assets held by councils in relation to their differing debt levels i.e. taking a total balance sheet approach
   - Allowed for differing forecast population growth
   - Based the ability to service debt by calculating the surplus after allowing for all revenue and running costs instead of focusing just on rates revenue
   - Grouped councils into sectors to enable comparison like with like. That, is rural councils have different pressures to metropolitan councils

2 We advised that a practical initial approach was to use a "snap shot" of the 2013 Financial Reports published by the 78 councils.

3 We reviewed the main criteria the LGFA use when assessing a local government authority summarised as:

   - Debt levels relative to asset base
   - Debt levels relative to population
   - Ability to repay debt

4 While we were comfortable with the focus that the LGFA used around asset / debt ratios and the ability to service debts, we modified some of the underlying ratios and assumptions. We settled on the following measures:

   - Total debt as a percentage of saleable assets
   - Total debt as a percentage of total assets
   - Total debt per head of population
   - EBITDA Coverage Ratio of Principal and Interest

- EBITDA Coverage Ratio of Interest
- Population Growth Forecasts

5 Obtained the published 2013 financial statements and ten year long term plan for 78 local authorities.

6 Reviewed definitions and data provided by LGFA and established that the data we were able to utilise included the following:

- Rates
- Population Forecasts
- Population Trend
- Various definitions and approaches

7 Gathered the following financial data from the 2013 financial statements for 78 local authorities, using the LGFA's methodology and compiled the following data:

- Rates
- Total Income
- Depreciation & Amortisation
- Finance Costs
- Total Expenses
- Net Profit before Tax
- Capital Revenue
- Cash and Cash Equivalent
- Current Assets
- Infrastructure Assets
- Restricted Assets (including Heritage Assets)
- Total Assets
- Current Borrowings
- Current Liabilities
- Non-Current Borrowings
- Total Liabilities
- Net Assets
- Loan Repayment
- Finance Lease repayment
- Net Cashflow from Operating Activities

8 As a quality assurance step we compared the following financial data compiled for the local authorities against the data from LGFA:

- Rates
- Net Debt
- Population Growth

This allowed us to check if the financial data compiled (other than Population Growth) aligns with LGFA's definition and calculations. During the process we investigated any material differences between our compiled data and LGFA's data provided. We have used LGFA's data for population growth but this is not based on the 2007 census as the 2013 data is not available until later this year.

9 We used our professional judgement to set bands.

10 The data was then analysed and our summary report drafted for review by LGNZ for comments and to add expert contextual commentary on the sector.

11 The report was then finalised.

Metrics Background and Ratings Approach

We detail the logic for each metric below.

Total Debt over Total Assets

- Total debt to total assets is a leverage ratio that measures total amount of debt relative to assets.
- The higher the ratio, the higher the degree of leverage, and consequently, financial risk.
- We have used the following ratios:
  - Excellent less than 7% (Rating 4)
  - Good 7% - under 13% (Rating 3)
  - Sound over 13%-20% (Rating 2)
  - Needs further review above 20% (Rating 1)

Total Debt over Saleable Assets

- Saleable assets are considered to be all council assets that are not restricted or infrastructure assets. This is a useful measure of assets that councils could "repurpose" to more core use (i.e. away from cash and invest into roading).
- It is a more rigorous measurement that solely relying on total debt over total assets. While it is extremely unlikely any council assets would be sold in the situation of borrowing default, this value and the percentage below allows comparison of councils with similar debt levels.
- We have used the following ratios:
  - Excellent less than 20% (Rating 4)
  - Good 20% - 40% (Rating 3)
  - Sound 41%-65% (Rating 2)
  - Needs further review above 65% (Rating 1)

Debt per Head of Population

- To produce a more readily even comparison between councils, population was used as the denominator in ratios as opposed to "ratepayers". Ratepayers is a problematic definition which generically focuses on "rateable units" and ignores the fact that rates are not weighted evenly between different classes of "ratepayers" (such as business or residential) and that a large part of the population effectively pay rates via rental accommodation.
- Exceptions to this approach would be holiday areas such as Taupo, Queenstown and Thames Coromandel.

- We have used the following grading:
    - 0-$1,000 per head (Rating 5)
    - $1,001-$2,000 per head (Rating 4)
    - $2,001-$3,000 per head (Rating 3)
    - $3,001-$4,000 per head (Rating 2)
    - $4,000+ per head (Rating 1)

EBITDA Coverage Ratio of Principal and Interest

- EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) is a useful measure of funds available to meet debt repayments (principal and interest).

- This ratio measures how many times the Council's EBITDA can cover its estimated principal and interest repayments.

- While the nature of most council's income is very steady from rates, most lenders would allow for the lower end of covenants for this ratio, based on our experience:
    - Excellent more than 3 times + coverage (Rating 4)
    - Good 2.0-3.0 times + coverage (Rating 3)
    - Sound above 1.0 but less than 2.0 times coverage (Rating 2)
    - Needs further review 1.0 or less coverage (Rating 1)

EBITDA Coverage Ratio of Interest

This ratio measures how many times the Council's EBITDA can cover its estimated finance costs.

- Excellent over 3.5 times coverage (Rating 4)
- Good over 2.5 to 3.5 times coverage (Rating 3)
- Sound 1.5 to 2.5 times coverage (Rating 2)
- Needs further review 1.5 or less coverage (Rating 1)

Population Growth

This measure gives further context about the expected population growth in each council's region. It can be useful as an approximation of expected ability to generate more rates to repay future or current borrowings, or in future analysis when compared to the ten year plan forecasts of debt and income.

- Positive Growth (Rating 3)
- Static Growth (Rating 2)
- Declining Growth (Rating 1)

It is important to note the population forecasts are based on the 2007 Census. The projections from the most recent Census should be available later in 2014.

Please Note

When using the data in this report and analysis please consider

- This report and rankings should not replace an in-depth review of each individual council for financial stability but is designed to be a proxy of financial strength.

- The assumptions detailed in this report.

- The lack of uniformity in the way some financial information is presented in council financial statements has given rise to judgement calls in gathering and analysing the underlying data

- The fact that infrastructure investment has lifecycle characteristics. Some councils in the analysis will have recently made major infrastructure investments resulting in higher than average debt levels. Other councils may yet to make those investments because their infrastructure is at a different lifecycle stage. Consequently they may have low debt.

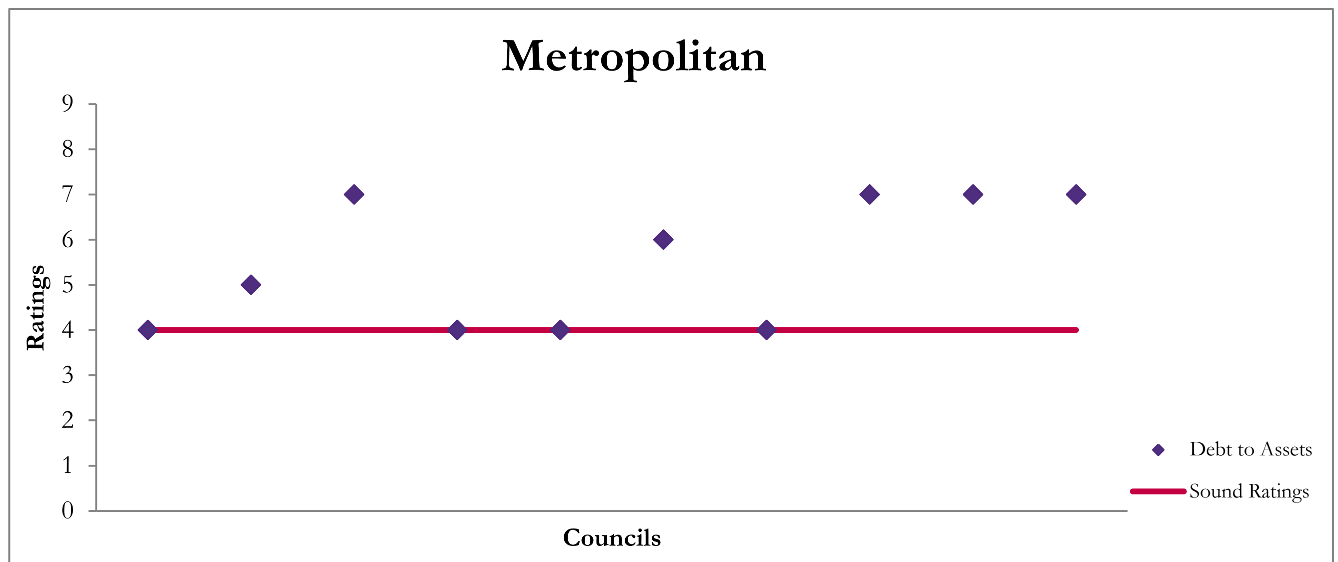
Results by Metric Category

Debt to Assets

Measuring council debt in relation to council assets, both total and non-restricted assets, gives an indication of financial strength and risk relating to a council's overall debt relative to its asset base.

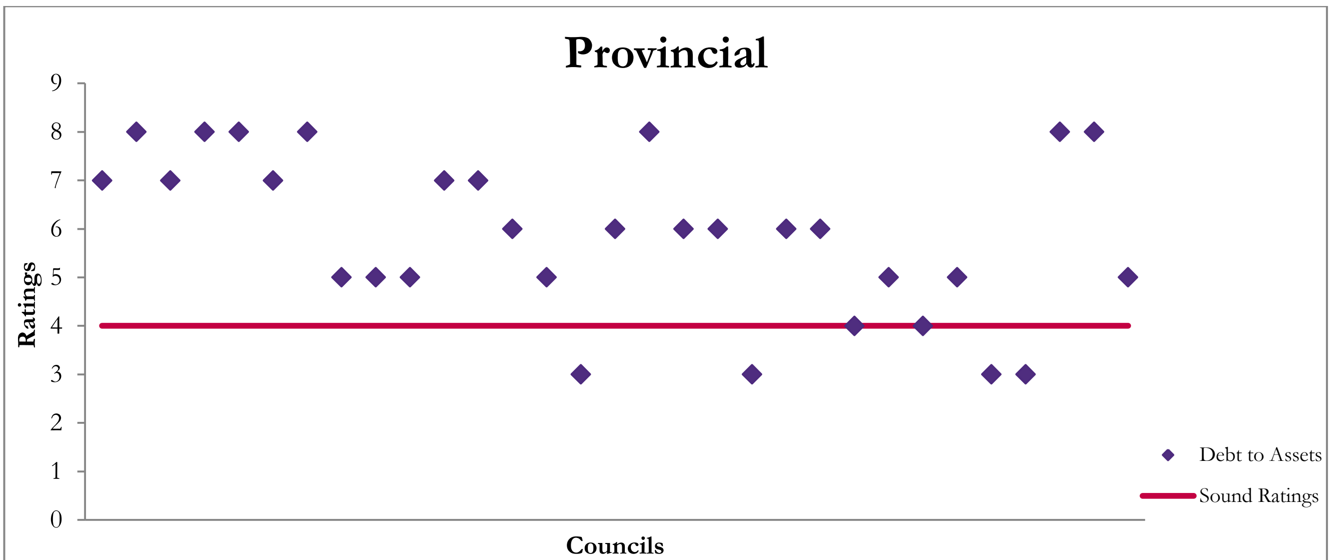
Using a percentage measure removes the misleading absolute values, that is, if a lay person saw a debt of a billion dollars it may seem very high, but it is not if the underlying asset base is 10 billion dollars.

If a council has a lower level of debt it could indicate it has scope to borrow more to replace infrastructure (subject to the ability to service debt repayments). A council with a higher level of debt may need to be more careful that its future income streams can manage the additional costs unless it is creating assets whose value is growing.



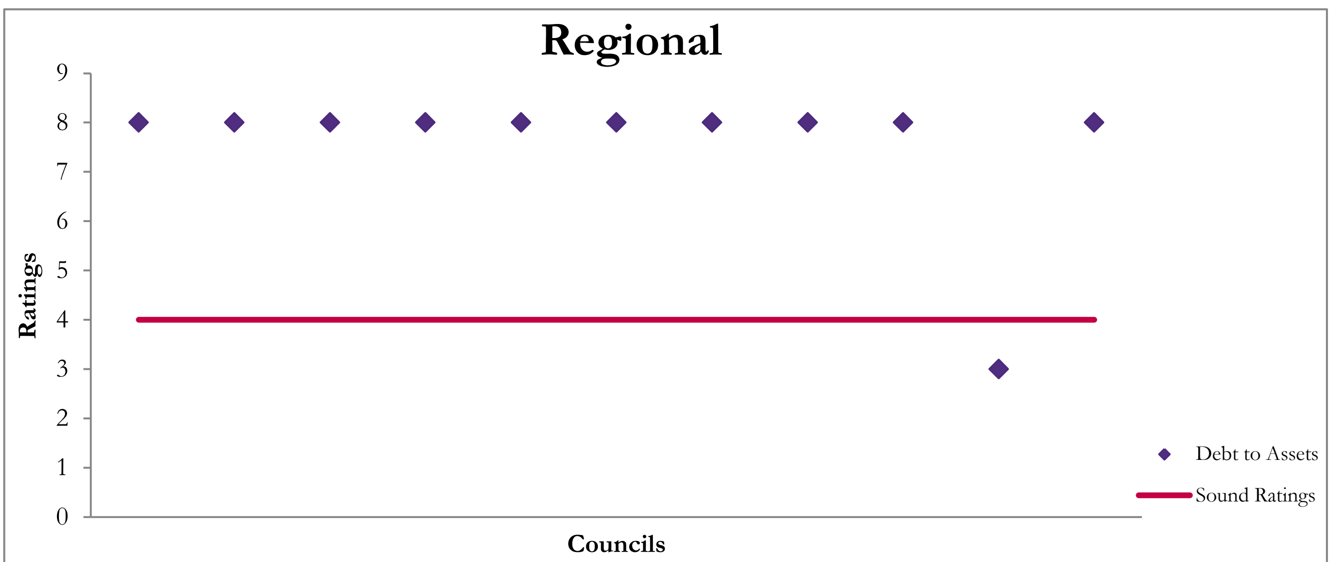
Comment

Metropolitan councils provide a wide range of complex urban infrastructures. The relationship between debt and the level of assets can be affected by high population growth, where a council is required to borrow to put infrastructure in place for future generations, or by the need to undertake major renewal programmes, especially where infrastructure is nearing the end of its useful life.



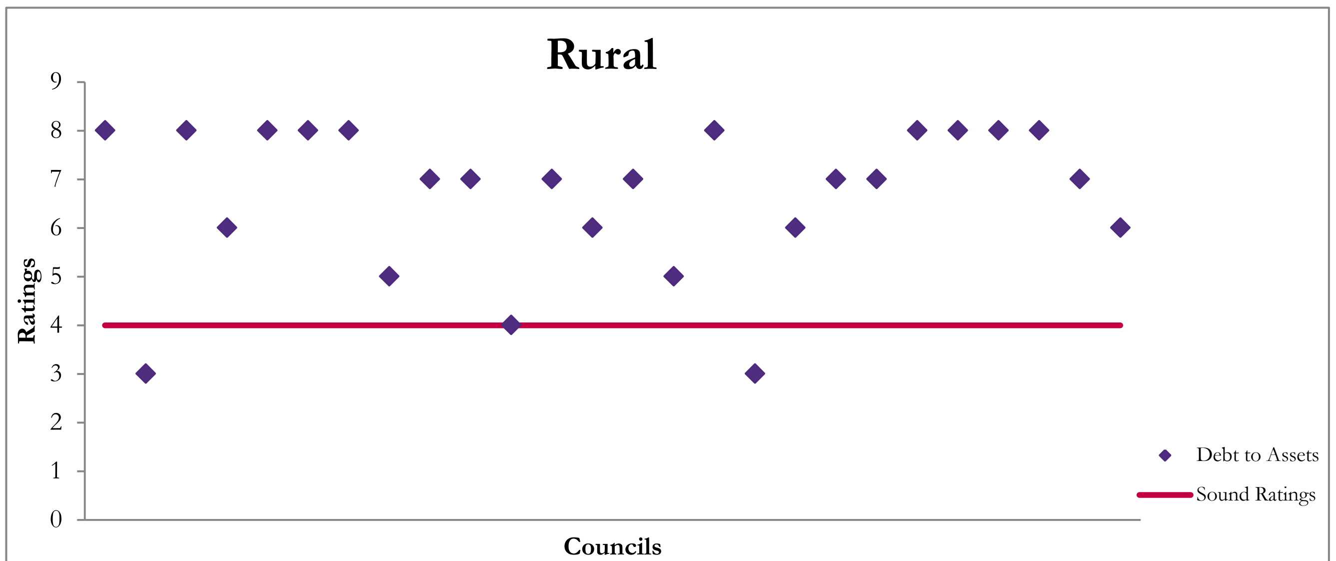
Comment

Provincial councils, those with populations between 20,000 and 90,000, face similar issues as metropolitan councils with the debt to asset figure a reflection of the cost of borrowing to build infrastructure for future generations or the cost of existing infrastructure renewals. Rotorua District, Kapiti Coast District, Western Bay of Plenty District and Taupo District each fall below the rating line for different reasons. Both Kapiti Coast and Western Bay of Plenty Districts face high growth pressures and borrowing reflects the cost of putting in place infrastructure for future residents. Taupo District has chosen a financial strategy which has higher levels of debt while at the same time maintaining a large investment fund. Rotorua District has been facing major infrastructure renewal demands with a relatively static population.



Comment

Generally regional councils have low levels of debt as their asset bases are small when compared to territorial authorities. The exception is Wellington Regional Council which has significant investments in bulk water infrastructure and public transport. The council is investing to meet the needs of growing populations in the Wellington region as well as building resilience to deal with extreme climatic events.



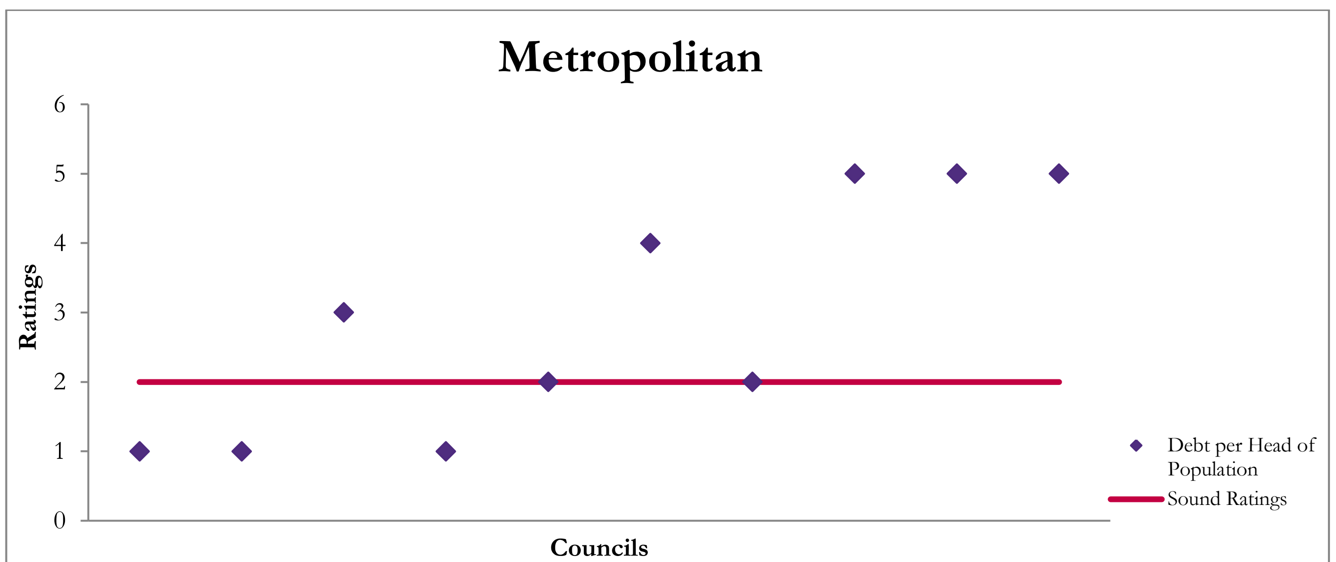
Comment

Rural councils tend to use debt to invest in infrastructure for towns and communities. Kaipara and Waitomo District Councils have higher levels of debt in relation to assets and have adopted strategies for addressing this imbalance over the life of their long term plans.

Debt per Head of Population

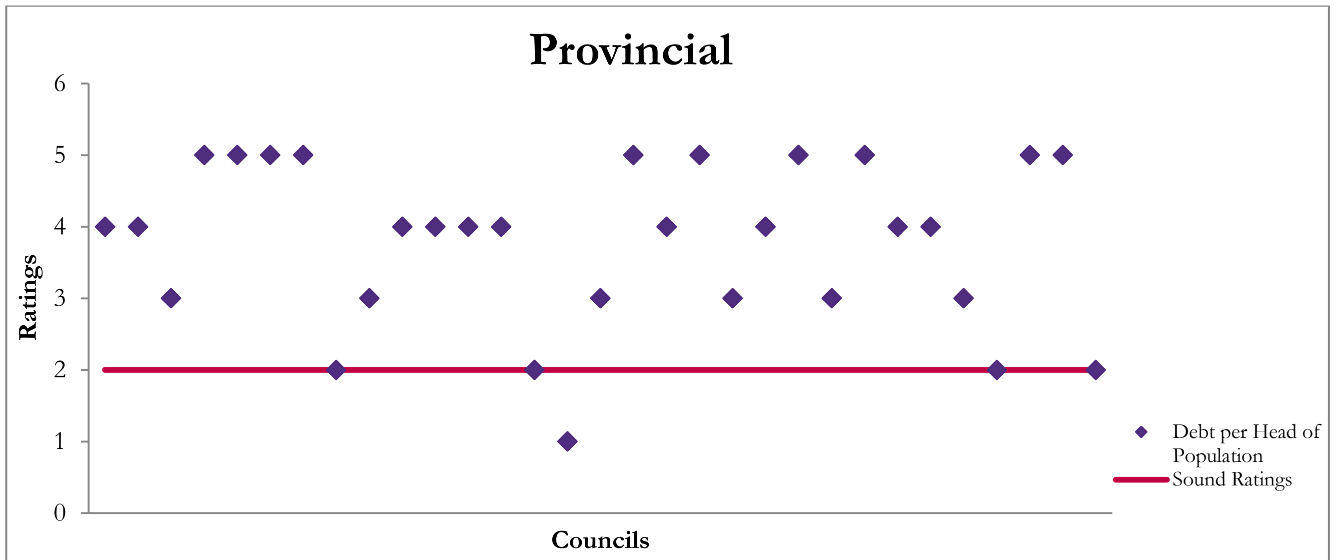
To allow comparison between councils over time, this metric measures the debt carry per population head. Population rather than ratepayer is used as this is a measure of other items that affect council income not just rates, such as growth of local businesses, rental properties, and other council services.

A larger population should be more able to service more debt. This will be a useful metric to measure council debt over time.



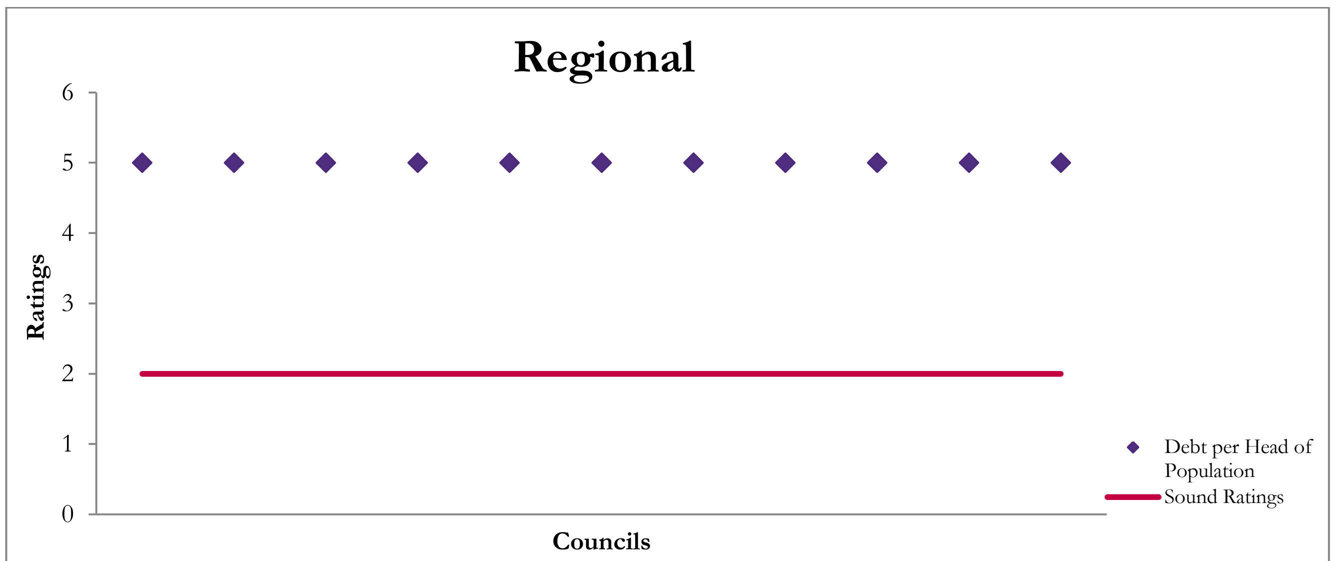
Comment

The three councils that are narrowly below the rating line on this metric are Christchurch City Council, due to the effect of the earthquake re-investment programme; Auckland Council, due to infrastructure investment, and Dunedin City Council, which has been investing in infrastructure renewal and amenity development.



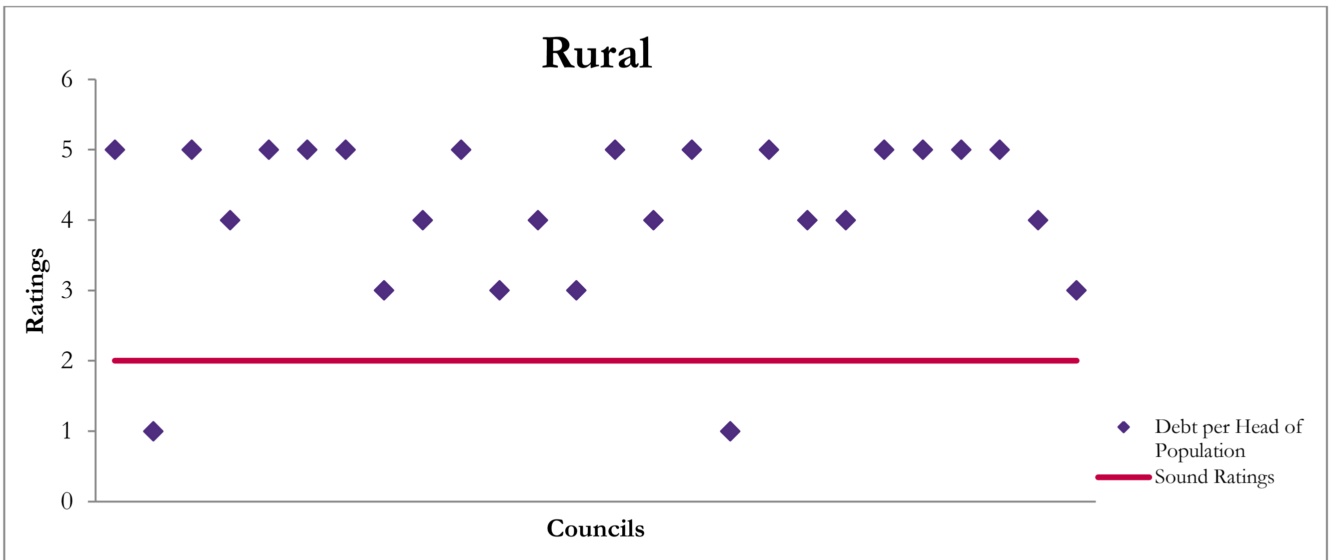
Comment

Provincial councils have a sound ranking in relation to debt carry per head of population. Taupo District Council sits below the line as the measure uses "gross" rather than "net" debt. Taupo District Council's financial strategy involves a combination of high debt and high equity, through its investment fund.



Comment

Regional councils tend to have low levels of debt per capita due to the nature of the services they provide, which generally don't have a large asset component.



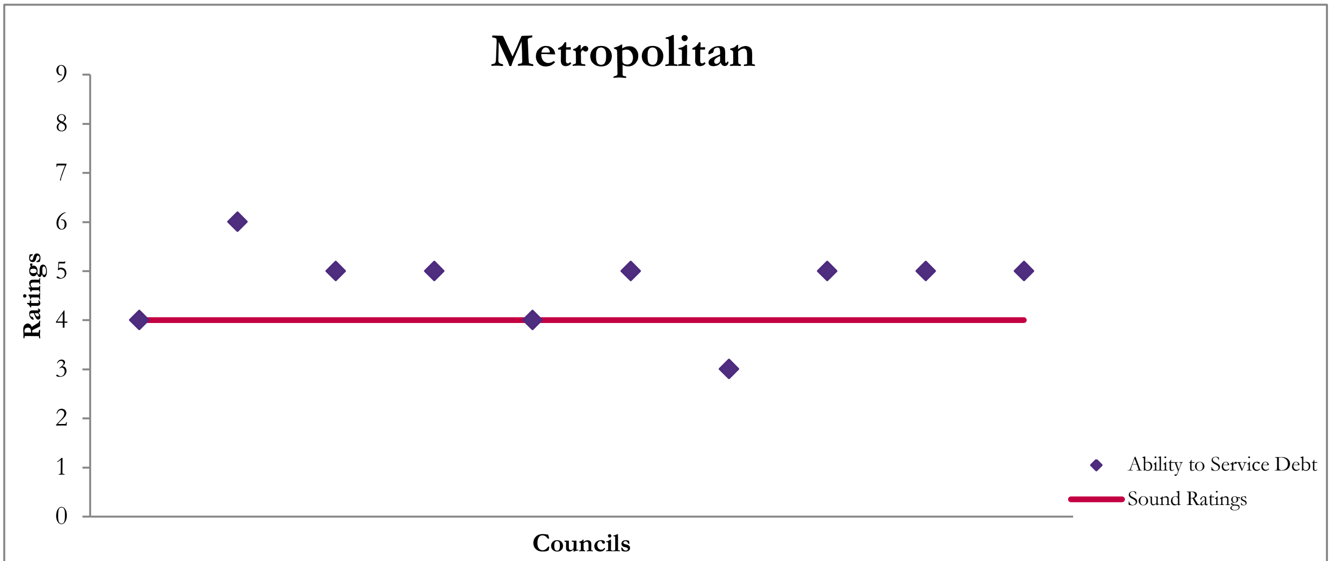
Comment

Many rural councils have little or no debt, often a reflection of the rate of population growth pressures and therefore lack of any inter-generational reasons for borrowing. In some cases it reflects a conscious policy of financing policy to build up funds in advance of capital investments. Kaipara and Waitomo District Councils tend to have higher per capita debt than their peers, as noted in previous commentary.

Ability to service debt

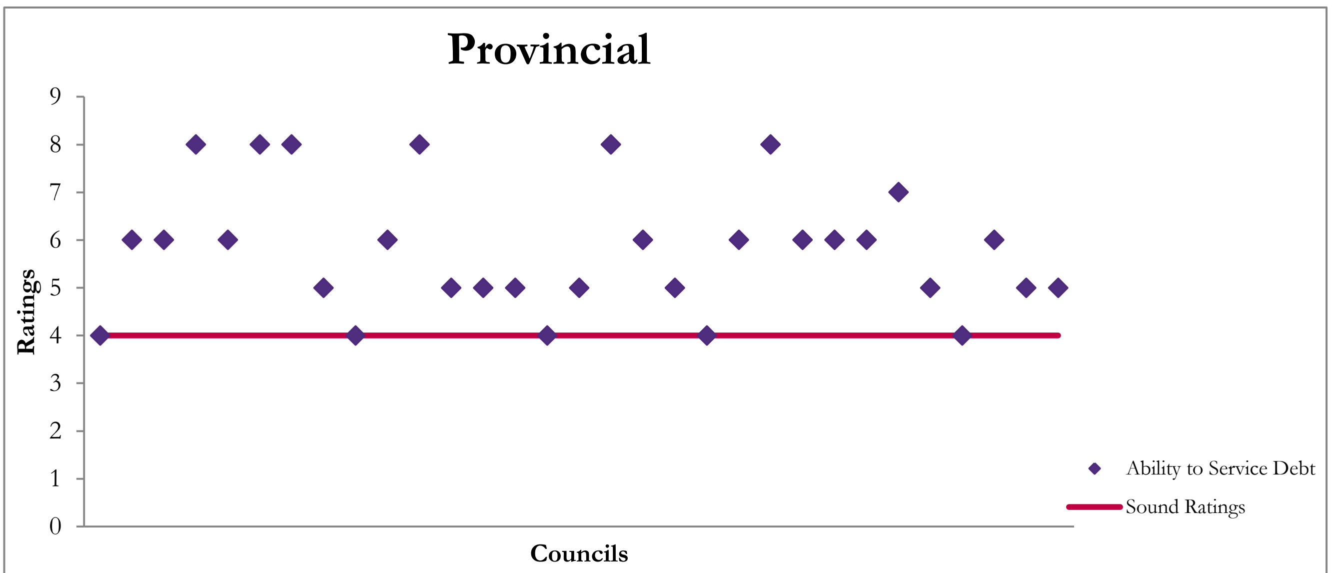
This metric measures a council's ability to service both its debt principal and interest costs. The metric uses an equivalent of operating cash produced, so takes into account those councils with significant operating revenues other than rates and can take into account the different levels of operating costs and obligations between councils.

The more times the cash equivalent can cover debt obligations, the better.



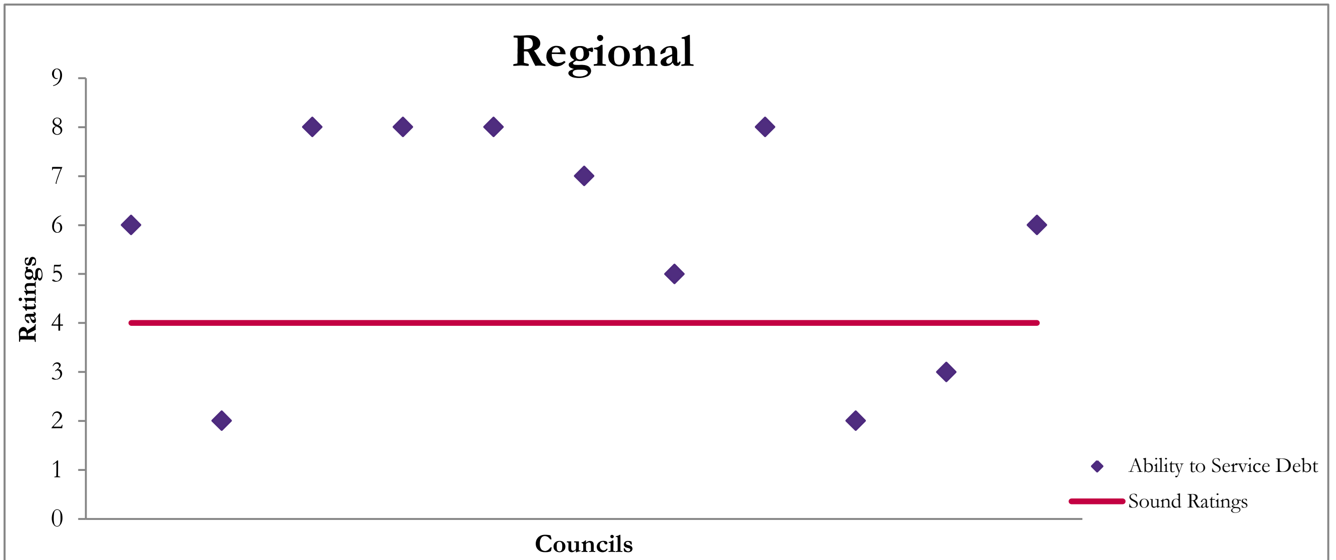
Comment

Metropolitan councils show a sound ability to service the cost of debt. In this metric Tauranga is the only council which is below the rating line. This is due to the financial strategy adopted by the council which is to fund a major portion of its growth-related infrastructure through development contribution income, which ensures that costs created by future generations are largely met by those generations. As noted in the methodology the criteria employed in this assessment do not take development contribution income into account. If it was to be taken into account Tauranga City Council would be well above the line.



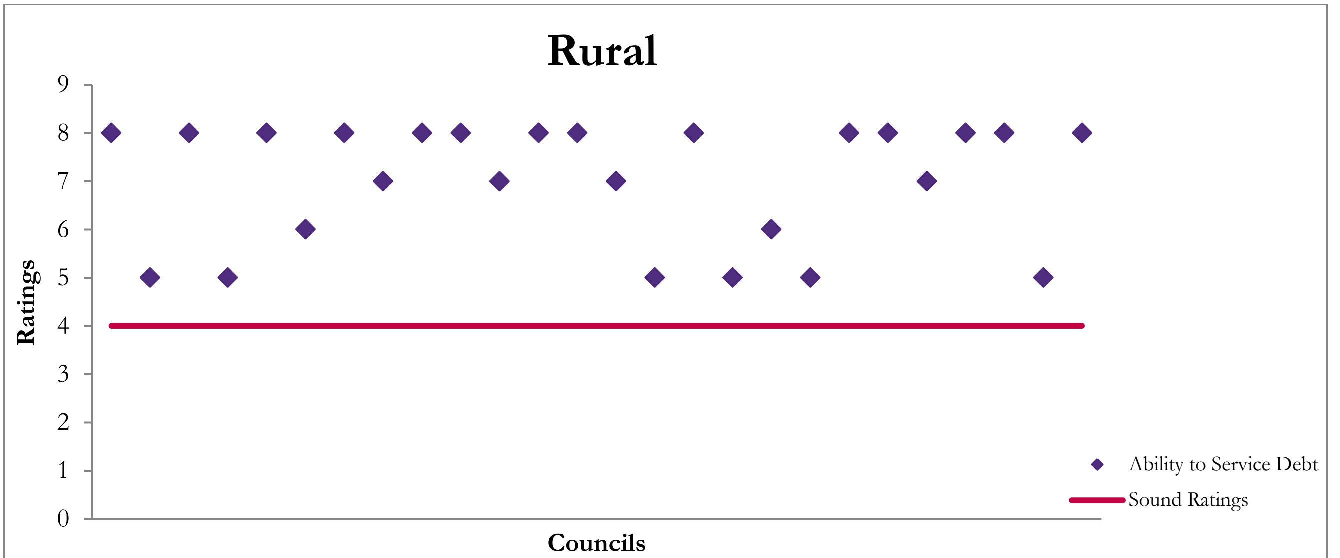
Comment

With regard to their ability to service debt all provincial councils are either Sound or very Sound.



Comment

Within the framework some regional councils, namely Wellington, Southland and Hawkes Bay, sit below the rating line. This reflects the fact that much of their income is received from their shareholdings in local port companies and other investments, rather than property rates. This form of income is not taken into account in the methodology and thus is not included in the assessment. If it was included the councils would sit well above the line.



Comment

In terms of their ability to service the cost of debt all rural councils are Sound.

Grant Thornton

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