Section 3: Financial Strategy

Purpose

This strategy sets out our approach for achieving the right balance between making progress for Auckland and ensuring that Auckland is an affordable place to live, work and do business.

It also describes how we ensure our financial management is fair and prudent, and sets out our objectives and targets for managing our key investments.

Summary

In addition to the requirements of providing day-to-day services, Auckland faces significant demand for infrastructure. At the same time Auckland needs to remain affordable, which means keeping increases in rates and other Auckland Council charges close to the rate of inflation.

To meet this challenge we must make sure that we get the most value out of every dollar we collect. The key ways we will do this are:

1. maximising efficiency savings
2. maximising the disposal of non-strategic surplus assets
3. maximising the return on our investments
4. partnering with others and investigating alternative funding mechanisms.

To ensure our finances remain prudent and sustainable, we will fully fund depreciation from current revenue by 2025 and target our interest expense to be no more than 12 per cent of our income.

This will enable an affordable and prudent capital programme of $17 billion over the next 10 years, utilising only our current funding sources. If Aucklanders are prepared to accept a new way to pay for fixing Auckland’s Transport, then we could afford to spend an additional $3.4 billion on transport over this period.

Auckland’s growth and infrastructure needs

Auckland is expected to experience significant population growth. Over the next 30 years our population is projected to grow by over 716,000 people, with 237,000 of these people arriving in the next 10 years. We anticipate that to accommodate this growth, 109,000 new dwellings and 4.3 million square meters of business space will need to be built over the next 10 years. These projected changes in population and land use are the primary drivers of the capital investment outlined in this strategy, and as a consequence, the primary drivers of our 10-year financial plans overall. Our proposed capital investment to cater for growth is outlined in the Proposed Investment section below.

Our 30-year infrastructure strategy describes the benefits of investing in infrastructure, but also outlines how decades of underinvestment combined with rapid growth mean Auckland now faces unprecedented demand for new and expanded infrastructure.

The cost of meeting this demand is substantial and despite significant funding streams from central government and other sources, we cannot undertake all the infrastructure investment we would like, within the timeframes we would like, while also keeping Auckland affordable.

For transport alone, the gap between the 30 year funding requirement identified in the Auckland Plan and currently available funding sources has been estimated to be $12 billion.

Our infrastructure strategy therefore outlines our key strategies for managing the various drivers of demand for Auckland infrastructure over the next 30 years.

This financial strategy sets out how we plan to meet the cost of maintaining existing service levels while also addressing Auckland’s infrastructure needs. Because the gap between infrastructure demand and available...
funding is so large, we need a financial strategy that ensures that we get the most value out of every dollar we collect.

Affordability constraints

Previous feedback has told us that Aucklanders clearly support making progress, particularly with fixing Auckland’s transport problems and improving the quality of Auckland’s urban environment. However we have also heard that there is no appetite for large increases in rates or the council debt.

While affordability is often expressed in terms of consumer price inflation, due to a healthy economy the income for the average Auckland household is growing faster than inflation. This means that on average our community is getting wealthier and their ability to pay for enhanced assets and services for Auckland is increasing.

Auckland Council also currently has ample capacity to borrow more.

Auckland therefore does not face any hard and fast funding constraints. The key question is how willing are Aucklanders to pay higher rates and other charges in order to make progress.

Proposed revenue parameters

Using only our current funding mechanisms, we consider that the following parameters represent the most appropriate balance between progress and affordability:

- overall average general rates increases for existing ratepayers of 3.5 per cent per annum
- water charges that increase at 2.5 per cent per annum for the next two years and 3.6 per cent thereafter
- development contribution charges that increase with inflation
- user charges that are standardised across the region, adjusted to represent appropriate levels of cost recovery and then increased with inflation each year.

To provide certainty and predictability to ratepayers, Auckland Council is proposing to limit overall average general rates increases for existing ratepayers to 3.5 per cent per annum. This limit excludes targeted rates for things like refuse and recycling collections, and refers to the overall average increase across all ratepayers.

Rates for individual properties are not restricted and will vary depending on a range of factors including property revaluations and whether the property is used for business, residential or farming purposes.1

The following chart shows the projected path of overall average general rates increases for existing ratepayers, rates revenue and other revenue sources for the next 10 years.

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1 For further information on Auckland Council’s rating policy, please refer to section 9

Auckland Council Long-term Plan 2015-2025
Supporting Information
Maximising the value from every dollar collected

Given these revenue parameters, we have sought to ensure that we get the most value out of every dollar we collect to help us address Auckland’s investment needs. The primary ways we have done this are:

1. maximising efficiency savings
2. maximising the disposal of non-strategic surplus assets
3. maximising the return on our investments
4. partnering with others and investigating alternative funding mechanisms.

1. Efficiency savings

In an environment where we cannot afford to do everything today, it is essential that we make sure that every dollar we do spend provides value for money. Efficiency savings (delivering the same or more for less) have increased from $81 million in the council’s first full year to $183 million for the 2014/2015 year, compared to the cost of delivering services under the legacy councils. Some of the ways in which we have achieved these savings are:

- simplifying and improving our business processes
- better procurement and tendering processes
- bringing more work in-house to reduce our reliance on external providers
- reducing the number of office buildings we occupy.

We are targeting significant further efficiency savings through the next ten years, as detailed in the table below. We are looking to innovative ways of achieving better outcomes for less money with a continued focus on better use of technology and smarter processes.

Efficiency savings targets

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<tr>
<td>Savings from prior years</td>
<td>183</td>
<td>219</td>
<td>235</td>
<td>249</td>
<td>256</td>
<td>263</td>
<td>270</td>
<td>277</td>
<td>284</td>
<td>291</td>
</tr>
<tr>
<td>Increase</td>
<td>36</td>
<td>16</td>
<td>14</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Annual efficiency savings</td>
<td>219</td>
<td>235</td>
<td>249</td>
<td>256</td>
<td>263</td>
<td>270</td>
<td>277</td>
<td>284</td>
<td>291</td>
<td>298</td>
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2. Disposal of non-strategic surplus assets

Auckland Council has a very large holding of land and buildings, some of which are not needed for providing the council services, not providing a market rental income, are poorly utilised or simply located in the wrong place. Because we will not have sufficient funding to provide all the new infrastructure we would like over the next 10 years, disposing of surplus assets will help maximise what we can provide. The following table shows the amount of disposals we are targeting for the next 10 years.

Disposal of non-strategic surplus assets

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</thead>
<tbody>
<tr>
<td>Targeted net proceeds from disposal</td>
<td>69</td>
<td>65</td>
<td>53</td>
<td>62</td>
<td>65</td>
<td>67</td>
<td>69</td>
<td>69</td>
<td>69</td>
<td>69</td>
</tr>
</tbody>
</table>

3. Return on investments

The council is expecting $1.3 billion in revenue from financial investments and equity securities over the next 10 years. We plan to explore opportunities to increase the return from these investments to maximise the
investment we can make in Auckland for any given revenue parameters. Our proposed approach to managing these investments is discussed later on in this strategy.

4. Partnering and new funding mechanisms

Auckland Council recognises that we can achieve greater progress towards becoming the world’s most liveable city by partnering with other organisations including the private sector, central government, charitable organisations and community groups. An example of this is partnering with charitable trusts on the Youth Connections programme which connects young people with opportunities in employment, education and training.

We can also do more if we are prepared to consider new ways of paying for things. An example of this is the Skypath Public Private Partnership that the council is evaluating, for which the private sector would cover the capital costs. The alternative transport funding mechanisms discussed later in this strategy to enable Auckland Plan Transport Network is another key example of this.

Prudent financial management

We consider that the fairest way to pay for long-life assets is to borrow and spread the cost across different generations of ratepayers. However, we need to ensure we use debt sustainably and that servicing our debt is affordable for both current and future ratepayers. We also need to make sure that we have enough flexibility to deal with any unexpected shocks such as another global financial crisis.

To ensure that we remain prudent, we have adopted a set of three prudential limits that will ensure our borrowings and interest expense do not grow too large relative to our rates and other revenue. Together with our large asset base, these limits underpin our AA credit rating, which is stronger than any New Zealand bank. However, after hearing Aucklanders expressing strong concern about the level of the council debt, we have taken an even more conservative approach of targeting to spend no more than 12 per cent of our income on the interest generated by debt.

Depreciation is a non-cash charge that reflects the reduction in the usability of our assets over time. Fully funding depreciation from rates and current revenue would mean that on average, over the long run, we are not relying on borrowing to fund asset replacement. This represents a very sustainable approach. Unfortunately, the legacy councils only funded 63 per cent of depreciation so we propose to progressively move to 100 per cent over the next 10 years.

For further information about our approach to depreciation funding and the use of debt to fund our activities, please refer to our Revenue and Financing Policy in section 9.1 of this Supporting Information.

Proposed investment

Combining our revenue growth settings with a 12 per cent target of interest to revenue will enable an affordable and prudent capital programme of $17 billion over the next 10 years (using only our existing funding mechanisms).

We propose to allocate this capital spending as follows:
This level of spend will result in the council debt growing by $3.5 billion over the next ten years, from $7.3 billion in June 2015 to $10.8 billion by June 2025. The following charts show how this projected debt level compares with our asset projections and how the growth in debt compares with our investment in new assets.
The above chart shows that by 2025 the council is much less reliant on borrowing to fund its capital expenditure programme than it is today. This is largely due to the council having fully implemented its deprecation funding policy by 2025.

The parameters and targets outlined in this strategy will also enable us to spend $40 billion over the next 10 years on the operational cost of delivering the council services and initiatives. This includes the interest and ownership cost of new assets. The following chart shows the make up of this spend.
In general, these levels of capital and operating expenditure will be sufficient to maintain existing service levels and provide for a reasonable and appropriate level of demand for new or improved assets and services. For some activities, slight reductions to service levels are proposed as detailed in Section 5 of this supporting material.

The one significant exception is transport. The transport capital expenditure has been reduced by $2.5 billion (down to $6.8 billion) compared to our previous plan. Most of this reduction relates to investment to cater for growth and improve levels of service. This has resulted in a reduction in the investment across the board in areas such as the cycle and walking network, park ‘n rides, public transport infrastructure and the roading network. This change will impact on previously projected public transport boardings as illustrated in the following chart.

The level of renewal capital expenditure has also decreased by $200 million over ten years relative to our previous plan, with decreases more prominent in the first three years. This will see a change in the condition of our transport assets and therefore it is projected that there will be a decrease in level of service over 10 years as shown in the following chart. We will minimise and closely monitor this through continued active asset management, with a primary focus on safety.
Fixing Auckland’s transport

The spending plan outlined above represents what we can achieve with our current funding mechanisms. However, this spending plan will not meet our aspirations for transport and will in fact result in Auckland’s transport problems getting worse over time as Auckland grows.

To achieve the transport outcomes set out in the Auckland Plan (our blueprint for building the world’s most liveable city) new funding tools are needed. As an alternative to the Basic Transport Network included in the above spending plan, the Auckland Plan Transport Network would involve additional capital spending of $12 billion over the next 30 years in order to fix our traffic and public transport issues. The main benefit of this additional investment would be less congested roads, as well as faster and more frequent public transport that would become the preferred way of getting around.

A group of independent experts have worked out two ways Auckland could fund the advanced transport system:

1. annual petrol tax increases of 1.2 cents per litre and an average annual rates increase of around one percent (in addition to the proposed 3.5 per cent).

2. a motorway user charge of around $2 when people enter Auckland’s motorway system.

Over the next 10 years, this would enable $3.4 billion of additional transport capital investment and increase the council debt by an additional $1.7 billion to be $12.2 billion by 2025.
Debt management

At $10.8 billion, our total projected group debt (including all CCOs) by June 2025 will remain at a prudent level relative to our assets and income. This is reflected in the council’s very high credit rating (an independent evaluation of our ability to repay debt and the likelihood of defaulting on our obligations).

<table>
<thead>
<tr>
<th>Entity</th>
<th>S&amp;P credit rating</th>
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<tbody>
<tr>
<td>New Zealand Government</td>
<td>AA+</td>
</tr>
<tr>
<td>Auckland Council</td>
<td>AA</td>
</tr>
<tr>
<td>Bank of New Zealand (BNZ)</td>
<td>AA-</td>
</tr>
<tr>
<td>Fonterra</td>
<td>A</td>
</tr>
<tr>
<td>Spark</td>
<td>A-</td>
</tr>
</tbody>
</table>

To ensure that debt levels continue to remain prudent and sustainable, the council has set the following prudential debt limits:

<table>
<thead>
<tr>
<th>Measure</th>
<th>2015/16</th>
<th>Peak</th>
<th>2024/25</th>
<th>Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing net debt as percentage of total revenue</td>
<td>201.1%</td>
<td>204.2%</td>
<td>164.0%</td>
<td>&lt; 275%</td>
</tr>
<tr>
<td>Net interest as percentage of total revenue</td>
<td>11.4%</td>
<td>12.0%</td>
<td>10.8%</td>
<td>&lt; 15%</td>
</tr>
<tr>
<td>Net interest as percentage of rates revenue</td>
<td>19.4%</td>
<td>20.5%</td>
<td>17.4%</td>
<td>&lt; 25%</td>
</tr>
</tbody>
</table>

These limits are indicators of the ability of the council to cover its borrowing costs from its different revenue sources. We ensure that debt levels will remain within those limits over the 10-year horizon.

The council uses a combination of operating income sources to pay for interest including, rates, fees and charges such as water and wastewater tariffs, and investment income such as commercial rental revenue and ports revenue.

In a similar way to how you might fix your mortgage, we protect the council from rises in interest rates through the use of fixed interest rates and the use of interest rate hedging instruments. To a large extent, this locks in the council’s future borrowing cost and protects us from rising interest rates.

To ensure that we are not too dependent on the state of global financial markets, we ensure that we always have sufficient cash, liquid investments and committed lines of credit available to allow us to pay our bills for at least the next six months. We also make sure that we borrow from a range of domestic and international lenders so that a problem with any one source of borrowings does not have too large an impact.

In general, the council will provide rates revenue as security for its borrowings including its borrowings through the New Zealand Local Government Funding Agency (NZLGFA) and the European Medium Term Note (EMTN) programme. However, in specific cases, the council may consider whether alternative security is appropriate, for example security over property that is specifically connected with the borrowing.

Auckland Council’s financial risks (market risk, credit risk and liquidity risk) are managed under our Treasury Management Policy which focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the financial performance of the council group. The Treasury Management Policy contains an interest rate exposure policy which provides the objectives and processes for managing these risks and how compliance with the policy is measured.

Investment management

The council is expecting $1.3 billion in revenue from financial investments and equity securities over the next 10 years. The four key types of investments, the council’s objectives for holding them and target returns are discussed below. More information on how the council manages its investment is contained in our Treasury Management Policy.

Equity investments in commercial activities

For the purposes of calculating the council’s prudential borrowing limits and credit rating, a number of adjustments are made to gross borrowing, including the exclusion of borrowing relating to Watercare Services Limited. After these adjustments, net borrowing at 30 June 2015 is forecast at $4.8 billion rising to $6.2 billion in 2024/2025. For more details, see Note 3 - Prospective Prudential Financial Ratios in the financial statements section of this supporting material.
The council has significant shareholdings in Ports of Auckland Limited, Auckland International Airport Limited and Auckland Film Studios Limited, which are managed by Auckland Council Investment Limited (ACIL). ACIL manages these activities to maximise financial returns while supporting the realisation of the council's broader strategic objectives. The targeted return on investment\(^3\) for major investments managed by ACIL is projected to be between 7.6 and 13.5 per cent over the next 10 years.

**Financial assets**

The council has a portfolio of diversified financial assets (DFA) made up of equities, bonds and cash. The council holds the DFA as a reserve to meet unforeseen funding issues that may prevent it from borrowing to fund its activities. The target return is to exceed the Official Cash Rate plus consumer price index inflation and the council expects the portfolio to return an average of 7 per cent per annum over the period of this LTP.

**Trusts and reserves**

The council has a number of trusts and reserves to fund specific activities. The trusts are mainly endowments from private individuals and organisations to help fund specified activities. The council manages these and uses the returns to fund the relevant activities. For the purposes of this LTP, revenue from trusts and reserves is assumed to be utilised for specified activities in the year it is received. Accordingly, no movement in trusts and reserves balances is forecast.

The council has set a target for the returns to exceed the interest rate for the 90 day bank bill and corporate A grade bonds for the relevant year.

**Shareholding in the New Zealand Local Government Funding Agency (NZLGFA)**

The council is a shareholder in the New Zealand Local Government Funding Agency (NZLGFA). The council expects to fund some of its borrowings from the NZLGFA at interest rates lower than those offered by other New Zealand lenders, which will reduce the council's overall borrowing costs.

The expected return on the council's investment in NZLGFA is 4.5 per cent.

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\(^3\) Return on investment is calculated as the dividend from ACIL to Auckland Council plus change in shareholder funding, divided by shareholder funding at the end of the year.