SOUTHLAND
DISTRICT COUNCIL

DRAFT: Financial Strategy 2021-31

Supporting document for the Long Term Plan 2031

March 2021

Southland District Council
Te Rohe Pōtae o Murihiku

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Targets at a glance

Net Debt Limit: 175% of revenue

Rates increase limit: Limited to 8% annually over the period

Balanced budget (everyday costs can be funded from everyday revenue)

Rates as % median household income below 5%

Focus on providing a level of funding to maintain service levels that the community can reasonably afford and without placing a financial burden on future generations

Ability to maintain services within strategy limits

Overall we will continue to fund and deliver the full range of services currently being offered, maintaining levels of service over the 10 year period.

In some areas there will be increased levels of service, particularly with planned investments to meet higher regulatory standards being required for things like wastewater discharges.

We have signalled in our Infrastructure Strategy that decisions about whether to increase expenditure or amend levels of service for community infrastructure (such as halls and open spaces) will be required during the period and we intend to engage with communities on this over the next three years.

What is a financial strategy?

Our Financial Strategy supports Council's strategic direction and shows how we intend to manage our finances prudently and whether we will have the financial capacity (income) to meet our financial needs (expenses) now and in the future. It outlines our approach to financial management over the next 10 years and the impact on rates, debt, levels of service and investments and sets limits on rates and debt that we will use when considering future proposals for funding and expenditure.

The financial landscape

Council's 2018 Financial Strategy was one of transition. We were in a relatively good financial position. Our population was projected to increase slightly (and age) but with spare capacity in our networks, we were not expecting to have to build a lot of new infrastructure. The majority of our business was planned to continue as usual and we were continuing to phase in rate funding depreciation on our key infrastructure assets. The inquiry into the Havelock North gastro outbreak resulted in tighter controls around water supplies and a review of how supplies should be managed in the future. We'd started to look at the risks to our infrastructure from climate change and sea level rise/extreme weather. We knew that we needed to invest more in infrastructure to meet increasing regulatory requirements and maintain service levels however we were conscious of the impact that increasing rates could have in some areas. Our initial look at rates affordability indicated that our rates for residences in two towns were above 5% of household income. We signalled that more work needed to be done to quantify these issues and map a pathway forward.

Snapshot 2018 – 2028:

- $54 million average rates (68% of revenue)
- 3.2% rate increase in Y1
  3.0% average rate increase
- Net debt Y1-10: $38 - $73 million*
  Peak debt: $75 million
- 40% rate funding depreciation in 2018/2019
- Reserves Y1-10: $37 - $38 million
- Opex: $79 million average
- Capex: $26 million average

* 2018 LTP net debt figures have been restated to include external and internal debt

Where we are at now and where are we heading to?

This Financial Strategy builds on the direction of the 2018 strategy and starts to fill in some of the blanks. We now have a better understanding of the potential changes coming from the government's three water reforms and we have incorporated higher environmental and regulatory requirements into our plan. Additionally, our own environmental monitoring role is changing and we are having to increase our capacity to fulfil requirements. We are still predicting a gradual population increase that is ageing with very little change in land use.

Some other things have changed. Our work on understanding the impacts of climate change is also progressing with a regional mapping project underway to provide better information to assist with our infrastructure planning and design.

So far Southland has been relatively cushioned from the economic impacts of Covid-19 with its primary production base. However, tourism centres like Te Anau are starting to feel the pinch with borders closed and visitor numbers to the region down. The pandemic has created a lot of uncertainty for businesses in the area which could have flow-on impacts for our rate revenue collection as some parts of the community may have greater difficulty paying rates.

Our second look at rates affordability incorporated regional council rates into our analysis. This showed that in 2019/20 median rates across Southland district made up 3.95% of median household income.

Snapshot 2021-2031:

- $72 million average rates (65% of revenue)
- 10.15% rate increase in Y1
  5.9% average rate increase
- Net debt Y1-10: $41 - $105 million
  Peak debt: $123 million
- 65-70% rate funding depreciation in 2021/22
- Reserves Y1-10: $35 - $86 million
- Opex: $106 million average
- Capex: $45 million average

What issues are we facing?

We need to invest in infrastructure to meet the higher standards imposed by legislation and regulatory bodies, particularly for our wastewater treatment and rural water supplies. We are also planning to lift our programme of renewals for our other critical assets like roads, bridges and pipes. Over the next 10 years we need to spend $448 million on our core infrastructure and our projections show that this is expected to jump up to over $640 million in the following 10 years as more infrastructure is due to be replaced.

Covid-19 and the flow-on economic impact on the district from border closures is also creating uncertainty. We are seeing the impact of our decision in 2020 to keep rates lower by funding costs from reserves because of Covid-19. We are now having to raise rates in the early part of our plan as we transition away from using reserves. We are also conscious of how our increasing costs may impacts rates for parts of the community that are affected more deeply.

Council is still developing a full picture of the impact that climate change might have on our services and how that might affect our future costs and what funding we might need. In this plan the effects of climate change as we know it now are being factored into our current infrastructure design and decision making.

Funding our considerable infrastructure from our small population base across a number of towns is challenging. We operate 21 water supplies, 19 wastewater schemes, 25 stormwater schemes, 20 waste sites, 5,000 kilometres of roads, 850 bridges as well as over 400 community facilities all for a population of 32,500. We do not have the same economies of scale as other cities and districts who have a larger population and fewer assets to look after. Research that we completed in 2020 indicates that the level of rates for households in our district are nearing 5% of median household income (which Council uses as an indicator of affordability). Based on our Long Term Plan we are now projecting rates will make up 4.4% of median household income in year one of the plan and remain below 5% for three years before rising to just below 6% in year 10. This indicates that maintaining our levels of service and meeting higher standards while keeping rates affordable is becoming increasingly difficult.

What are we working towards?

In order to tackle the issues and maintain levels of service, over the course of the next ten years

…we will be working towards:

- rate funding asset renewals rather than loan funding (by fully funding deprecation on the most of our infrastructure in 10 years)
- removing the use of reserves or loan funding to offset rate increases
- maintaining a balanced budget (where our everyday revenue meets our everyday costs)
- maintaining our capacity to borrow so we can fund unexpected costs in the future or respond to natural disasters
- balancing rates, debt and reserves so that each generation only pays once for their share of the costs of long life infrastructure (intergenerational equity)
- maximising our other revenue where possible without taking on excessive risk

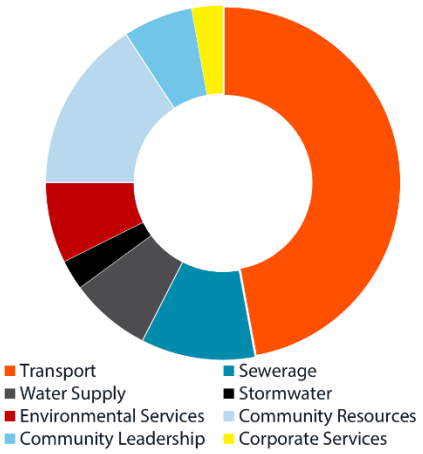
…to do this we need to:

- increase our rates in the early part of the plan and change the limit on rates increases to 8% annually
- raise our net debt ceiling to help fund our increased capital costs and maintain borrowing capacity for any unplanned events to 175% of total revenue
- ensure we are fully funding our roading operating and capital expenditure from rates
- delay fully funding depreciation on our water and wastewater assets until 2028/2029 and then consider funding depreciation on other community infrastructure
- ensure our fees and charges reflect the cost of providing the services
- build flexibility into our rate remissions and postponement policy to enable us to provide relief for significant future unexpected events
- engage with our community around what affordability is and the level of service that can be provided within this context

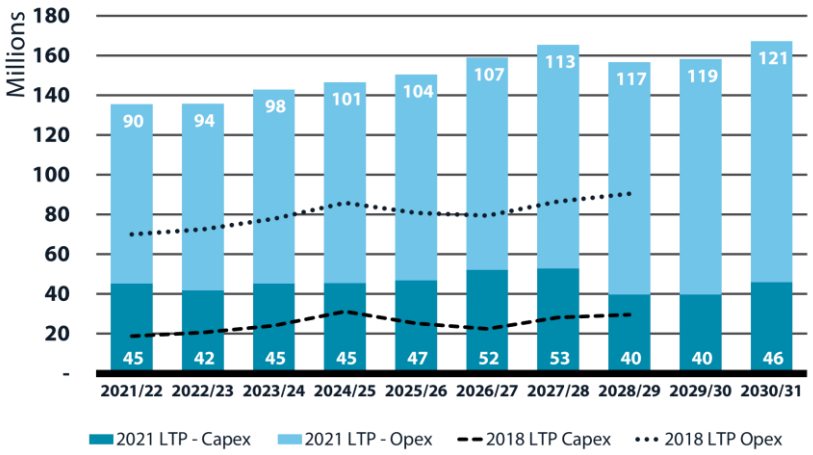
Our financial situation and approach

The tables and graphs below summarise the key financial data from our Long Term Plan 2031 to show the context for our strategy.

Total Expenditure By Activity 2021-31



Total Projected Expenditure



Summary Profit and Loss	21/22 $m	22/23 $m	23/24 $m	24/25 $m	25/26 $m	26/27 $m	27/28 $m	28/29 $m	29/30 $m	30/31 $m
Rates revenue	55	60	64	68	72	74	78	82	84	88
Other revenue	37	32	32	35	37	38	41	42	44	46
Less										
Operating costs (excl depcn)	63	65	68	70	71	73	77	81	81	83
Depreciation (funded)	20	22	24	26	28	29	32	32	34	34
Depreciation (non-funded)	7	7	6	5	5	5	4	4	4	4
Surplus/(Deficit)	**2**	**(2)**	**(2)**	**2**	**5**	**5**	**6**	**7**	**9**	**13**

Summary Balance Sheet	21/22 $m	22/23 $m	23/24 $m	24/25 $m	25/26 $m	26/27 $m	27/28 $m	28/29 $m	29/30 $m	30/31 $m
Reserves	35	36	38	42	46	51	58	68	77	86
Cash & Investments	38	39	41	46	50	55	63	72	82	90
External loans	77	94	114	132	147	167	185	190	193	197
Capital Expenditure (capex)										
- to replace existing assets	28	28	33	35	36	35	36	37	36	42
- to improve the level of service	16	13	12	10	11	17	17	3	4	4
- to meet additional demand	1	1	-	-	-	-	-	-	-	-
Total capex (fixed asset additions)	45	42	45	45	47	52	53	40	40	46

Our operating expenditure

Our strategy is to annually meet our operating expenditure from rates and other day to day revenue like fees and charges to balance our budget

Operating costs are the ongoing expenses that we incur for our normal day-to-day running.

Our operating costs over the period have gone up primarily due to inflationary pressures, the cost of meeting regulatory requirements, improving maintenance, funding of depreciation and changes in our annual roading costs. Our operating costs will average $106 million each year (compared to $79 million in our 2018 Long Term Plan).

These increases in cost mean that we will need to collect more rates over the next 10 years and increase our other revenue including fees.

Our capital expenditure

Our strategy is to fund our capital expenditure from a mix of reserves (including rate funded depreciation reserves), loans and rates. We do this because it spreads the costs across the life of the asset so that those who use or benefit from the asset pay for their use

Capital expenditure is the cost of replacing or building new assets. We categorise our capital expenditure into three groups:

- renewals – which is the cost to replace assets
- levels of service – which is the cost related to improving the level of service or building a new asset *(levels of service may also include an element of renewal where existing assets are also being replaced as part of the project)*
- demand – which is the cost to provide additional capacity to accommodate growth or demand

We have five key methods for funding our capital costs – rates, other reserves (including rate funded depreciation reserves), loans, grants/subsidies and financial/development contributions.

Funding depreciation is one of the methods that is commonly used. Depreciation is a term used to estimate the annual cost of using an asset. We collect depreciation each year through rates. For example, if a pipe cost $100 and was expected to last 100 years, then we would charge you $1 in your rates each year to reflect the annual use.

At the moment we are collecting rates related to the depreciation of our core infrastructural assets including roading, bridges, streetlights, water and wastewater. If we have a year where we have surplus funds in our depreciation reserves we will also use these to reduce any debt associated with that asset group.

Loans are the other method commonly used to fund capital expenditure.

Snapshot of depreciation

	Y1	Y10
What we fund in the plan		
Funded	$20m	$34m
Unfunded	$7m	$4m
What we have in reserves		
Reserves	$2m	$6m

Paying for renewals

Our overall approach is to pay for the renewal of assets firstly from any specific reserves collected for that asset (including depreciation reserves). If we don't have enough in our reserves we will use a loan. In the case of roading, we fund all of our capital expenditure (including renewals and level of service improvements) from rates because a consistent a level of capital expenditure is needed every year.

More information about how we fund the operating and capital expenditure for each of our activities can be found in our Revenue and Financing Policy 2021.

Paying for levels of service

We fund level of service related capital expenditure from loans.

Paying for demand

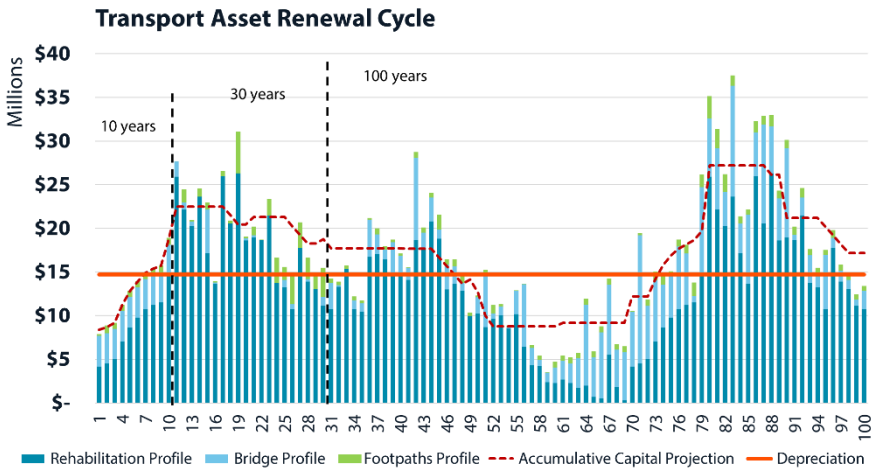
We fund demand related capital expenditure from financial/development contributions (where we have these) or loans.

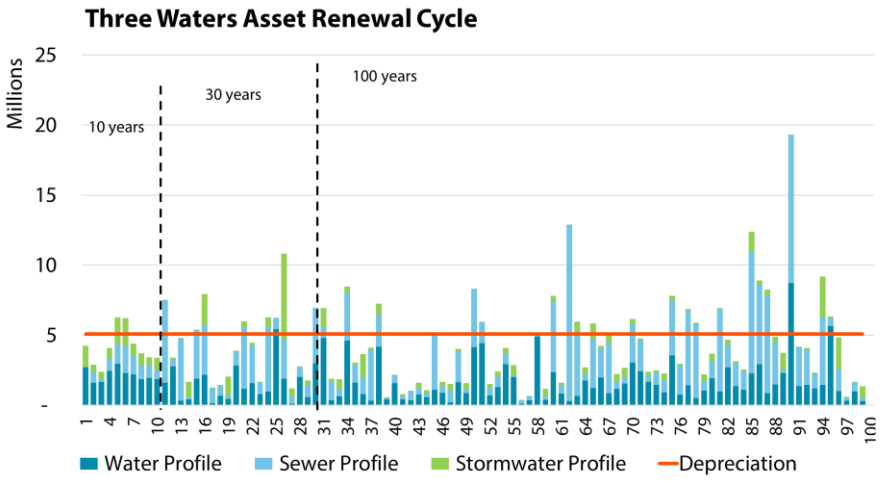
What's happening with our capital costs?

Our capital costs are increasing over the 10 year period and average $45 million each year (up from $26 million in 2018 Long Term Plan).

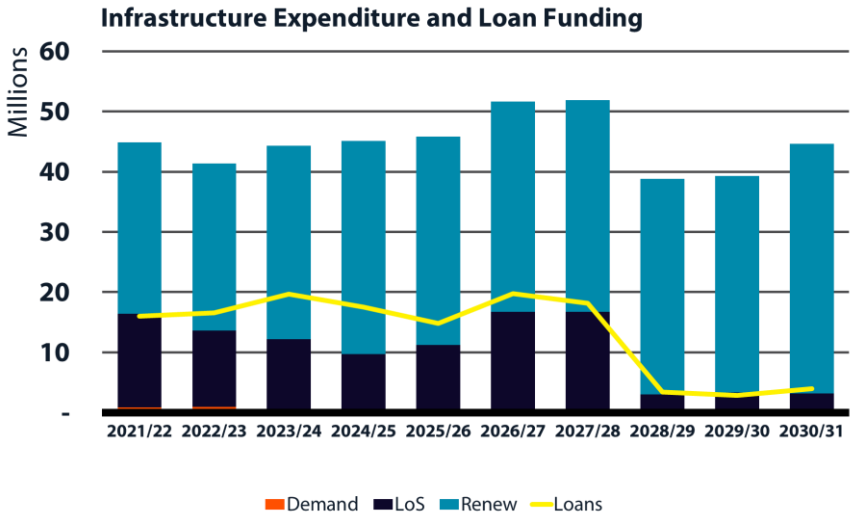
Council's Infrastructure Strategy identifies that significant additional investment in renewals and capital improvement are required in our infrastructure within the next 30 years to ensure that we continue to provide service to the community and to meet increased regulatory standards for things like wastewater discharges and drinking water.

Our asset renewal cycles suggest that we cannot afford to defer this work because in the next 30 years around 30% of the value of our three water assets and 32% of the value of our transport assets are expected to need replacing. Deferring work would also be likely to result in higher costs overall.





The graph below provides an indication of what we are using loans for. Where the yellow loan line sits within the blue renewals bar is where Council is loan and reserve funding renewals.



Core infrastructure focus

Transport
(focus on renewals)
Funding a greater number of wooden bridge replacements and gradually increasing the quantity of sealed roads we rebuild.
$296 million over 10 years

Water supply
(focus on renewals and meeting regulatory requirements)
Increasing funding to replace pipes in some of our older areas to reduce leakage and pipe failures and upgrading plants and equipment to meet drinking water standards.
$33 million over 10 years

Wastewater
(focus on meeting regulatory requirements)
Funding to renew consents for wastewater treatment discharges and upgrading treatment as a result.
$64 million over 10 years

Stormwater
(focus on maintenance and renewals)
Funding for condition assessments to improve information about assets and gradually increasing funding to replace ageing reticulation and addressing overflow and infiltration issues
$13 million over 10 years

More information about our assets and what is needed over the next 30 years is detailed in Council's 2021-2031 Infrastructure Strategy and supporting Activity Management Plans.

The graph shows that between 2022/23 and 2027/28 a portion of our renewal capital expenditure is being funded by loans. This is because we are still phasing in rate funded depreciation on our core infrastructure assets and we will not be collecting enough depreciation to cover our renewal costs.

By 2028/29 Council is aiming to fund 100% of depreciation on critical[1] infrastructure assets (five years later than originally planned). If we chose to fully fund these renewals in 2021/22, then the proposed rates would need to increase by $1.9 million which would equate to additional 3.8% over and above the current

[1] Critical infrastructure relates to roads, bridges, water and sewerage and also includes solid waste, computers and vehicles

rate increase. In developing this strategy we considered funding depreciation on other assets including stormwater and other community facilities like playgrounds and buildings. If we chose to fully fund these renewals, then the proposed rates would need to increase $2.8 million which equates to an additional 6.2% increase in rates in 2021/22. However, given the existing priority around critical infrastructure, combined with uncertainty about whether some community assets will be replaced in the future and pressure on rates, we think it is best if we look at this for our Long Term Plan 2024.

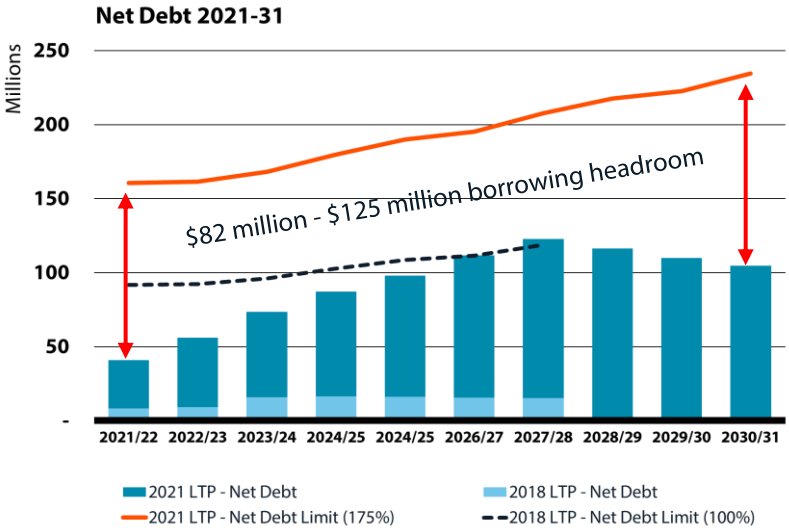
Our debt

Our strategy is to use debt to fund the cost of improving assets to increase levels of service or fund asset replacements where rates are insufficient. We also use debt to fund unexpected capital costs or to respond to natural disasters. From time to time Council may also use debt for operational expenditure that has a benefit over multiple years

New debt limit:
Net debt <=175% of total income ($161-$234 million)

Traditionally Council has had very low levels of debt and has been in a position to internally borrow from its own reserves to fund capital expenditure. We are anticipating that net debt will increase over the period from $41 million, reaching $105 million in 2030/31 (~78% of total revenue). Debt servicing costs will average $2.9 million each year and reach $3.9 million by year 10.

The graph shows the net debt profile and Council's previous net debt limit based on 100% of total income. We are proposing to increase our net debt limit to 175% of total income. Net debt will peak at 103% of total revenue in 2027/28 ($123 million).



We are deliberately setting our net debt limit higher than needed to ensure we have sufficient headroom to access funding for unexpected events like natural disasters or unplanned capital costs.

Preserving the capacity to borrow in exceptional circumstances is part of our strategy to be financially prudent and have the ability to respond to emergencies or natural disasters.

In setting the limit we have considered the effect of debt repayments at this limit on the overall rates. As an example, $10 million borrowed at an interest rate of 2% for 30 years equates to a 1% increase in rates.

We look to manage debt prudently within the constraints of our financial management policies (including our policies on Investment and Liability and Revenue and Financing).

Security

The security for borrowing will be by way of a charge over rates in line with Council's Investment and Liability Policy.

We are conscious of the impact that the repayment of debt has on the community, particularly with median household rates projected to be above 5% of median household income during the plan period.

Overall we consider our approach to debt to be prudent, particularly given our current net debt levels, our approach to phasing in depreciation and the need for investment in core infrastructure.

However, we are also conscious about years 10-30 as our asset renewal cycles show a greater proportion of our assets will need to be replaced in this period. We will continue to work on our asset renewal profiles to refine our forecasts further and develop a more accurate picture of our long-term capital funding needs.

Rates

Our strategy is to set rates at a level sufficient to meet our annual operating expenditure

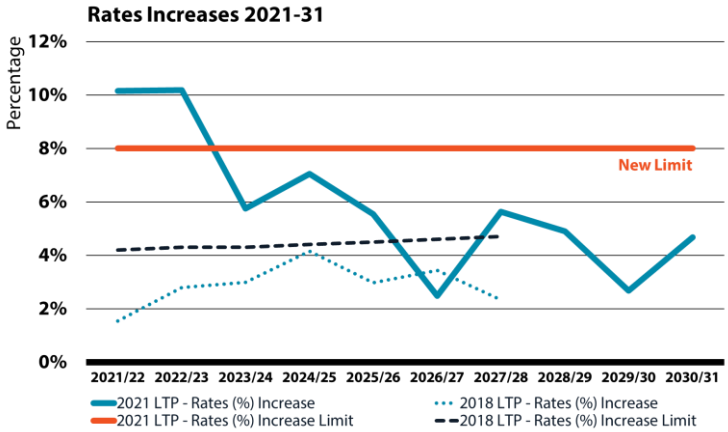
New rates limit:
Yr 1-10: 8% per annum

Rates are our primary income source and we use rates to fund the balance of our operational expenditure after allowing for other revenue.

To date our strategy has been to limit rate increases to the local government inflation measure (the LGCI or local government cost index) plus 2%. In 2018 that meant a forecast rate limit of between 4.0% and 4.7% per year with rates increases averaging 3%. However, we cannot continue to maintain our services by holding rates to 3% in the long term. It is not a realistic option unless we either lower our level of service or load more costs onto future generations.

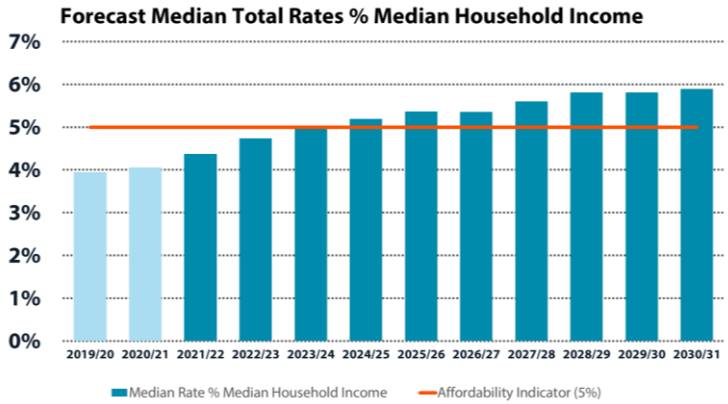
This means we are revising our rate increase limit to 8% per annum. In years 1-2 we are projecting a rate increase higher than our limit primarily because:

- we are transitioning away from using reserves (primarily related to our decision in 2020 to keep rates low because of Covid-19); and
- we have a number of changes to our operating costs (refer to 'Our operating expenditure' on page 5).



Rates increases for the remaining years will be below the revised cap (between 2.5% and 7%). We know that average rate increases of 8% is not ideal. However, this approach results from considering what is financially prudent now and in the longer term, particularly to deliver on our Infrastructure Strategy aims to maintain existing service levels, comply with legislative requirements, address the infrastructure deficit and allow room for responding to unexpected events.

In 2020 Council released a report into rates affordability which identified that at an overall level, median rates (for Southland District and Environment Southland combined) made up 3.95% of median household income in 2019/2020. This report identified that at a district level rates were affordable (being less than 5% of median household income), but noted affordability issues at the household level, particularly in low income urban areas and where there is a high proportion of fixed service rates for water, sewerage and rubbish/recycling.



Information about how we share rates out across the district can be found in our Long Term Plan or Annual Plan Funding Impact Statement and Revenue and Financing Policy.

Over the next three years we are projecting median rates to remain below 5% of median household income increasing to just below 6% by year 10.

Checking to see that we have the balance right will be part of our focus over the next three years along with ensuring that we get the most value out of every dollar spent.

In the meantime residents on low incomes will continue to be encouraged to access the government's rates rebate scheme to help offset the increase and our rates remission and postponement policies will continue to provide some options for assistance where needed.

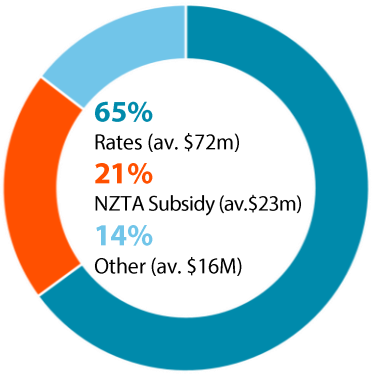
Other revenue

Council also collects other revenue including from fees and charges, grants/subsidies and financial contributions. The chart opposite shows the mix of revenue sources averaged across the ten years.

The largest proportion of non-rate funding is from Waka Kotahi NZ Transport Agency who fund around 52% of our transport infrastructure costs. Any variations in the level of their subsidy has the potential to have a significant impact on our proposed roading programme.

We also collect fees and charges from users, forestry revenue and other income. We review our fees annually to keep up with changes in the cost of delivering our services and to ensure that we recover the proportion of the costs that individual users benefit from.

Forecast mix of revenue sources 2021-31



Reserves

Council has two types of reserves. We have reserves that are held for a specific purpose which are restricted in use and general reserves which can be used as needed. Reserves are used as the first source of funding for project related costs. Council's total reserves are projected to increase to $86 million in year 10 (up from $35 million).

Investments

We continue to hold and manage a number of investments for strategic reasons where there is some community, social, physical or economic benefit accruing. Council's Investment and Liability Policy outlines our approach to financial investments and equity securities which is summarised below.

Insurance

Our strategy is to ensure that Council has sufficient insurance coverage to replace assets that are damaged resulting in significant financial loss.

Currently we insure all of our above and below ground water, wastewater, stormwater assets as well as community facilities. Roads and bridges are not insured given that government support is generally provided for significant events.

Financial investments

We hold cash investments as part of our day-to-day working capital management and these are usually held in short term deposits or bonds. Returns are market related to the type of investment made. Other reasons for holding these are to provide cash in the event of a natural disaster and invest reserve funds.

Council has forestry assets which are held as a long term commercial investment with returns reflecting market conditions. Surplus funds are used to offset rates.

Council holds property to both support the economic, physical and social development of the district and achieve an acceptable rate of return depending on the purpose held (from none to market rents).

Council will occasionally provide a loan or advance to a community organisation to provide the provision of community services or recreational opportunities that Council would normally be involved in. Council sets the terms and conditions including security requirements as they are granted.

Equity securities

Council holds such assets only for strategic purposes. Council has shares in a specialist local government insurance company and a local company to assist in the development and operations at Milford Sound. Council does not expect a return on these investments.

Should Council borrow from the Local Government Funding Agency (LGFA), Council would be required to invest in financial bonds at 1.6% of the borrowing. Council will receive interest and full repayment of these "borrower's notes" upon repayment of the loan to which they relate. Interest is calculated to cover the cost of funds.