



## **‘Debt Maxima’ for New Zealand Local Government – Year 2006 challenges**

### **PREFACE**

#### **Authors Note:**

*From time to time the Author ‘contributes’ thought pieces addressing New Zealand Local Government (‘NZLG’ or ‘sector’) financial management issues.*

*Such contributions have invariably gone unremarked except perhaps for those who have sometimes expressed the view that ‘it might have been better as an executive summary’. Some might even question the need for ‘yet another paper’. But for serious and long term observers of the sector the issues of NZLG ‘DEBT’ have been looming for some time now, mounting to the point where ...*

*Council Debt is now the number one financial issue facing the sector*

*Hence this paper!*

*Whereas other contributions of the Author have passed with barely a ripple, considering the importance of the sectors debt issues is it too much to expect receipt of some useful feedback and constructive! criticism from professionals in the sector who should be making it their business to contribute to this debate?*

*For my part I undertake to incorporate all useful commentary in a final version of this paper, which will be widely circulated and presented in public in November 2005.*

*The issues concerning Council debt, its accumulation and acceptable maxima have long excited politicians and local ratepayers groups. Debt is an emotive subject.*

*In addition, arguably no other facet of Council finances has the potential that debt has, to impact through rates and charges upon Council communities.*

*As this paper evolved, it became clear that the issues associated with Council debt were both too numerous and complex to cover ‘fully’.*

*The complexity of these factors explains the somewhat abbreviated ‘list of topics’ that concludes the paper... amounting to no more than an identification of a series of further matters all worthy of further consideration. On the matters of debt ‘segmentation’ I have offered some tentative policy suggestions, for others I have merely at this point included some ‘thoughts’ intended to stimulate discussion and debate.*

*Such is the weight of the financial management issues concerned with Council debt proposed to be raised over the next ten year period (to 2016) that sensible answers will be need to be found to all of these matters ...and fast!*



## 1. INTRODUCTION

This paper amounts to an attempt to:

- identify the current (August 2005) financial management issues,
- principally the debt and funding related issues facing NZLG 'sector'
- in the run up to the drafting of their 2006 long term financial plans as part of the development of their 2006 - 2016 long term Council Community plans (LTCCP's).

The '06 LTCCP's' will be both of genuine historical and operational significance to the sector. This is because for the first time, the full effect of the Local Government (2002) Act, (LGA 02) including audit coverage and their comprehensive preparation will be felt. At the same time, the Council debt mountain is rising up before our very eyes – (*ref*; [www.kauriglen.co.nz/larry/presentations/LTCCPlan.htm](http://www.kauriglen.co.nz/larry/presentations/LTCCPlan.htm)).

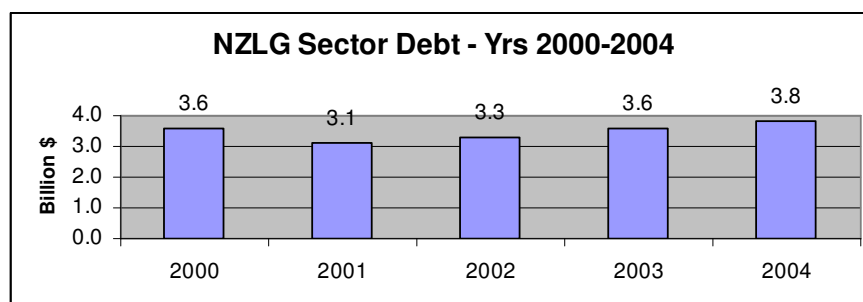
There is little evidence that sector financial managers are 'prepared for it'.

### 1.0 What is the evidence of mounting debt?

There is plenty of the evidence of mounting NZLG sector debt. The daily newspaper headlines say as much in reporting proposed programmes of Council's capital expenditures principally to be spent on roads, water and wastewater. There are also public debates as to how the money needed is to be raised using a variety of funding methods including tolls, public/private funding and debt raising.

There is 'some' specific sector debt related evidence that clearly indicates the 'size of the debt mountain'.

- A sample of 2004 and 2005 LTCCPs provides ample proof of rising debt amongst Councils experiencing unprecedented levels of growth, for example:
  - the Rodney District Council's debt levels will have quadrupled from 2003 to 2007,
  - the Kaipara District's will go from around \$8 M in 2005 to over \$30 M in 2007,
  - Waimakariri debt will increase from \$0.2M in 2004 to \$45 M in 2009.
- The mounting total of the sector debt for District and City Councils has risen over the last five years.



Regional Councils, minor players by and large in the debt-raising field add another estimated \$500 million to the above totals.

Based on this data, there is little doubt that New Zealand Council debt levels are set to 'explode'. The problems associated with managing these unprecedented debt levels are far from being resolved.

*Hence this paper!*



### **1.1 A new policy framework is needed**

The tasks associated with managing these developments will include the need to completely rethink current conventional wisdom and to fully review the financial management policy environment in so far as it relates to sector debt.

The revised policies that are now needed will have to encompass the funding (including the borrowings) necessary to finance what might fairly be considered the ‘enormous’ and hitherto unforeseen capital sums required to finance proposed and largely essential infrastructural asset developments over the next ten or more years.

### **1.2 How has this debt ... just happened?**

A good portion of the added funding necessary within the sector has arisen naturally out of growth of the period from 1999 to 2004 comprising a continuous five years of unprecedented growth across ‘NZ (Inc)’.

With projections of growth set to continue and with continuing very significant demands being made to meet more stringent standards of environmental and public health (upgrades), taken together with considerations involving more costly green fields developments, (water and wastewater in the main), and lets not forget huge roading developments, there are few signs that would indicate that the emerging high debt environment is ‘just a blip’.

The revisions to debt policy settings being developed now, will have to stand the test of time given typical loan terms of over twenty years as well as further growth related debt funded needs over the medium to long term.

### **1.3 Time is up ...so what must happen? ... now!**

A full accounting of the history of Council debt-raising leading up to the present day circumstances lies well outside the scope of this paper. Events have conspired however to a point where at the present time:

- Funding of essential infrastructure over the period 2006 to 2016 will require huge amounts of funding from a variety of sources including debt
- Estimates for some Council’s over this period involve at least a doubling of previously considered Council debt maxima (see examples above).
- Existing Council debt settings and the financial management framework-environment in which debt maxima are presently managed are proving to be quite inadequate in meeting future demands for capital expenditure
- Traditional and existing maximum Treasury Borrowing Policy debt levels will be breached, as capital projects come to be funded and
- not surprisingly ... revised Treasury Borrowing Management policies and practice are being put under close scrutiny with the need to devise the means by which the Council debt related issues may and in the very near future will be addressed.

*Hence this paper!*

### **1.4 Past its ‘shelf life’**

In summary it is blindingly obvious that existing notions of debt maxima for local government have become, for many Council’s ‘shelf life expired’. They are ‘not up it’ in that the higher



planned debt maxima if they are to be permitted will mean not just an overhaul of the existing limits but a complete rethink of the whole subject of NZLG debt management practice. Implicit in any 'rethink' that will be necessary designed to permit higher debt levels, and 'amounting to a 'relaxation' of existing debt limits, these circumstances pose something of a dilemma for financial managers and advisors.

### **1.5 A dilemma ... of credibility ... and the continuing need for prudence**

The dilemma arises in these circumstances amongst the sector's financial analysts that a relaxation of what have been previously considered maximum debt levels 'had better be justified' ... if only merely to preserve their credibility.

That is, if changes are sought to existing and acceptable financial management practice of what were previously considered to be prudent levels of maximum Council debt then there had better be very good reasons for allowing any relaxations and recommending such changes, all of which tend to higher and possibly much less prudent debt levels.

The matter and notions of prudence remain (unsurprisingly) on the table. If they prevailed in the past they cannot now credibly merely be ignored and replaced with something 'more practical' and 'more convenient' for the future.

Strictures for prudent financial management are still in force and are of continuing validity. They arise from the principal legislation covering all Council's financial management practice, the Local Government No 3 (1996) Amendment Act, its s. 122B. These provisions remain the time honoured, essentially commonsense prudential limits including those relevant to setting 'prudent debt maxima' ... they involve the exercise at all times of the use of:

*s. 122B ... 'prudent, effective and efficient financial management' ... that is sound financial management practice and process.*

*Hence this paper!*

### **1.6 Do you remember an Inn Miranda? ...And what about the old Loan Polls?**

If it is accepted that good practice guidelines of the past should not now be simply ignored, there is one other reflection from the past that is worth recalling. It relates to the 'public interest' importance of Council debt, not just in policy and financial management terms but also as a matter of considerable public debate and consultation. Debt *is* an emotive issue and this fact can have a very influential part to play in setting debt levels that are acceptable to a community and which invariably directly influence the level of Council's rates and charges.

These views are reinforced by reflecting upon the motivation for the old Council 'Loan Polls'. Why were such apparently arcane matters as Council debt raising made the subject of a special Act, the Local Authorities Loans Act 1956 (the 'Loans Act') and involved the need to poll ratepayers for approval to borrow?

They say that if you can still remember and reminisce, (coherently that is) about the swinging sixties ...then you can't have been there. So for those with good long-term memories or for the trainspotters who read historical accounts of New Zealand local government practice of the sixties... and for that matter right through to the eighties too it is useful to reflect on why a loan poll was deemed necessary then.

The answer is simple. It was for the very reasons given already because...



*‘debt can be an emotive issue and has a very influential part to play in setting the level of rates and charges’ (above).*

Nothing of this ‘public interest’ about Council debt has altered. In fact the consultative processes of LGA 02 still place considerable demands upon elected members and managers within the sector to justify their plans including proposed debt-raising.

### **1.7 Be careful out there ...**

With changing times, notions of public interest and prudence do not just ‘get ditched’ and so it is for the sentiments driving the requirement to poll that is, to consult with ratepayers, they do not now with changes to the law just ‘evaporate’. Loan polls are gone but other mechanisms now give the public some say in these matters.

The ‘consultative’ content of LGA 02 (see principally s’s 82 to 90 and Schedule 10 Part 1) now effectively replace loan polls.

A community not happy with proposed levels of debt can still ‘have their say’. They are also, as the Act decrees to be provided with ‘meaningful’ information that fully informs them, satisfies their curiosity and allays any fears they may have, [LGA 02 S 83 1 (a)].<sup>1</sup>

The fact remains that Council loan raising (or for that matter Council financing of any kind including alternatives to borrowing) remain financial matters of considerable public interest. For the reasons given, analysts and financial managers had better tread carefully and with considered forethought when proposing a re jiggling of Council debt maxima as they are likely to come under increasing and more intense public gaze particularly as the level of rates and charges associated with higher debt ‘begin to bite’.

*Hence this paper!*

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<sup>1</sup> Note that any local authority still has a total discretion (under LGA 02 S. 9) as to whether it will conduct a loan poll by way of a ‘referendum’. There are no prerequisites for this process. It might be a rare event for a council to allow a loan proposal to be put to a vote and note that the result would not be binding unless the council resolves to be bound.



## 2. EXISTING AND GENERALLY ACCEPTED COUNCIL DEBT MAXIMA

### 2.0 The current ... and enduring principles of prudence and sustainability involved

Since 1996 with the introduction of the sector's financial management regime, an extensive database and methodology has been developed concerned with addressing the specific practice of deriving the policy settings of debt and their maxima for each New Zealand Council.

These paraphernalia of debt ratios, debt parameters, limits, coefficients and funding mechanism calculations are all aimed at addressing just one simple (and enduring) question, which is:

*'Given the exercise of financial management prudence, what is the maximum level of debt that (this Council) can sustain?'*

The keywords here are 'prudence' and 'sustain'. This simple proposition is one that must always be remembered, whatever the winds of change are that may blow around the sector's financial policy setting landscape.

The single question of prudent and sustainable debt levels translates, in an 'operational sense' into Council's consideration and knowledge *inter alia* of the numerous factors and financial and public policy issues affecting their Council and Community.

When considering debt settings these matters involve:

- naturally enough, the exercise of demonstrably prudent judgments
- which must be informed by information concerned with a City or District resident's and
- their ability to pay for Council goods and services, ( the key determinant of 'sustainability')
- given existing and proposed rating and charging policy settings including factoring in for example
- the use of flat or regressive taxing, capital or land value property bases
- judgmental rating settings including differentials

... all of which are matters associated with the process and use of moderated decision making

- leading to and reaching fair and reasoned judgments
- tied into consideration of the resulting need to borrow (if any),
- whilst properly allowing for feasible sustainability/affordability of the necessary funding/debt and associated debt servicing costs
- and as a consequence devising financial management policy settings consistent with the above ... the particular Council's prudent and sustainable maximum debt levels.

### 2.1 So what are the sector's existing debt policy settings?

Subject to the arcane considerations (not discussed herein) of the limit (less?) depths of the debt security of a local authority's 'rating taxing base' there has been general acceptance reached over the whole sector of notions of prudence as to Council debt maxima. These involve the use of acceptable kinds of Council debt parameters, (so termed 'treasury management borrowing' limits). Many, such as the Income to Debt ratio have more or less become 'industry' (sector) standards.

These have become 'rules of thumb' used for establishing prudent and sustainable Council debt maxima arising from sound practice (drawn from both New Zealand and overseas experience).



For example, for the last nine years (since 1996) some generally accepted rules of thumb governing Council debt maxima have emerged and include the following ...

- Debt per capita should not exceed \$750 per resident
- Debt per ratepayer should not exceed \$1,500 per ratepayer
- The (annual Council) income to debt ratio should never be less than 1:1 and generally higher
- Debt interest should have some absolute or ‘%’ equivalence with Council rating revenue

The debt parameters that have been set over recent times to manage Council debt as a whole include the following samples ... examples:

*“A maximum Income to Debt ratio (for a wealthy well funded Council possessing its own acceptably high levels of residential and ratepayer ‘Ability to Pay’ set) that does not fall below unity that is 1:1.”*

*“ Interest on Council debt annual payments will never exceed (say) 20% of total annual general rating revenue”.*

*Or a set of “Borrowing Policies” taken from Gisborne District.*

*GDC Borrowing Limits.*

*In managing debt, the Gisborne District Council will adhere to the following limits:*

- *The gross interest expense of all debt (including internal loans) will not exceed 15% of annual rates revenue.*
- *Total debt (including internal debt) per capita will not exceed \$1000.*
- *Net cashflows from operating activities will exceed gross annual interest expense by 2 times 6.*
- *Liquidity ratio of 1:17.*

Along with a number of other atypical ratios and ‘treasury benchmarks’ these forms of treasury management controls have achieved general currency and acceptability. These sets (of financial ratios) have served the sector well in the past by introducing notions of prudence, by capping mandated maximum sustainable debt levels and all have lead to well understood control and reporting mechanisms for a financial debt compliance and performance regime based upon these measures.

Are such ratio (debt parameters) and or rules of thumb useful? Are they not too imprecise? Some might say ‘yes’ but ...

Whatever their limitations, these simple ‘rules or measures’ possess the merit that they have, until of late been honoured in practice. Few New Zealand Council’s have come close over the last nine years to seriously challenging them.

Not so for the future. These rules are now ‘not coping’ they will be ‘blown out of the water’ given present proposed Council debt maxima.





## **2.2 Something's 'gotta give'**

Unfortunately the problem now is that existing debt controls (parameters) will no longer support the very high levels of debt proposed within the sector and something 'is about to give'.

Based as many of them are on absolutes, (specific dollars, percentages etc) such limits will not in future, automatically come into play given the higher projected debt levels. They can usefully remain in place for some traditional and conservative Council debt circumstances but they will need to be supplemented with other debt management techniques more applicable to emerging present day and proposed methods of Council financing.

As an example of the parlous Council debt circumstances that have arrived in the sector the Rodney District's proposed debt levels, held to around \$1,600 per ratepayer to date after having been much lower in the preceding nine years will climb, in less than three years to around \$4,500! per ratepayer not, it should be noted anywhere near the generally accepted 'rule of thumb' maximum debt level of \$1,500 per ratepayer.

Given these plainly unsatisfactory (and unpalatable) facts something 'has got to give'. There is now a pressing need to revisit and review existing Council debt / borrowing management policies.

Allowing for all of the caveats concerning prudence and the inherent dangers of making these changes (including the dilemma of justifying/discarding existing parameters above) the time has come to determine ... if there is not a better way.





### **3. A BETTER WAY ... COUNCIL DEBT MANAGEMENT ALTERNATIVES ... A TENTATIVE VIEW**

#### **3.0 What is possible?**

Fortunately, I believe that there is for New Zealand Councils and their debt management strategies ... a better way.

Some Councils, albeit with many using a largely haphazard form of incremental debt policy development have in recent years been doing some of the thinking necessary and have made useful improvements to their treasury management (borrowing) policies.

Few of the Councils sampled for these recent debt policy changes or with whom the matter has been discussed have addressed the issues comprehensively however. Few have radically altered their borrowing policies since the late nineties. Most have just 'fiddled with them' by allowing their debt to rise even to levels that exceed! their own debt maxima guidelines.

There has been a widespread trend to merely liberalise existing ratios, an instance being the Rodney District who now have an actual income to debt ratio of considerably less than 1: 1, (0.66 to 1 or thereabouts) when they previously had set this at close to 2:1.

The Rodney District Council is now clearly in breach of its own notions of prudence and is placed at considerable financial and political risk as a consequence. Many other Councils having set more demanding initial limits have almost universally have had to relax these, to cope with rising debt levels.

Other Councils who have revised their policies have gone further. Some have got part of the picture right, for example the Far North and Kaipara District's with their 'segmentation of debt' approach ... an approach that will be considered in considerable detail later in this paper.

#### **3.1 Its time for a change ...**

Most of the pragmatic and rather haphazard debt management policy revisions occurring since the late nineties have been responses taken to begin to address issues or complexities of Council funding that were simply 'not thought of or were not abroad in the mid to late nineties' when the existing debt ratios and Council's long term financial plans (LTFS's) were first put in place. For the last nine or so years they 'coped', now they won't.

Currently, many Council's and not just Rodney soon will also be well in breach of their initial debt maxima settings, some are moving (in the RDC's case by 2006/07) to debt levels that are clearly going to be in breach even of their modified ('challenging' and higher debt) settings.

Council's that fit this pattern have largely to date adopted a *lassaiz faire* attitude to debt policy development (the incremental approach mentioned above). This has been true of their auditors too, possibly both hoping that 'something will turn up'.

It is noteworthy though, that Councils faced with these issues have not cut down their proposed debt levels, many do not consider that they possess this luxury as this would involve removal of essential infrastructural developments from their capital projects lists.

Their proposed capital works projects the Councils say 'just have to go ahead' for a variety of reasons such as growth demands and to meet mandated environmental standards improvements.



These are the usual explanations (suspects?) and justification if it could be called that given by Councils for the ‘full steam ahead and to hell with the rocks and reefs’ approach. The real effect of these positions on debt and the policy developments necessary have not been (fully) thought through.

### **3.2 What is missing from this picture?**

In addition to the obvious flaws associated with adopting reactive, pragmatic and incremental responses, missing from current sector debt policy setting and developments of recent times are two broad areas warranting scrutiny.

The first is just the simple fact of a vacuum or paucity of reasoning for any legitimate extension of higher debt level management strategies, that is a lack of thoughtful analysis which has generally lead to the default position of ... ‘full steam ahead ... the borrow and hope strategy’. This strategy has now failed as is evidenced by Councils that are already in breach of their key debt ratios or those who soon will be.

The second culprit ‘missing in action’ is any alternative debt setting policy ‘framework’ put in place of the present debt setting environment, one which has a good prospect of facilitating higher debt levels. The simple ‘nineties’ approach was built on a thin analytical framework largely populated with broad brush ratio and relational debt parameter development (see examples above).

A comprehensive, thoughtful and analytical approach to debt policy development has generally been absent. Such a framework now is essential

The first of the suspects ... ‘the policy vacuum’ needs to be filled. I believe it can be in a relatively straightforward manner arising from, amongst other things this paper and its critiques.

As for the second, that is developments involving a new framework incorporating all debt management ideas extant. This will be more complex and may take some time (a period of years?) to more fully, and with experience develop.<sup>2</sup>

There are also many ‘interested’ parties to these topics including the advisors and financiers to the sector. Note that my research paper refers to users and interested parties to such a debate.<sup>3</sup>

### **3.3 Filling the vacuum**

The simple answer to address the paucity of debt related policy advice is for Councils that have stretched their debt limits without much, if any forethought to now take some responsibility and commence a rationalisation process relating to their actions.

That is, they should provide valid rational justification for their extensions of debt and their ratios and these should be based upon sound principles of prudent financial management. To date many Councils have just not bothered and with huge increases in forecast debt ‘push has now come to shove’.

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<sup>2</sup> The topics that conclude Section Five of this paper refer to the many debt related issues of this nature.

<sup>3</sup> **ref:** [www.kauriglen.co.nz/larry/marketing/LTCCPdataFirstPrinciples.doc](http://www.kauriglen.co.nz/larry/marketing/LTCCPdataFirstPrinciples.doc) ‘para 1.2(d) These persons and groups will be the sources for essential technical data that must be obtained for performance measurement purposes. Such data is held by engineering, economic, statistical, environmental, social and other agencies and consultancies or can be obtained from within existing local government databases. An identification process of these groups and an evaluation of the data on hand will be necessary.’



The business of this paper is to fill this policy vacuum and where possible to provide Councils with a sound conceptual and a practical framework likely to be better suited to current demands involving new debt or funding mechanisms and higher debt levels.

In addressing these issues many of the evolving financial management techniques mentioned (above) will come into play. Councils that have in the past 'just fiddled' should now begin to more rigorously address their own circumstances. They may start by looking critically at the true nature and quality of their total debt.

The thinking needed to fill the void might best be commenced with an example, a concept already introduced by some Councils, the so termed 'segmentation of debt' idea. In short, this idea simply put arises,

- by examining and dividing total Council debt into performing or non performing groups (debt tranches) and then
- by applying rational analysis to these,
- many Council's might find that such analysis could well justify added debt levels without a breach of traditional debt ratios ...
- with the use of specific targeted rates policies
- set so as to service debt taken from the affected parties, that is from the beneficiaries of the service derived from the debt funded asset
- associated with the relevant tranche of debt .

More detailed particulars of these 'segmentation of debt strategies' will be given later in this paper.

In summary therefore, this paper will attempt to fill a policy vacuum (as a 'thought piece'). I will hope for responses and useful suggestions so as to suggest a workable (operationalised) framework ... the methodology and rationale to cater for the sectors circumstances ...

- where existing Council debt management controls / parameters are likely to be breached ...
- where one, or a number of identified new debt strategies can be identified and used
- that will provide proper justification, giving reasons for added debt
- that will fit within a coherent framework of debt policies (plural) and
- that will meet the needs of future, long term (LTCCP 06 ) Council borrowings.



## 4. NEW COUNCIL DEBT POLICIES ... A FRAMEWORK UNDER DEVELOPMENT

### 4.0 A grab bag of good ideas

From within the changing Council financial management environment of the last several years there have emerged a number of 'good ideas', all of which relate to Council's debt maxima and their management which if adopted comprehensively ...

*'will meet the needs of future, long term (LTCCP 06 ) Council borrowings'*

There has been change. In recent years better techniques of financial analysis of Council debt have proliferated, for example recognition of the need to incorporate NPV data into financial planning. The sectors financial scene has altered...

- with introduction of new mechanisms for Council capital funding, a changing of the game somewhat, for example ...
- the use of private funding,
- the use of funding and operational vehicles such as joint venturing,
- the design, build, operate and transfer schemes and
- the many variants of these,
- the introduction of capital (development) contributions and
- the recent emergence of substantial Central Government subsidies and grants.

Many of these initiatives are not debt raising mechanisms at all but the use of some of them give rise to issues involving Council debt obligations of some kind many without directly 'putting debt onto Council balance sheets'.

For example, a Council's 'associated' joint venture or trust investment that raises its own equity and debt may, (repeat may) not require accounting consolidation. These instruments/schemes/financial engineered arrangements have the potential for significant 'impact or effect' upon the argumentation of this paper. They may for instance replace the need for Council itself to raise debt and they may exempt Council from having to include these borrowings within its umbrella Council debt controls.<sup>4</sup>

### 4.1 Lets (for now) just confine ourselves to picking 'Winners'...

Of the many candidates amongst the emerging 'good ideas', ideas that will assist in developing better more comprehensive and principled debt policy settings, the sector has over recent years developed the following concepts and practices. These have included from a long list of possible 'Winners' the following:

- The segmentation of Council debt across the whole Council's debt portfolio that is intended to distinguish performing debt from non-performing debt. Subsequent analysis, the matching of separate (standalone) revenue streams with debt servicing costs is often very instrumental in justifying further borrowings.
- Use of and the constructive tensions associated with the debate concerning either a District (or City) wide, so termed 'Corporate' management of total Council debt ... or as a clear

<sup>4</sup> Consideration of these (largely form over substance) issues are too numerous and complicated for this paper (and for simple souls) to consider. But the comprehensive framework envisaged by this paper would need to factor these into the result. Policy to deal with these various schemes will have to soon be developed (see Section Five of this paper).



alternative a 'sub-District' or even 'local scheme' view of Council debt(s) assigned to the asset or asset group it has funded, the so termed 'honey pot' funding approach. The latter if adopted lends itself to the use of targeted rating for debt servicing costs.

- Distinguishable criteria for determining the differing degrees of performing debt to include at one extreme ...
  - fully performing commercial borrowings attached to pledged assets and
  - at the other extreme fully non-performing debt, for example general Council or core debt being used to fund Council deficits or unprofitable non-income earning Council ventures.

This analysis often (in the first case) legitimises the non-consolidation or exclusion of the debt impact upon 'Council' only debt policies and upon Council 'balance sheets'.

- New or at least modified funding mechanisms will help. With the advent of the Rating 2002 Act and the more extensive use of the targeted rating funding mechanisms, these will allow better means of recovering all costs of a specific Council service including its associated debt servicing charges. Selection of a capital or mixed capital and land value basis of rating may assist as it often leads to a more principled visible and 'targeted' debt servicing funding strategy.
- Some tentative 'creative' funding mechanisms using so termed financial engineering including third party financing of Council capital expenditure. On a case by case basis the usage, audit and practice to deal with these schemes viz Council debt will gradually emerge ... (it is hoped).
- Capital contributions, principally taken in the form of the property developer's provision of the capital costs of utilities as well as similar, largely optional policies for capital payments from individual ratepayers ... all tend to relieve the need for Councils to borrow.
- Postponement of rates effects (which partly removes some of the need to borrow directly by Council as real property equity is put in place as security).
- Very recent and new alternative sources of Council funding from Central Government most often for a level of subsidy to poorer sections of the community to assist with addressing the serious public health issues concerned (which partly removes some of the need to borrow directly by Council as another source of finance is or may be found).
- Prospects of public private partnerships (PPP) in a myriad of forms including full blown Build, Own, Operate, and Transfer schemes, the less arms length Design, Build and Transfer construction contracts and imminent plans that could involve Council tolling of local roads.
- Off balance sheet funding of such investments as joint ventures (ports and airports obviating the need to borrow directly by Council).
- A separate case by case treatment of Council's corporate subsidiaries commercial debt, particularly where the debt is fully performing and is backed with commercial or other revenue earning assets
- A critical analysis of 'Council Only' as opposed to 'Consolidated or Group' debt and the revenue streams that service these differing debts (with a view to the quarantining of non-core, non-Council debt ... outside of the Council Only' debt parameters).

All of the above 'ideas' come in for consideration when future (LTCCP 06) planning of proposed debt levels is conducted. For use as a checklist the above list is useful. For the underlying detail as to how they all fit together in a comprehensive Council debt policy setting framework ... much is still to be done, both at the generic policy development level and for each particular Council's circumstances.



## 4.2 This papers key proposition

This paper proposes the view that the ‘good ideas’ list (above) contains a set of likely candidates ...that is the ‘Winners’ when it comes to revising existing Council borrowing (debt) limits.

A selection and combination of these ‘ideas’, properly justified in financial and policy terms may well provide for revised debt policies that possess an acceptable level of comfort equal to or above that which will be needed to demonstrate the desired level of financial prudence.

The set of ‘ideas’, represent recent developments coming from good practice within the sector, they are based on better and more detailed analysis. Best of all, most of these (though not all) of the ideas or techniques listed (above) have the effect of either ...

- increasing mandated debt levels, for example, those involving certain rationalisations including the use of a ‘segmented’ view of Council debt or
- at the very least, replacing direct Council borrowings by something completely different (for instance pursuing ‘no Council debt required’ strategies, the use of ‘contributions’ or third party financing *in lieu* of Council debt).

## 4.3 Not so fast ...

Until the full and comprehensive analysis for each Council using the prospect of incorporating these good ideas is completed, there are no guarantees that higher debt levels will or can be justified.

There are no points given for (unprincipled) second guessing the outcome of this exercise ... although on the face of it, most of these potential ‘winners’ will have the effect of permitting higher debt levels.

And ... in simple cases, that is for less complicated small to medium sized Councils going about their core business uncluttered with other investments or other more commercial activities, useful and properly considered liberalisation of Council debt ratios may often be justified.

In all of this it is very important to point out that there remain the still to be applied acid tests of the ability of the Council’s community to sustain (that word sustain again) any new and higher levels of debt. This goes without saying. But what will happen in the new analytical environment is that these judgments will now be much better informed by the analysis, much more so than for the more ‘steam driven seat of the pants borrow and hope’ strategies of the past.<sup>5</sup>

This paper will only, in passing consider the complexities of PPP and tolling options. Some of the common risk management techniques associated with these forms of capital raising, are similar to, and are connected with policies associated, for example with targeted rates and contributions policy settings.

These schemes involve amongst other things a common requirement of debt financing to identify, risk assess, quarantine and ‘lock in’ the revenue streams associated with debt servicing costs

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<sup>5</sup> For example, there are well documented cases of NPV analysis and iterative modelling, coupled with the use of such techniques as ‘back ending’ of third party debt funding, plus the addition of Central Government funding (often acquired after heavy ‘lobbying’ based on the detailed analysis) that gave the ‘go ahead’ on schemes or projects when other less integrated examinations of the debt consequences earlier had suggested a ‘non starter’.

Another example might be in circumstances where a good portion of Council debt is proven to be fully performing, that is, it is serviced by rock solid assured future revenue streams. This will tend to suggest that debt levels might rise beyond existing levels which previously had a built in buffer for these factors that are now considered on a factual principled basis to be not required.



involving the use of targeted rates or (say) a PPP or tolled project. Major issues of risk apportionment also arise, particularly the future assignment of revenue risk when a full PPP involves an asset's operation. These and other complexities have the potential to materially skew the debt policy issues and must not be just ignored. Go figure ...

#### **4.4 Lets not 'throw out the baby' though**

Given that this paper will, when complete suggest significant changes to the way we deal in future with the demands of very high levels (by any standards) of Council debt, it is still vital to identify the underlying and pretty much non negotiable fundamentals of this analysis.

In doing so it will be found that some of this fundamentalism, even including the more detailed seemingly more radical approaches to debt management involve no change from what is currently in place. As already stated, one such fundamental is the need to demonstrate that the proposed levels of debt are and will remain for the foreseeable future ... sustainable. Issues of ability to pay unsurprisingly remain 'on the table'.

In spite of the new demands for higher Council debt levels the law also remains the same (principally s.122B of the '96 Act') ... the need to prove 'prudence' remains, it is still a largely non-negotiable fundamental of good debt management.

Another example remains ... the need to give adequate reasons for all policy settings including debt. The earlier example of loan polls and the public interest in debt will be heightened in future and hence the need to more fully explain and consult upon these plans.

In this brave new world ... not everything to do with Council debt management has gone the way of the Moa, far from it.





## 5. AN UNFINISHED SYMPHONY

This paper, as a first draft (August 2005) is a work in progress. Having just re-read it, it really at this stage only achieves the objectives of stating the obvious and of outlining a possible approach by which NZLG sector debt issues might, in future be better managed.

The author intends to 'learn on the job' by implementing these ideas for client Councils as the opportunities arise.

For example, a number of Councils currently have recognised that their debt policies 'are not cutting the mustard' they are out of date and need wholesale revision. True.

In these cases the analysis of this paper and hopefully the flood of others peoples 'good ideas' will provide a picking list of 'ideas', that is a list of candidates' ... the 'Winners' and these, when worked through for the individual Council's circumstances will comprise the first draft of their new improved debt management policies.

It remains to be seen if 'all of this works' but whatever the outcome it will produce results that will be much better than the earlier broadbrush ones, the 'borrow and hope' approaches (still in vogue). As experience with these assignments is accumulated and with good sharing of ideas, something much better than what we currently have will emerge.

### 5.0 A long list of work in progress

The following table indicates the numerous additional debt related topics still to be explored.

Watch this space, in fact PLEASE help to fill it in by advising me at ...

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Topics	Feedback invited	Authors Comments
LGA 02 S 101 implications of community liability		
Segmented debt case studies including the need to 'quarantine' a tranche of associated debt.		
Central Govt money, its impact and the case of 'indefinite funding'.		
Bridging the time gap re construction and funding for development costs ... followed by rates using back ended funding.		
Use of NPV calcs and allowances for interest and inflation.		
Audit standpoint and findings from JOG research due August 11.		
Ability to pay and sub district A to P data.		
Performing non performing debt criteria		
Impact of development contributions		
Best payoff period issue 'for loans 30 years not 15'.		
Risk issues re PPP's or other types of TP funding		
Tolls.		
Borrowing for roads or bridges.		
Off balance sheet issues and use of BOOTs and LGA 02.		
Impact of IFRS?		
In substance effects of JVs sales of airports etc ... how creative do we get to address mounting debt issues.		
Social capital .... funding by ratepayers a Winner? I doubt it.		



## 6. FURTHER PROGRESS, THE POLICY DEVELOPMENTS ASSOCIATED WITH SEGMENTATION OF DEBT ... A 'QUARANTINED DEBT' CASE STUDY ... KAIPARA DISTRICT COUNCIL'S 'ECOCARE'

Of the topics listed in the previous section of this paper there is one case study, a particular set of circumstances that has already been directly addressed in practice. The circumstances of this case are sufficiently advanced in thought and practice to provide the raw material for a development of tentative guidance on the revisions needed to debt management policies and the methodology involved.

The case study addressed under this heading is the so termed 'EcoCare' project (its full title '*Mangawhai EcoCare Wastewater Treatment Scheme*') that is currently under development at Mangawhai in the Kaipara District (KDC), Northland.

The particulars (spelt out in considerable detail) of the specific management policies developed for the EcoCare project are recorded in the KDC 2004 - 2014 Long Term Council Community Plan [see *ref*; Appendix 1 (LTCCP Vol 2 pages 24 to 30) and Appendix 2 (LTCCP Vol 2 pages 102 & 103).]

One initial observation about the LTCCP disclosures of the appendices ...it is most unusual to see such detail of policy in a Council document as is the case for KDC and its EcoCare project. Given the major significance of this development and the impact of it upon the Council's 'balance sheet' and the additional \$30 M of EcoCare debt (existing KDC debt is a mere \$9.7 M) ... the attention paid to and the disclosures of these matters is less surprising.

The case study situation concerned with Mangawhai EcoCare directly relates to this paper's 'topics' listed in Section Five of this paper shown in the table as ...

*'Segmented debt case studies including the need to 'quarantine' a tranche of associated debt'.*

A number of other related topics are less directly 'informed' by this case study and include the Section Five topics of ...

*'Ability to pay and sub district data'*

*'Bridging the time gap re construction and funding for development costs ... followed by rates using back ended funding'*

*'Off balance sheet issues and use of BOOT's and LGA 02'*

*'Risk issues re PPP's or other types of Third Party funding'*

All of these so termed 'topics' share many of the qualities of the principal topic, they are matters associated with 'segmentation or quarantining' of debt.

### 6.0 What is 'segmented' debt?

A good starting place for this analysis is to define some of the more important terms. Some are largely self-explanatory such as 'Ability to Pay', others, such as debt segmentation and the various



models of financial engineering (such as Design, Build, Fund and Operate ... 'DBFOs') will in time require more technical and detailed description.

Firstly a 'segmentation' of debt arises from a separation of total Council and applies only to debt obligations of the Council to external third parties (excluding any notions of 'internal debt'<sup>6</sup>).

The concept is intended to separate out debt tranches (to segment debt) that can be included or excluded from Council debt parameters (ratios) depending upon the associated debt funded assets capacity to produce their own debt servicing revenues, (fully performing or non performing assets / debt).

## 6.1 To explain more fully ...

- if some part or parts of Council debt are directly associated with revenue producing (performing) assets,
- and these effectively 'self-service' their own debt obligations
- then, on a segmented 'stand alone' basis this component of debt may be exempted from other Council debt controls (ratios or parameters of a prudential nature) and
- may be treated as distinct from debt that is not associated with revenue producing assets.

For example, debt that may be segmented is deemed to be fully performing if it is associated with say utility/infrastructural assets that provide services that will be fully paid for by identifiable consenting community's, from their identifiable future revenues, the feasibility (including the ability of the community to pay) of which has been fully proven.

Fully performing assets are usually readily identified. Whilst there may be variants of these clear cut circumstances it is sufficient to say:

- that a 'segment' of Council debt is effectively fully performing
- if all of the costs of its associated service asset,
- including most importantly any of its associated debt servicing costs
- can feasibly be met by an identifiable community and
- are planned in future to be fully recouped from Council controlled revenues derived from the service use of the asset.<sup>7</sup>

## 6.2 Its been done

Segmentation of debt has been practiced within the NZLG sector already. It has, for some time been recognised that in terms of prudent financial management the key problem of 'sustainability' of debt and with it the prudence associated with raising debt was influenced by whether or not debt could be identified (segmented) and attached to assets that would, more or less be automatically self sustaining (performing) ...(above).

Where these things could be achieved, useful rationalisations of debt management have been made.

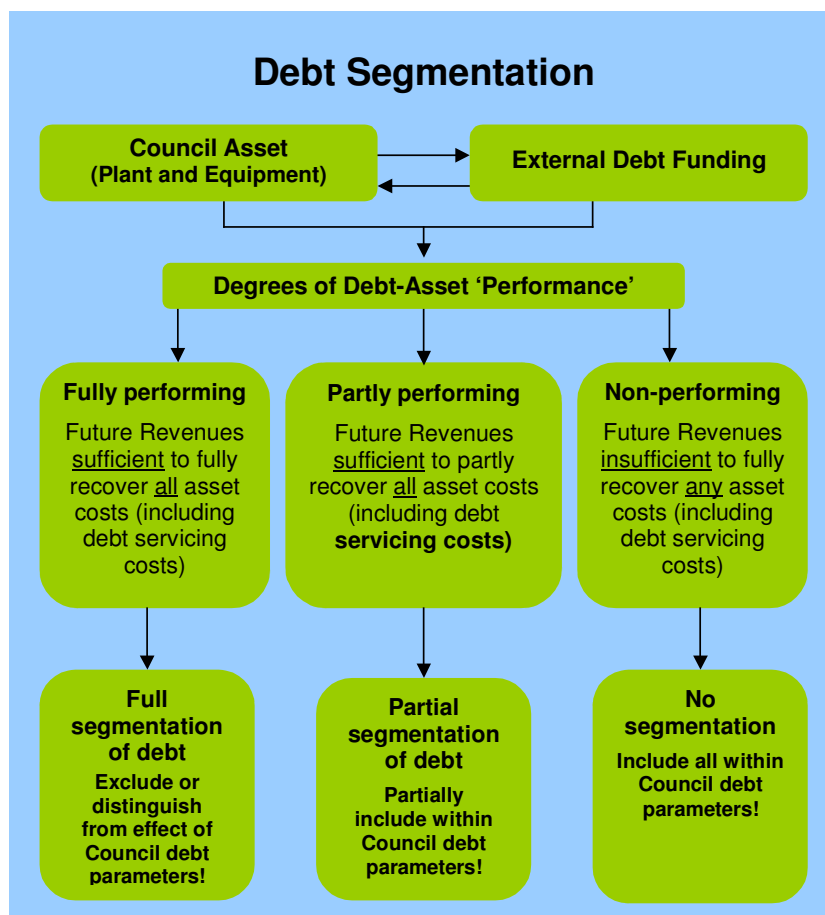
This paper attempts to codify and suggest management techniques to deal with these cases ... something largely lacking to date.

The flowchart below shows the differing components/segments of debt that might exist based on the extent to which each segment is said to be 'performing' or not.<sup>8</sup>

<sup>6</sup> Re internal debt exclusion ... internal debt issues need further distinction!

<sup>7</sup> Re rules as to what certainty of recoupment of revenues is necessary ... these need further distinction!

<sup>8</sup> Re pledged off balance sheet or hired or HP assets ... these need further distinction!



### 6.3 A need to quarantine segmented debt

The NZLG sector is at present proposing 'massive' debt increases, (see Section one of this paper for details). Anecdotal evidence suggests that much of this debt (although not all of it!) will be associated with revenue earning, service based infrastructural asset developments.

The Mangawhai EcoCare project at first view is likely to be typical of a fully performing debt related case. Many schemes like EcoCare are on the drawing board and are set to follow. There are also numerous other proposals, many involving complex financial engineering which are less tractable than EcoCare or do not 'fit' the circumstances more fully described in this paper.

This paper, as stated, though not deeply delving into the more complicated financing associated with the complex schemes starts the ball rolling to the extent that some of the concepts developed and the analytical approach adopted should assist with their (the complex schemes) better management.

For example, other Council debt funded projects, the BOOT's and others such as Council owned local roads or bridges are to be distinguished from this study (for instance road tolls and revenues of these schemes which are still problematical – complex to say the least), as they do not fit the more common ubiquitous circumstances that are becoming apparent ... mostly those relating to the more tractable water and wastewater projects ... and their readily identified certainties of revenue.



#### **6.4 There is much at stake**

It might in passing be added, that without the distinctions, such as those involved with ‘segmentation of debt’ (one subject of this paper), existing Council debt parameters (to repeat from earlier sections of this paper) will simply not cope with forecast debt increases.

It is important then if good practice is to emerge to deal with the high debt levels proposed that these cases get ‘nailed’, commencing with this paper’s suggestions of appropriate rules of practice.

A ‘segmentation of debt approach’ and its consequent suggested differing treatment for prudential debt management purposes, if logically conducted in a principled fashion will meet the objections mentioned in the introduction to this paper.

That is, objections that might be raised against the liberalisation of Council debt levels now tending toward permitting hitherto unparalleled high levels of Council debt. In following guidelines of better practice, good prudential management will be promoted and sanctioned on a principled basis, not one just arising from matters of expediency associated with the (pressing) need to borrow such large sums.

To achieve the necessary rigour of devising a ‘principled approach’ to debt management this paper (later in this section) suggests that certain rules should be set. The rules should be such that when followed the segmentation of debt exemptions or relaxations from the standard Council debt parameters are properly justified, (and are principled).

#### **6.5 Rules for exemption ...of standalone/quarantined segmented debt**

The existing debt parameters will not cope with the increases in debt proposed. Some exemption is necessary therefore, if it can be justified. Only under a particular set of circumstances can the liberalisations be permitted.

This paper suggests that there are two rules (inclusive ‘and’ type rules, not note, exclusive ones) that should be complied with if liberalisation of debt levels, those associated with debt segmentation are to be permitted.

#### **6.6 The first ‘rule’ ... the Circumstances that qualify**

The circumstances that should, with reasonable certainty prevail to allow for the use of an exemption for segmented debt include the existence of :

- an identifiable group or tranche of debt, being future financial obligations of a Council to external third parties (‘the debt’) and
- debt that is directly or could be associated with or is attributable to an asset or group of assets (‘the asset’) and
- asset(s) that are capable of and are expected to earn an identifiable, definable and quantifiable level of future Council revenue (‘the revenue’) and
- revenue that is available to the Council for the purposes of funding all costs related to the asset including ‘LGA 02’ compliant depreciation as well as the costs of debt servicing, that is, the associated – asset related debt servicing costs.



## 6.7 ‘And’ Rule two ... levels of Certainty

In addition and before allowing the exemption of segmented debt complying with the circumstances as described (above), it is necessary to achieve a desired level of certainty of the circumstances associated with any tranche of debt.

To achieve the necessary certainty ... not only that these circumstances exist but that they will in future prevail, the following considerations concerned with their certainty will have to be taken into account. They include criteria that are associated with the quarantining or so termed ‘ring fencing’ of the debt and include:

- the need for demonstrably accurate budgeting of all associated (often the scheme or project) costs and revenues
- sufficient testing and verification to prove the accuracy and reasonableness of the assumptions of the projections
- sufficient valid representations, comfort or assurances upon the issues and uncertainties of a particular scheme received from the parties concerned with the financial arrangements
- the satisfactory nature of the security and assurances gained over expected costs and revenues following completion of assessments of:
  - the relevant financial and contractual terms
  - consulted upon agreements elicited from the affected community agreeing to proceed with and pay for all of the asset related development’s associated costs
  - the ability to pay of the affected community including this determination at a whole of District, sub-District or affected local area parties levels
  - the presence of a consulted upon and approved funding mechanism (such as a specific asset related targeted rate) adopted and in place sufficient to produce, over time the required revenues
  - assurances (reasonably flexible ones?) that the terms and conditions of the segmentation will not be altered over the term of the arrangement.
  - inclusion of these (above) terms in the Councils adopted Significance Policy
  - Governance policies sufficiently enshrined for any future alterations to a Significance Policy affecting the financial arrangements

## 6.8 Outcome of compliance with the rules

Only following compliance with all of the terms of these two rules would it be considered prudent and appropriate to treat any tranche of debt as a standalone, quarantined segment of performing debt.

That tranche of debt can, if it meets the terms of the rules be excluded from application of the more restrictive Council debt parameters as it (the asset and the debt associated with it) is demonstrably and directly associated with the revenues necessary to self service all of the debt related costs.

The standard of compliance with these rules may vary as a matter of judgment. In some critical circumstances compliance should be very high, somewhat analogous to meeting the requirements of lenders under terms of a commercial debenture trust deed and the pledged assets associated with such arrangements.

In NZLG Council circumstances these more rigorous cases will arise where parties to a scheme, including possibly third party financiers will have committed the financial arrangements to a detailed contractual context. The Council’s own disclosures and policy framework should reflect a comparable degree of rigour and certainty. The long-term contractual obligations undertaken will often necessitate the segmentation and quarantining involved in any event.





Partial adherence to these rules or non compliance with them due, for example to a segment of debt not being associated with any future revenues (such as a community asset earning little or no revenues), would require that this remaining segmented non-performing debt be managed under the usual, albeit modified set of Council mandated prudential debt parameters.

Just what these remnants of the existing and ubiquitous Council debt parameters (the debt ratios and such) associated with the residual tranches of non-performing debt will look like after debt has been segmented is a matter for further study. Suffice to say that this remaining non performing debt will still need to be managed in accordance with prudential financial management policies *inter alia* involving sustainability issues and the community's ability to pay.

## **6.9 Conclusion**

The need for revised debt related rules should be apparent from the full argumentation of this paper including the funding sources pressures, the exigencies that the NZLG sector currently faces.

The case study of Section Six of the paper will in practice be used to apply the rules suggested for the treatment of segmented debt. The rules, when followed will provide a sufficiently documented audit trail of evidence in support of the Mangawhai EcoCare scheme's associated debt.

The 'EcoCare' scheme 'appears' on the basis of preliminary investigations to meet the requirements of the rules as to Circumstances and Certainty.<sup>9</sup> The proof of this conclusion still remains to be tested following the necessary field work required.

The 'EcoCare' scheme is intended to be self sustaining from its own identifiable future budgeted revenues to meet the costs of all associated asset development expense including the full recovery of debt servicing costs ... with reasonable and sufficient certainty.

The rules if followed will exempt Council from inclusion of the EcoCare debt within the scope of its standard existing Council mandated debt management parameters.<sup>10</sup>

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<sup>9</sup> There are other 'mini – EcoCare' schemes in the wind within the Kaipara District, Pahi and Bayleys to name just two. It is anticipated that they will be subject to the two rules (above), as they also 'appear' to conform as likely candidates for debt segmentation.

<sup>10</sup> Re other debt and commercial assets debt being treated the same ...still require further study.