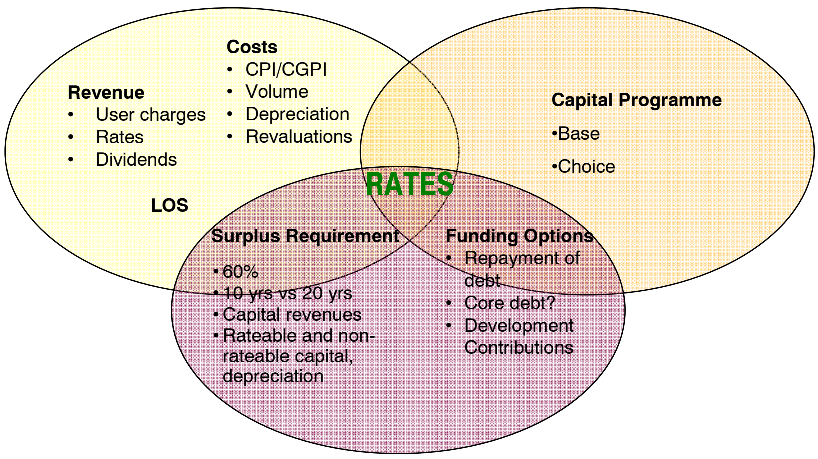
Financial Issues

Agenda:

- Inflation
- Finance Policy
  - → Surplus calculation
  - → Capital calculation
- Income Equalisation Reserve
- New Planning Model
  - → Base case
- Debt Period
- Development Contributions



Operating Surpluses

The Long Term Financial Strategy, adopted in July 2001, made provision for operating surpluses. These surpluses were increased to fund additional capital expenditure and repay debt. A formula was established which ensures that the funds generated from a combination of depreciation (less funds appropriated back to reserves and separate accounts) plus the balance of the operating surplus (in excess of the debt repayment provision) is sufficient to fund 56% of the average annual forecast capital expenditure over the next 20-year period. This funding percentage increases from 57% in 2003/04 to 66% by 2011/12.

Quote from 2004/05 Draft Annual Plan

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Capital Expenditure Financing

as per 2004/14 LTCCP

Capital expenditure, including "term" investments and debt repayment, will continue to be financed as in the past and disclosed in the Financial Summary of the Annual Plan. The financing sources to be used are:

- Depreciation funds and retained surpluses including capital revenues.
- Sale of assets.
- Special funds set aside for capital expenditure; and finally
- Borrowing.

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The financial management principles of the Council mandate several key elements of capital expenditure financial management. They are a continuation of past policies, and include:

- Debt will be repaid within 20 years of raising to ensure inter-generational equity.
- At least 59% of average annual capital expenditure will be funded from depreciation and operating surpluses.
- The balance of capital expenditure will be funded from reserves, sale of assets and lastly, loans.
- Operating expenditure will be funded from operating revenue.
- The Council will budget for an operating surplus each year which will be used in part to repay debt.
- Financial management will be based on maintaining projections within the five financial ratios, and on ensuring the Council continues to receive at least an AA credit rating from Standard and Poor.

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Current Policy Intent

- Ensure an adequate surplus was budgeted for that would ensure rates contributed to capital expenditure and repayment of debt.
- Rate for depreciation.
- Try and smooth the impact on rates of the capital programme (avg capex approach).
- Manage debt (20 year period and ratios).
- Phase in the approach (56% to 66%).

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Surplus

	2005/06 $M	
OPERATING SUMMARY		
Operating Expenditure	242.62	
Depreciation	67.70	
Interest Expense	5.91	
Total Operating Expenditure	316.23	
Ordinary Revenues	(82.93)	
Grants & Subsidies	(23.14)	
Interest & Dividends from CCHL	(30.00)	
Interest Received	(18.82)	
Rates	(174.21)	BALANCING FIGURE
	(329.09)	
Operating Surplus	(12.86)	CALCULATED FIGURE
Adjustments	5.68	
Operating Surplus/Contribution to Capital Pr	(7.18)	
Percentage Rate Increase	**3.49%**	

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Capital Programme Funding

- 60% Capital Programme (funded from depreciation and rates)
- 40% = Balance
  - Less Capital Contributions
  - Less Reserves Transfers
  - Less DRR (choice)
  - ➔ Borrowings

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Surplus must contain:

- Non-rated activity results, e.g. housing / dogs
- Capital revenues, e.g. LTNZ
- Development contributions
- Non-rated income, eg special dividend
- Vested assets
- Rates requirement from capital funding (60% - depreciation)
- Loan repayment provision (3% → 1.4%)
- Interest not available for rates, e.g. CEF inflation protection, special funds.

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Impact of Policy

- Average approach meant any project in the 10 year period would result in an increase in year 1 regardless – intergenerational issue??
- Moving from 56% to 66%, ie 1% increase each year meant a .6% (increasing to .7%) increase in rates year upon year.

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Issues with Application of Policy

- 20 years possible but in reality not practical – only use was to measure ratios for years 10 – 20.
- Average was a calculated figure – average of first 10 years was used as the actual numbers for years 11 – 20.
- Big projects treated differently.
- Policy is very general in nature and it is open to a number of interpretations.
- It appears simple, but there are complex components within it requiring judgement.

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		roll notes	Year 1 2004/2005 2004/05	Year 2 2005/2006 2005/06	Year 3 2006/2007 2006/07
Revised set out adjusted option	**NEW SURPLUS FORMULA BASED ON CAPITAL SPEND AVERAGE**				
	Inflation Year Index (Used in Cumulative Inflation Calc)		0	1	2
	Net Capital Works Programme		128,718,394	117,887,804	143,921,843
	Less Large Capital Items		9,671,030	5,214,590	-27,854,840
	Less Large Capital Items (Years 11-20 impact)				
	Less Transfund on Capital		-8,482,113	-10,421,181	-10,548,934
	Less Landfill Aftercare Capital - (To be Rate Funded)(Remove from Ave c		-178,019	-367,000	-367,000
	Less Landfill Aftercare Capital - Seperately Funded		-1,258,000	-1,145,000	-1,145,000
	Less Separate Account Capital Programme		-5,016,500	-1,667,400	-1,669,600
	Less Operating Revenue for Capital		-846,000	-846,000	-846,000
	Less Capital Reprogrammed (6 month review and year end provision)		-35,383,955		
	Sub Total - To be averaged over 20 Years		87,224,837	108,655,813	101,490,469
calculation	Capital Programme 20 year average		92,872,871	92,872,871	92,872,871
	Plus Inflation Provision		0	1,857,457	3,752,064
	Sub Total - Total 20 Year Averaged programme		92,872,871	94,730,329	96,624,935
	Percentage of Average to apply to the surplus	rolled forward	59.0%	60.0%	61.0%
	Sub Total - Capital average		**54,794,994**	**56,838,197**	**58,941,211**
	Plus Large Capital Items Average (Seperately calculated)		-866,852	-1,132,796	316,213
	Total - Capital average Component (to be funded)		**53,928,143**	**55,705,402**	**59,257,424**
	Plus Debt Repayment in Full		4,681,080	4,687,980	4,701,480
	Less Depreciation (Does not include Separate A/C Depn)		-62,973,421	-66,610,009	-69,725,373
	Plus Revenue not for rates (Includes Housing Depn)		4,951,538	2,169,156	1,357,316
	Plus CCHL Dividend (Special) not for rates		0	0	15,000,000
	Plus Transfund Subsidy-re City Streets Capital Programme		8,482,113	10,421,181	10,548,934
	Plus Operating Revenue for Capital (Capital Revenue)		846,000	846,000	846,000
	Plus Capital Item - Landfill Aftercare - (To be rate funded)		178,019	367,000	367,000
	Plus Capital ex Landfill Aftercare Special Fund (Add back to mitigate surp		1,258,000	1,145,000	1,145,000
	Sub Total - Natural Calculation		**11,351,472**	**8,731,710**	**23,497,780**
	Surplus Adjustment (Waste Minimisation Adjustments)	rolled forward			
	Surplus Adjustment (Error Contingency)		75,000	75,000	75,000
	Surplus Adjustment (Transfund Fluctuation Contingency)		400,000	400,000	400,000
	Surplus Adjustment (legit changes)		0		
	Surplus Adjustment (transition usually)	rolled forward	4,424,424	0	
	Calculated Surplus		**16,250,896**	**9,206,710**	**23,972,780**
	Calculated Surplus (Convert to a Credit)		**-16,250,896**	**-9,206,710**	**-23,972,780**
	Override of $0 if Surplus is in Debit		**-16,250,896**	**-9,206,710**	**-23,972,780**

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Income Equalization Reserve

- This reserve is build up from “extra surpluses”.
- It has been used as a tool to smooth rates.
- Solves short-term issues but can hide issues and eventually will be used up.

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Use of IER

As part of the 04/14 LTCCP, $28m was spread over 04/05 to 06/07.

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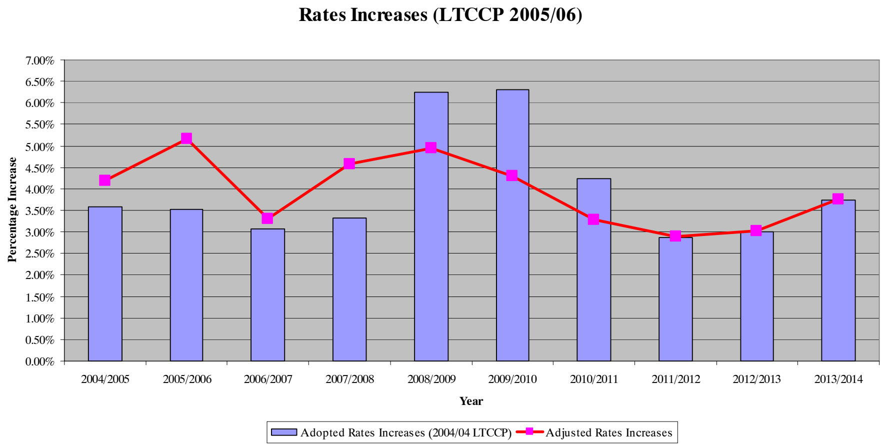

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Suggested Guidelines for IER

- As IER reflects extra surpluses which one could argue means the rates were too high, then any extra surplus should be applied against rates for the subsequent year.
- As there will be years when we fail to achieve our budgeted surplus, it would be unwise to fully apply positive years' surpluses.
- A logical approach is to look at 50% being applied to rate reductions with the balance going to reserves to be available to cover the years that the surplus was not achieved.

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Suggested Guidelines for IER (cont…)

- To ensure that the reserves do not build up to excessive levels, it would be prudent to “cap” the amount at say $10m.
- For the above to work we would need to be able to forecast our year end position around Feb. to incorporate into an annual plan/LTCCP.
- The 50% level would provide a buffer to our forecast being significantly out.
- You need to note that as we get better at our budgeting, the amounts of “extra surplus” will lessen considerably.

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New Planning Tool BPS

Our old financial model was based upon a spreadsheet developed 10 years ago. This:

- Had become extremely complex as it has been modified over the years.
- Is NOT well understood.
- Had many interdependencies
- Had started to produce results that were contrary to our expectations.

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- In designing BPS we went back to basics and have looked at what the intent was and what is sound accounting practice.
- We believe it CRITICAL that our process is as transparent as possible.
- Currently the Surplus calculation is managed outside the system.

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Basis for Current LTCCP

Our current 15.7% increase is based upon:

1. No average capital approach.
2. Ensuring the surplus provides for any loan repayments.
3. Depreciation does not subsidise rates.
4. Debt levels are identified and managed but the model only covers 10 years.
5. Full transparency.

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Base Case

	2008	2009	2010
Rates increase	.82%	5.4%	6.75%
Interest Expense (capex)	5.7m	10.9m	13.2m
Rate impact approx.	2.1%	3%	1.4%
IEF Drawdown	7.5m	5.7m	2m
Rate impact	-1.6%	1%	2.1%

Capital Changes Impact

	2007	2008	2009	2010
Scenario - push $20m capex out 2 years				
Change in rate funded Capex	-20m	+/-20m	+20m	0
Opex Change effects				
Change in interest expense @ 6.85%	-575,400	-1,370,000	-794,600	0
Change in Depn @ 4%	-400,000	-800,000	-400,000	0
Change in Loan Repayment Reserve @ 3%		-600,000	-600,000	0
Total Opex Rating change	-975,400	-2,770,000	-1,794,600	0
Change % based on $1.75m = 1%	-0.56%	-1.58%	-1.03%	0.00%
Year on year change	-0.56%	-1.03%	0.56%	1.03%

What this says is if you delay $20m you will get a 0.5% rate saving in year 1 and a further 1% saving in year 2.
$20m reduction = total saving of 1.5% which equates to the $12.5m = 1%.
The above is reversed when the $20m is added back in in 2009, 0.5% increase in 2009 and a further 1% in 2010.

Basis for Current LTCCP (cont…)

- The result is that this move WILL provide a robust and solid methodology to manage the Council 10 year LTCCP finances that has a better outcome over a ten year period.
- What it does however produce, is a one time financial adjustment to address the "adjustments" made in recent years that have resulted in the current policy limitations.

Way Forward

As the approach is a change in policy, the adjustment required can be:

- Fully absorbed in 06/07
- Phased in over 3 years
- Fully implemented for 06/07 but the impact spread over 3 years by utilising funds from the IER that accrued in 04/05.

Modelled option to utilise $19m IEF over 3 years (10/5/4). Note impacts on rates over years 1-4.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Percentage Rate Increase	15.72%	0.82%	5.40%	6.75%	0.20%	0.15%	-0.77%	-0.35%	-1.14%	-2.42%
Capex (excl vested)	191,351,951	207,153,248	165,896,709	124,534,439	129,438,795	126,450,065	138,306,220	129,654,136	116,264,674	119,510,889
Interest Revenue	-21,242,295	-18,899,530	-19,163,424	-19,830,906	-20,998,144	-22,178,113	-23,449,131	-24,615,573	-25,890,308	-27,404,913
Interest Expense	6,747,682	10,299,420	15,311,192	17,598,624	18,733,778	19,589,937	20,494,208	21,346,073	21,427,011	21,131,139
Borrowing	-44,074,113	-94,235,296	-47,913,008	-14,329,695	-17,556,471	-10,762,358	-22,291,946	-11,499,246	-750,000	-590,586
Accumulated Borrowing	-44,074,113	-138,309,409	-186,222,417	-200,552,112	-218,108,583	-228,870,941	-251,162,887	-262,662,133	-263,412,133	-264,002,719

Smoothing using IER $19m over 3 Years (10/5/4m)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Percentage Rate Increase	10.27%	3.64%	6.13%	8.68%	0.20%	0.15%	-0.77%	-0.35%	-1.13%	-2.40%
Capex (excl vested)	191,351,951	207,153,248	165,896,709	124,534,439	129,438,795	126,450,065	138,306,220	129,654,136	116,264,674	119,510,889
Interest Revenue	-20,902,295	-18,049,530	-18,007,424	-18,538,906	-19,706,144	-20,886,113	-22,157,131	-23,323,573	-24,598,308	-26,112,913
Interest Expense	6,747,682	10,299,420	15,311,192	17,598,624	18,733,778	19,589,937	20,494,208	21,346,073	21,427,011	21,131,139
Borrowing	-44,074,113	-94,235,296	-47,913,008	-14,329,695	-17,556,471	-10,762,358	-22,291,946	-11,499,246	-750,000	-590,586
Accumulated Borrowing	-44,074,113	-138,309,409	-186,222,417	-200,552,112	-218,108,583	-228,870,941	-251,162,887	-262,662,133	-263,412,133	-264,002,719

Change

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Operating Surplus	10,000,000	5,000,000	4,000,000	0	0	0	0	0	0	0
Rates required	9,660,000	4,150,000	2,844,000	-1,292,000	-1,292,000	-1,292,000	-1,292,000	-1,292,000	-1,292,000	-1,292,000
Adjusted Rate Base for Growth	0	0	0	0	0	0	0	0	0	0
Percentage Rate Increase	-5.45%	2.82%	0.73%	1.93%	0.00%	0.00%	0.00%	0.00%	0.01%	0.01%
Cumulative Rate Increases	-5.45%	-2.30%	-1.55%	0.69%	0.68%	0.67%	0.66%	0.65%	0.64%	0.63%
Capex (excl vested)	0	0	0	0	0	0	0	0	0	0
Interest Revenue	340,000	850,000	1,156,000	1,292,000	1,292,000	1,292,000	1,292,000	1,292,000	1,292,000	1,292,000
Interest Expense	0	0	0	0	0	0	0	0	0	0
Borrowing	0	0	0	0	0	0	0	0	0	0

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Debt Period

- Currently the policy is that debt will be repaid within 20 years of raising to ensure intergenerational equity.
- This sees us creating a “reserve” by charging rates 3% of the debt total.
- 3% over 20 years will provide for the full repayment because of the interest earned on the put aside funds.

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Debt Period (continued...)

- The Audit & Risk Committee recently reviewed and approved for referral to Council the liability management policy. This forms part of the LTCCP financial policies.
- This policy included a change in term of debt from 20 years to 30 years.
- This equates to a charge against rates of 1.4% compared to the 3% previous.
- The impacts are shown on the next slide. Please note this change is not yet incorporated into the financials we have been reviewing this week.

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- In considering the length of period of debt, one must consider the asset base it is covering. We have a mixture of asset lives ranging from three years (PCs etc.), to 80 years for pipes, to hundred's of years for land.
- As we DO NOT raise debt against specific assets, ie we manage our total portfolio, we reviewed the mix of our asset lives excluding land and believe that anything beyond 30 years is not logical or sound financial management.

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Development Contributions

Indicative Only

2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
9,591	11,083	12,681	17,051	19,182	19,527	19,556	19,584	19,642	19,699

10 year total $168 million

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Base with DCs (Indicative)

		Year 1 **2006/07**	Year 2 **2007/08**	Year 3 **2008/09**	Year 4 **2009/10**	Year 5 **2010/11**	Year 6 **2011/12**	Year 7 **2012/13**	Year 8 **2013/14**	Year 9 **2014/15**	Year 10 **2015/16**
Increase in Development Contributions											
DC Projection 10/2/06 (excl Reserves)		12,788,530	13,854,241	14,919,952	17,051,374	19,182,796	19,527,352	19,556,065	19,584,778	19,642,204	19,699,630
Reduced rate first 3 years (75/80/85%)		9,591,398	11,083,393	12,681,959	17,051,374	19,182,796	19,527,352	19,556,065	19,584,778	19,642,204	19,699,630
Less existing capital revenues (excl Reserves)		3,137,500	3,065,000	3,040,000	3,040,000	3,040,000	3,040,000	3040000	3040000	3040000	3040000
Increase		6,453,898	8,018,393	9,641,959	14,011,374	16,142,796	16,487,352	16,516,065	16,544,778	16,602,204	16,659,630
Borrowing Impact											
Capex	No change										
Less Capital Revenues		-6,453,898	-8,018,393	-9,641,959	-14,011,374	-16,142,796	-16,487,352	-16,516,065	-16,544,778	-16,602,204	-16,659,630
Less Depreciation rated for	No change	0	0	0	0	0	0	0	0	0	0
Amount to Borrow		-6,453,898	-8,018,393	-9,641,959	-14,011,374	-16,142,796	-16,487,352	-16,516,065	-16,544,778	-16,602,204	-16,659,630
Rating Impact											
Interest Expense		-185,679	-672,781	-1,268,751	-2,054,933	-3,076,033	-4,191,728	-5,321,938	-6,454,114	-7,589,084	-8,727,987
Depreciation @ 4%	No change	0	0	0	0	0	0	0	0	0	0
Loan Repayment 3%		0	-193,617	-434,169	-723,427	-1,143,769	-1,628,053	-2,122,673	-2,618,155	-3,114,498	-3,612,565
Rates required		-185,679	-866,398	-1,702,920	-2,778,361	-4,219,802	-5,819,780	-7,444,611	-9,072,269	-10,703,582	-12,340,551
Percentage Rate Increase		-0.10%	-0.38%	-0.46%	-0.58%	-0.76%	-0.83%	-0.83%	-0.82%	-0.81%	-0.80%
Cumulative Rate Increase		-0.10%	-0.48%	-0.94%	-1.52%	-2.28%	-3.11%	-3.94%	-4.76%	-5.58%	-6.38%

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MCTS Change from $85m to $160m

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	Total
Based on fully rating for depreciation											
Capex	429,156	1,341,255	1,424,856	10,813,528	10,008,435	10,941,314	9,443,077	9,761,857	10,441,289	10,125,980	74,730,748
Less LTNZ Revenues	-224,477	-152,465	-331,564	-4,884,230	-3,894,311	-3,074,719	-3,884,029	-6,805,985	-6,023,745	-4,158,215	-33,433,739
Less Development Contributions	-400	-15,336	-10,120	-325,200	-276,795	-323,614	-242,405	-254,663	-309,600	-240,000	-1,998,133
Less Depreciation rated for	-4,322	-35,641	-77,846	-268,509	-603,619	-980,303	-1,392,486	-1,787,441	-2,176,835	-2,557,648	-9,884,649
Amount to Borrow	**199,958**	**1,137,813**	**1,005,326**	**5,335,589**	**5,233,711**	**6,562,678**	**3,924,157**	**913,768**	**1,931,109**	**3,170,118**	**29,414,227**
Rating Impact											
Interest Expense 6.85%	5,753	46,432	120,561	314,007	676,564	1,073,307	1,446,941	1,629,137	1,720,999	1,888,926	8,922,625
Depreciation	4,322	35,641	77,846	268,509	603,619	980,303	1,392,486	1,787,441	2,176,835	2,557,648	9,884,649
Loan Repayment 3%	0	5,999	40,133	70,293	230,361	387,372	584,252	701,977	729,390	787,323	3,537,100
Rates required	**10,074**	**88,072**	**238,540**	**652,809**	**1,510,543**	**2,440,983**	**3,423,679**	**4,118,555**	**4,627,223**	**5,233,897**	**22,344,374**
Percentage Rate Increase	0.01%	0.04%	0.08%	0.22%	0.45%	0.48%	0.50%	0.35%	0.25%	0.30%	
Cumulative Rate Increase	0.01%	0.05%	0.13%	0.35%	0.81%	1.29%	1.79%	2.15%	2.40%	2.69%	

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