SOUTHLAND DISTRICT COUNCIL

Proposal to Join the Local Government Funding Agency Scheme

What is being proposed?

Southland District Council proposes to join the Local Government Funding Agency Ltd (LGFA) scheme as a Guaranteeing Local Authority.

Why is this being proposed?

The motivation behind this proposal is cost savings. Council considers that participating in the LGFA scheme provides an opportunity to borrow at lower interest margins, and that this benefit outweighs any costs and risks associated with the LGFA scheme. Through joining the scheme as a Guaranteeing Local Authority, the Council anticipates interest savings of $10,000 or 1% for every $1 million of debt. At our peak debt levels forecast by the 2018 Long Term Plan this will equal approximately $160,000 each year.

What is the LGFA?

The LGFA is a council-controlled trading organisation established by a group of local authorities and the Crown. It is designed to allow local authorities to borrow at more favourable interest rates. All local authorities can borrow from the LGFA, but different benefits apply depending on the level of participation. Southland District Council is proposing to join as a Guaranteeing Local Authority.

What is a Guaranteeing Local Authority?

A Guaranteeing Local Authority receives more favourable borrowing rates and in return guarantees the obligations of the LGFA. This guarantee becomes a contingent liability on the Council. The guarantee is limited to Council's rates income as a percentage of the total rates income of all the guaranteeing councils. It is estimated that the Southland District Council's share of the guarantee would be 0.73%. This means that if a $100 million call was made under the guarantee, the Southland District Council would contribute $730,000. This figure will change over time as the percentage of total rates income changes.

Currently there are 59 councils who have signed the joint and several guarantee. Council has assessed the likelihood of a:

- Council defaulting on its loans
- Loss on the loans even if a council does default; and
- Call on guarantors

and consider that all three factors have a very low probability.

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Te Rohe Pōtae o Murihiku
PO Box 903
15 Forth Street
Invercargill 9840
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Why is the Council consulting?

Although Council is not proposing to acquire shares in the LGFA, borrowing under the LGFA scheme will require it to acquire some capital notes issued by the LGFA that could, in some circumstances, be converted into shares in the LGFA. The Local Government Act requires that Council can become a shareholder in a council-controlled organisation it must undertake consultation.

How do I have my say on this proposal?

To have your say on this proposal, you need to provide feedback to the Southland District Council by 5.00pm, Friday 26 February 2021. You can provide your feedback by completing a submission form at makeitstick.nz or writing to:

Submission – LGFA
Southland District Council
PO Box 903
Invercargill 9840
Or by emailing: sdc@southlanddc.govt.nz

Can I talk to the Council about this proposal?

If you would like to talk to Council regarding the proposal, there will be an opportunity to do so and Council will contact you to arrange a time. Please indicate in your feedback if you would like this opportunity.

Key points to note

Council's current approach to borrowing: Currently, Council only borrows externally when it has no cash in the bank.

Council currently borrows internally; which means it borrows cash to fund District or local capital projects and raises an internal loan using cash from its reserves. External loans are only be taken out if internal loans exceed cash funds held.

As at June 2020 Council had $39.7million of reserves and $35.3million of internal loans.

Council is looking to possibly move internal loans to external loans. It would invest the resulting cash, paying a return to reserves and offsetting rates. Council's Investment Policy would need to be reviewed.

No commitment to borrowing: Even if Council joins the LGFA, it is still free to undertake all, some or no borrowings from the LGFA in future.

How do I get further information?

To get further information on this proposal, view the full proposal on the Southland District Council's website www.southlanddc.govt.nz.

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Table of Contents

Introduction 5
Statutory Considerations 5
Reason for the proposal 6
Analysis of Options 6
Should Council participate in the LGFA Scheme as a borrower? 6
Should the Council participate in the LGFA Scheme as a Principal Shareholding Local Authority? 9
Should Council participate in the LGFA Scheme as a Guaranteeing Local Authority? 7
LGFA Guarantee 7
Likelihood of Council Default 7
Likelihood of a Loss on the Loans in event of Default 7
Likelihood of a Call on Guarantors 8
Governance of LGFA 8
Performance of Local Authority Financing Vehicles in other Countries 8
Standard and Poor's Assessment of risk to Council from the guarantee 8
Should the Council participate in the LGFA Scheme as a Non-Guaranteeing Local Authority? 9
Opportunity to Make Submissions 10

Introduction

The Southland District Council is considering participating in the New Zealand Local Government Funding Agency Ltd (LGFA) scheme. The LGFA is designed to allow local authorities to borrow at more favourable interest rates.

The LGFA is a council-controlled trading organisation (CCTO) established by a group of local authorities and the Crown. There are 31 shareholders, comprising the New Zealand Government (20%) and thirty councils (80%). The LGFA governance structure comprises the New Zealand Government and thirty councils, the LGFA Shareholders Council and the LGFA Board of Directors.

The LGFA Shareholders Council comprises of five to ten appointees from the Council Shareholders and the Crown.

The LGFA Board is responsible for the strategic direction and control of the LGFA's activities, and is led by an independent chair.

All local authorities are able to borrow from the LGFA. Different benefits apply depending on the level of participation. Most local authorities borrowing from LGFA enter into guarantees in favour of LGFA and other local authorities. However, this is not compulsory. A local authority can choose not to provide these guarantees, which means it will not have this contingent liability, but would only be able to borrow a limited amount ($20,000,000), and will be required to pay higher interest rate.

Council is proposing it will participate as a Guaranteeing Local Authority, one which guarantees the obligations of the LGFA.

Principal Shareholding Local Authorities are required to invest capital in the LGFA, and expect to receive a return on that capital; it is acknowledged that this may be less than might be achieved by alternative investments. This is because the overarching objective is that the benefits of the LGFA scheme are passed to Local Authorities as lower borrowing margins, rather than being passed to shareholders as maximised profits.

It is not proposed that Council be a Principal Shareholder at this stage.

Statutory Considerations

Section 56 of the Local Government Act 2002 (LGA 2002) requires that before a local authority may establish or become a shareholder in a council-controlled organisation, the local authority must undertake consultation in accordance with section 82 of the Local Government Act 2002. Although Council is not proposing to acquire shares in the LGFA, borrowing under the LGFA Scheme will require it to acquire some capital notes issued by the LGFA that could, in some circumstances be converted into shares in the LGFA.

Reason for the proposal

Council believes that participating in the LGFA Scheme provides an opportunity to borrow at lower interest margins, and that this benefit outweighs any costs and risks associated with the LGFA Scheme.

Council is proposing it will participate in the Local Government Funding Agency as a Guaranteeing Local Authority, one which guarantees the obligations of the LGFA.

Council is consulting on this proposal for the reasons set out above under "Statutory Considerations".

Analysis of Options

The options in regards to this proposal are as follows:

1. Participate in the LGFA scheme as a Guaranteeing Local Authority only
2. Participate in the LGFA scheme, as a Non-Guaranteeing Local Authority
3. Participate in the LGFA scheme as a Principal Shareholding Local Authority.
4. Do not participate in the LGFA scheme.

That analysis is supplemented by some consideration of Council's specific circumstances below.

Should Council participate in the LGFA Scheme as a borrower?

As at 30 June 2020 Council had no external debt and $35.3 million of internal debt. This is expected to increase approximately $58.9 million as shown in the 2018-28 LTP. Consequently, the benefits of lower interest margins are significant.

Council has indicated a desire to externally borrow its current internal loans used to fund capital programmes. This means that cash reserves that are currently being used to fund these internal loans ($35.3million at 30 June 2020) would instead be available for investing. Council is currently reviewing its Investment and Liability policy and has indicated a desire to broaden the policy to allow for investments in managed funds. The current Investment and Liability Policy is available on Councils website.

Based on these forecasts Council anticipates interest savings of approximately $10,000 or 1.0% for every $1.0 million of debt by participating as a Guaranteeing Local Authority. The peak external debt level in the 2018 Long Term Plan is $15.8 million adding Councils intention to externally borrow its internal loans, $35.3million this equates to approximately $511,000 of interest savings per annum. There will be some up-front legal costs associated with joining the LGFA of approximately $24,000 and annual ongoing costs of approximately $11,200 associated with meeting its legal requirements. The Council believes that the benefit of these savings indicated above outweigh the costs of borrowing from LGFA.

Council will also consider in the future, obtaining a credit rating. Obtaining a credit rating will potentially provide Council will additional interest savings of 0.1% to 0.3%. The potential cost of obtaining this rating is approximately $60,000.

Joining LGFA as a member council does not mean Council has any legal obligation to use LGFA for its borrowings. Council is free to borrow from whatever borrowing source is the cheapest at the time of borrowing.

Consequently, Council proposes that option (4) is NOT adopted.

Option One: Should Council participate in the LGFA Scheme as a Guaranteeing Local Authority?

If the Council joined the LGFA Scheme as a Guaranteeing Local Authority, it would be able to borrow more than $20 million from the LGFA and would be charged a lower interest rate for its borrowing.

LGFA currently has 71 member councils and is the largest lender to the local government sector with loans outstanding of approximately $11.9 billion. One of the contributing factors to the success of LGFA in delivering low cost funding to the sector has been its AA+ credit rating. This is the same as the New Zealand Government.

LGFA would not achieve the AA+ credit rating without the guarantee structure and therefore there would be no savings in borrowing costs to councils.

LGFA Guarantee

Currently there are 59 councils who have signed the joint and several guarantee. It is important to note that guarantors are guaranteeing LGFA and not individual councils.

The guarantee is limited to a council's rates income as a percentage of the rates income of all the guaranteeing councils. If Southland District Council became a guaranteeing council, it is estimated that although Council's share is limited, the dollar value of the call is not. Council's share of the guarantee would be 0.73%. This means that if a $100 million call was made under the guarantee, Council would contribute $730,000. This figure may change over time as the percentage of total rates income changes.

When assessing the risk or consequence of a call under the guarantee we need to assess the likelihood of a:

1. Council defaulting on its loans;
2. Likelihood of call on guarantors

All the above factors have a very low probability due to the following mitigating factors.

Likelihood of Council Default

Because of the ability of local authorities to rate and collect these rates, there has never been a default by a New Zealand Council. There is strong oversight of the sector by the Office of the Auditor General (OAG) and the Department of Internal Affairs (DIA). Additionally, if the Government has concerns over the performance of a council, there are a number of intervention steps that can be taken, including the appointment of a Crown Observer through to the appointment of Commissioners.

Likelihood of a Loss on the Loans in event of Default

Councils that borrow from LGFA need to comply with a number of financial covenants as part of the borrowing, on an annual basis. The covenants restrict the amount of money a council can borrow. In its 2017 report on LGFA, Standard and Poor's state that "LGFA's loan quality is exceptional; all loans in its portfolio are neither past due nor impaired since LGFA's inception in 2011. It has sound underwriting processes, which involve periodic compliance to the covenants that it sets".

Further all lending undertaken by LGFA to councils is done with a security charge over the council's rates. This means that in the event of a default by a council, LGFA can appoint a statutory manager who can impose a special rate that would be able to recover the amount owed to LGFA. This ensures all lending to councils is the first ranking creditor.

Likelihood of a Call on Guarantors

As at June 2020, LGFA had capital of $265.9 million. This was made up of $83.6 million of equity and $182.3 million of borrower notes which could be converted into equity. In addition, there is a further $20 million of uncalled capital. This provides almost $286 million of equity that could be used before a call was made under the guarantee. It is important to note that the borrower notes represent 1.6% of the total borrowing of councils to enable the security to obtain the AA+ rating. These borrower notes do attract a return from LGFA, but it is at the discretion of the LGFA. The borrower notes are returnable on debt repayment.

Further while the New Zealand Government does not guarantee LGFA it is a 20% shareholder in LGFA. In addition, the Government currently provides a $1.5 billion committed credit facility to LGFA. This would provide LGFA access to funding in the event of a severe disruption in capital markets which in turn would provide continuity of funding to the New Zealand local authority sector. The Government is a member of the LGFA Shareholder Council.

Governance of LGFA

The Board of LGFA is currently made up of 5 independent directors and 1 non-independent director. A non-independent director is someone who works in the local authority sector. There is a requirement that the majority of the directors are independent. One of the key objectives of the Director's is to protect the interests of the guaranteeing councils.

Performance of Local Authority Financing Vehicles in other Countries

There are many local authority financing vehicles that have been set up and successfully operated in other countries. These include financing vehicles in Denmark, Sweden, Norway, Finland, Netherlands, France, United Kingdom, Japan and Canada. They all utilise a cross- guarantee structure by member councils similar to the structure of LGFA. There has never been a call under the guarantee in any of these countries. The oldest of the entities is in Denmark which has successfully operated for 120 years.

Standard and Poor's Assessment of risk to Council from the guarantee

Standard and Poor's noted in their credit rating report on Auckland Council on 25 September 2018 that:

> *"As part of the arrangements supporting the Local Government Funding Agency (LGFA), Auckland is party to a joint and several guarantee, which we consider a contingent liability. Given the strength of the institutional framework in New Zealand and the requirement that all debt be secured over rates, we believe that the likelihood of a default scenario that would trigger the joint and several guarantee is low. Therefore, the LGFA liability doesn't affect our view of Auckland's contingent liabilities."*

Consequently, the Council is proposing that it will participate in the LGFA Scheme, as a Guaranteeing Local Authority. Consequently, Council proposes that option (1) is adopted.

Option Two: Should Council participate in the LGFA Scheme as a Non-Guaranteeing Local Authority?

If the Council was to join the LGFA Scheme without being a Guaranteeing Local Authority, the cost of participating would be less. However, it would face higher funding costs, reducing some of the benefit of participating. Additionally, the Council would be unable to borrow more than $20 million.

The LGFA charges a higher interest rate to Councils that are not guaranteeing borrowers. At present 0.1%, if Council does not have a credit rating and 0.2% to 0.3% if it does get a rating. This is offset by the risk of the guarantee, however as stated above the risk of the guarantee is considered to be low, compared to the savings.

Council proposes that option (2) is NOT adopted.

Option Three: Should Council participate in the LGFA Scheme as a Principal Shareholding Local Authority?

Investing in the LGFA Scheme as a Principal Shareholding Local Authority would provide a return on the amount invested in purchasing shares in the LGFA. It would also give the Council some rights in relation to the governance of the LGFA. However:

- Any return paid would be a return on equity and would not be paid if the LGFA ever got into financial strife.
- The Council would have to invest additional capital to join the LGFA scheme, because it would need to purchase shares in the LGFA.
- The Council would be required to subscribe for uncalled capital in the LGFA; and
- The Council would have to also become a Guaranteeing Local Authority with the attendant risks detailed below.
- If Council wanted to become a Principal Shareholding Local Authority, it would need to find a current Principal Shareholding Local Authority that was prepared to sell some of its shares in the LGFA to the Council as currently all existing shares are subscribed for.

Consequently, Council proposes that option (3) is NOT adopted.

Opportunity to Make Submissions

Submissions are invited on this Proposal. Submissions must:

1. Be in letter form or entered into Council's online portal at **makeitstick.nz** clearly showing the submitter's name, address and contact phone number.
2. Be clearly labelled SUBMISSION – LGFA.
3. Indicate whether the submitter wishes to be heard by Councillors in support of his/her submission. (Note – the substance of the submission should be in writing. Verbal presentations should be restricted to around five minutes.)
4. Be received by 5.00pm, Friday 26 February 2021

Submissions can be:

Posted to:	Southland District Council Submission – LGFA PO Box 903 Invercargill 9840
Delivered to:	Any Southland District Council office.
E-mailed to:	sdc@southlanddc.govt.nz