

NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY LIMITED (LGFA) ESTABLISHMENT ISSUES II

1. In this paper we:
 - (a) provide a general summary of the New Zealand Local Government Funding Agency Limited (LGFA) and the roles of the councils (**Principal Shareholding Local Authorities**) who will hold ordinary shares in it;
 - (b) describe the contractual framework of the LGFA funding structure and the purpose of each of the principal contracts that participating councils will be required to be party to; and
 - (c) discuss the process for incorporation of LGFA, in particular matters requiring council action.

General Summary

2. The LGFA is the limited liability company to be established to give effect to the proposed funding structure for councils in New Zealand.
3. It is intended that LGFA will borrow funds from domestic and international sources and on-lend those funds to councils, ultimately driving a lower cost of funds for those councils.
4. LGFA's establishment is facilitated by the Local Government Borrowing Act 2011 (**LGBA 2011**). That Act applies to LGFA on the basis LGFA remains a council controlled organisation (**CCO**) under the Local Government Act 2002 (**LGA 2002**).
5. Under the LGBA 2011, LGFA will be able to access wider funding markets as it will not be subject to the same domestic currency borrowing restriction that currently applies to councils. In addition, the LGBA 2011 exempts LGFA from various regulatory and taxation criteria which would otherwise apply to it, including the non-bank deposit taker regime and the prospectus requirements of the Securities Act 1978, and enables councils to lend on favourable terms to LGFA and provide guarantees of LGFA's obligations.
6. It is proposed that LGFA will initially be incorporated with:
 - (a) one share (to be held by one of the "tight nine" councils);
 - (b) six directors (being the six directors nominated by the "tight nine"); and
 - (c) a simple form of constitution.
7. Following incorporation, LGFA will undertake a number of actions that are intended to precede the acquisition of LGFA shares by the initial shareholding councils. These actions include:
 - (a) putting in place D&O insurance coverage for directors and employees, deeds of indemnity for directors and employees and initial approval of director remuneration;

- (b) adopting LGFA's initial statement of intent and foundation policies;
- (c) executing service documentation with the New Zealand Debt Management Office; and
- (d) executing equity subscription agreements in relation to the proposed subscription of shares in LGFA by the "tight nine" councils and the New Zealand Government.

8. There is a two-stage subscription process contemplated for LGFA.

- (a) *First Opening:* An initial subscription of ordinary shares, in which each of the "tight nine" councils and the New Zealand Government will enter into an agreement with LGFA for the subscription of ordinary shares (**First Opening**). A total of 45 million ordinary shares will be issued in the First Opening, comprising 20 million each of paid up and unpaid ordinary shares to be issued to the relevant councils, and 5 million fully paid ordinary shares to be issued to the New Zealand Government.
- (b) *Second Opening:* An equity transfer (**Second Opening**) proposed to occur by way of a pro-rata sell down of paid and unpaid ordinary shares by each of the existing "tight nine" councils to (currently) ten other councils. The "tight nine" will retain an aggregate ownership interest of at least 51% in LGFA following the Second Opening (although this majority may not be retained subsequently if members of the "tight nine" voluntarily transfer their holdings).

9. As a condition to:

- (a) the subscription of ordinary shares by the "tight nine" pursuant to the First Opening; and
- (b) the purchase of ordinary shares by the additional councils pursuant to the Second Opening,

each Principal Shareholding Local Authority will be required to execute, or accede to the terms of, certain governance, operational and security documents.

10. Those documents include the:

- (a) Shareholders' Agreement;
- (b) Multi-Issuer Deed;
- (c) Notes Subscription Agreement;
- (d) Equity Commitment Deed;
- (e) Guarantee; and
- (f) various security stock certificates.

11. Councils proposing to participate in the LGFA structure, but who do not propose to hold any ordinary shares in LGFA, will still be required to execute, or accede to, the:

- (a) Notes Subscription Agreement;
- (b) Guarantee (if borrowing in excess of \$20 million); and
- (c) certain security stock certificates.

Contractual Framework

12. A diagram of the contractual framework is attached as Appendix A. The principal documents making up this framework are summarised below.

Constitution

13. Following the issue of LGFA shares to the "tight nine" in the First Opening, it is intended that LGFA will adopt the Constitution (in place of the constitution initially adopted on Incorporation).

14. The Constitution is LGFA's constituting document. Subject to the arrangements agreed between the shareholding councils and the New Zealand Government in the Shareholders' Agreement, it sets out provisions relating to LGFA's corporate structure and governance. In particular, the Constitution details:

- (a) LGFA's share capital (including permitted classes of share capital, calls on shares and requirements relating to the transfer of interests in shares);
- (b) the requirements for shareholder and board meetings; and
- (c) the process for the appointment and removal of directors, and the rights and obligations of directors.

15. In addition, the Constitution allows LGFA to amend certain default positions that would otherwise apply under the Companies Act 1993. These amendments include conferring on LGFA a right to acquire its own share capital, an ability to issue redeemable shares (as contemplated under the Equity Commitment Deed and Notes Subscription Agreement) and provide for LGFA to indemnify current and former LGFA directors and employees and to effect D&O insurance for them.

Shareholders' Agreement

16. A council may only become a shareholder in LGFA if it has agreed to be bound by the Shareholders' Agreement.

17. This agreement sets out various governance arrangements for LGFA, including:
- (a) the appointment and rotation policy for directors;
 - (b) the establishment of a shareholders' council to advise shareholders on a range of operational and governance issues;

- (c) prescribed matters requiring approval by ordinary or special resolution of shareholders;
- (d) the reimbursement of councils for applicable NZLGA establishment costs;
- (e) the process for the sell down of shares under the Second Opening;
- (f) pre-emptive rights that apply to any proposed transfer of shares by a shareholder; and
- (g) the commitment of councils to source their debt funding requirements through LGFA.

18. The Shareholders' Agreement operates in conjunction with the Constitution. The Constitution provides that in the event of a conflict between the Constitution and the Shareholders' Agreement, the Shareholders' Agreement will prevail.

Subscription Agreement

- 19. The Subscription Agreements set out the terms for the issue of shares to the "tight nine" councils in the First Opening.
- 20. Each of the "tight nine" councils' Subscription Agreements are conditional on each other of the "tight nine" also subscribing and agreeing to enter into the requisite documentation.
- 21. Under these agreements, subject to a number of conditions being satisfied, LGFA will issue to the proposed initial shareholding councils 40 million shares (comprising 20 million each of paid up and unpaid shares) and 5 million fully paid up shares to the New Zealand Government.
- 22. Following settlement, LGFA and the shareholders will arrange for execution of the various LGFA security and operational documents referred to in paragraph 10 above.
- 23. In entering into a Subscription Agreement the relevant subscribing council is required to represent and warrant certain matters, including as to its ability to enter into the documents and the transactions contemplated by it, as well as compliance with the consultation requirement under section 56 of the LGA 2002.

Guarantee

- 24. The councils are required to be bound by the terms of the Guarantee as a condition of being a shareholder in, or borrowing (a proposed minimum of \$20 million) from, LGFA.
- 25. Under the Guarantee, each guarantor is liable on demand to pay a proportion of any amounts due by LGFA which are not paid to LGFA's guaranteed creditors on any relevant due date for those amounts. The extent of a guarantor's liability is based on its share of the aggregate annual rates income of all guarantors for the latest financial year. If any guarantor defaults in its payment obligations, the amount of that default must be borne by the non-defaulting guarantors on the same proportional basis.

26. The Guarantee includes provisions for the release of a council's guarantee obligations with respect to future incurred LGFA debt if that council ceases to be an LGFA shareholder and no longer has any outstanding borrowing from LGFA.
27. A council's obligations under the Guarantee will be secured by a security stock certificate issued under that council's debenture trust deed.

Equity Commitment Deed

28. A council which is required to enter into the Guarantee is also required to enter into the Equity Commitment Deed.
29. Under this deed a council is required, in certain circumstances, to subscribe for redeemable shares in LGFA. The relevant circumstance is where all unpaid capital in LGFA has been paid up and there remains a risk of imminent default by LGFA under its borrowed money indebtedness.
30. All councils under the deed will be called at the same time and in an equivalent proportion to their potential liability under the Guarantee (that is, by reference to their annual rates income). A failure by one council to take up its shares will result in the remaining councils being required to take the shortfall in the same manner as applies to a shortfall under the Guarantee. A council's obligation under the deed reduces in line with any reduction in its Guarantee obligations.
31. If LGFA requires a council to subscribe for redeemable shares it will also offer to lend the council the requisite funds by subscribing for securities to be issued by that council.
32. A council's obligation to subscribe for redeemable shares is to be secured by a security stock certificate issued under its debenture trust deed.

Multi-Issuer Deed

33. In order to borrow from LGFA, a council is required to enter into the Multi-Issuer Deed.
34. This deed sets out the procedure for councils to issue, and LGFA to subscribe for, securities (**LG Securities**) issued by the relevant council. The standard conditions applicable to LG Securities are scheduled to the deed and the process for issuing the LG Securities is set out in clause 4 of the deed, which councils should review. If a council makes a payment under the Guarantee, LGFA's consequent obligation to reimburse the relevant council will be set off against any amount a council may owe under any LG Securities.
35. Financial covenants are provided for under the deed. Failure to comply with them will give rise to an event of review which may result in the council being required to redeem its LG Securities.
36. A council's obligations under the deed will be secured by a security stock certificate issued under its debenture trust deed.

Notes Subscription Agreement

37. As a condition to borrowing from LGFA, a council is required to accede to the Notes Subscription Agreement.

38. Under this agreement whenever a council issues LG Securities to LGFA, LGFA shall issue borrower notes (**Borrower Notes**) to the council equal to 1.6% of the principal amount of the LG Securities.
39. The subscription monies paid by the councils for the Borrower Notes provide a capital buffer for LGFA in addition to the paid and unpaid share capital.
40. The councils will receive interest on the Borrower Notes at a rate set by LGFA (which will be the same rate for all Borrower Notes).
41. Borrower Notes will convert into redeemable shares if LGFA determines there is a risk of imminent default by LGFA under its own indebtedness. If it is not legally possible to convert Borrower Notes LGFA may instead extend their maturity date.
42. Unless converted, Borrower Notes will be redeemed on their maturity date (initially set to coincide with the maturity date of the LG Securities they were issued in connection with and subject to extension as noted above) but on a subordinated basis.

Master Trust Deed

43. LGFA will enter into a Master Trust Deed with a trustee company under which it will issue securities to investors.

Security Trust Deeds

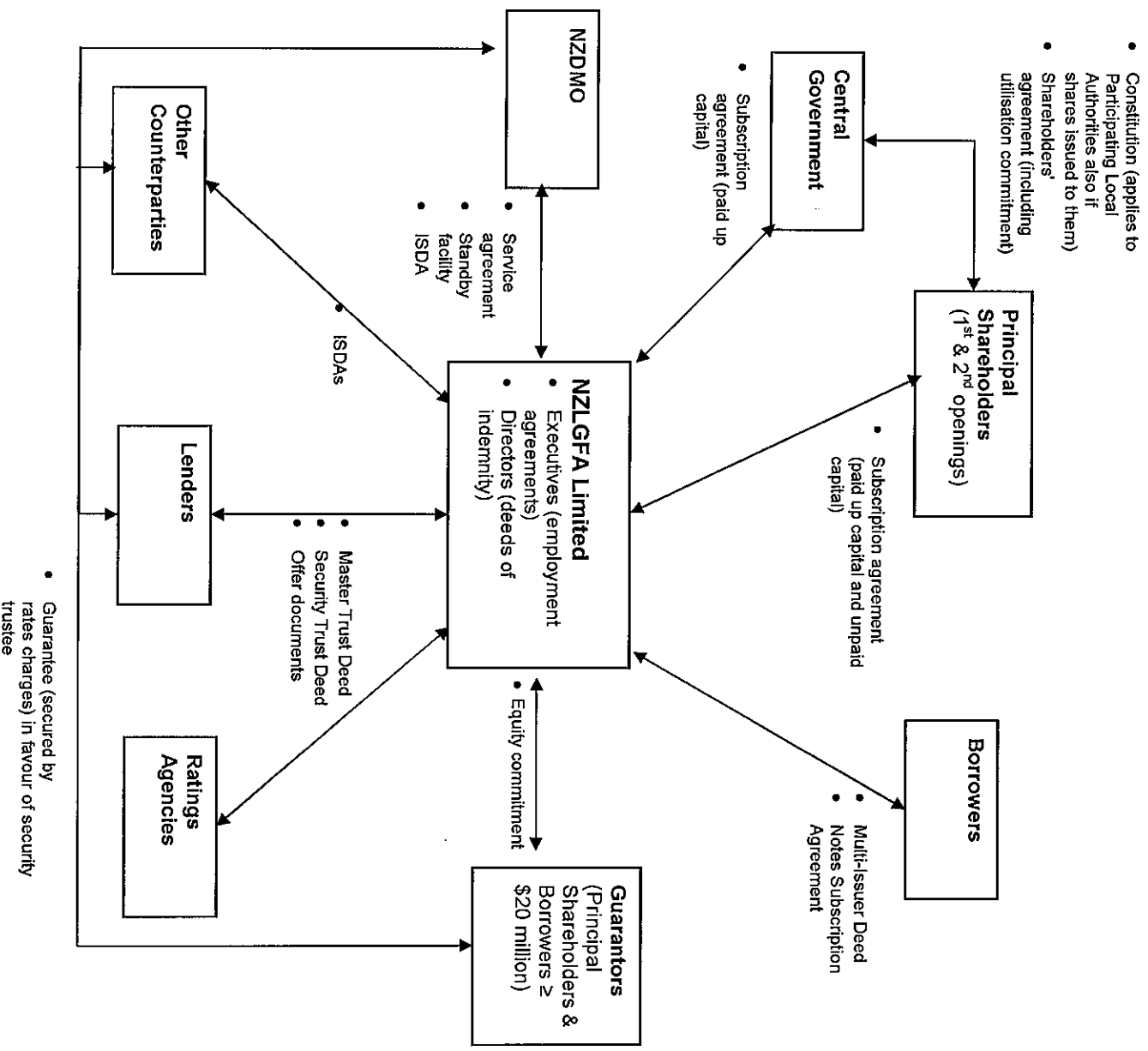
44. LGFA will also enter into a Security Trust Deed with a trustee company. The security trustee will hold the benefit of the Guarantee and related security stock certificates on behalf of the LGFA creditors.

Councils Process for Establishment of LGFA

45. Attached, as Appendix B, is a compliance checklist for Principal Shareholding Local Authorities covering the various matters for councils to consider, and ensure are satisfied, before progressing with involvement in LGFA.

APPENDIX A

CONTRACTUAL STRUCTURE



APPENDIX B

LOCAL GOVERNMENT ACT 2002 COMPLIANCE CHECKLIST

Before executing any of the LGFA documents, all principal shareholding local authorities should ensure they have complied with their obligations under the Local Government Act 2002 (**LGA 02**). We set out below the matters relevant to compliance with the LGA 02.

1. Is the local authority's investment in the LGFA consistent with the local authority's investment policy?

Section 102(2)(c) requires a local authority to adopt an investment policy. The policy must cover the particular matters set out in section 105. Generally, local authorities will expect to comply with their investment policies unless there is good reason not to.

Every principal shareholding local authority has amended, or is currently in the process of amending, its investment policy to enable its investment in the LGFA.¹ Almost all local authorities have added a section to their policies specific to the LGFA investment, using the same standard wording.²

Currently, for all local authorities, investment policies are part of long term plans. Accordingly, to amend the policies, it has been necessary to amend long term plans (due to section 51(3) Local Government Act 2002 Amendment Act 2010). Amendment to the long term plan necessitates the use of the special consultative procedure under sections 83 and 84 (section 93(5)).

Each principal shareholding local authority must, therefore, have used the special consultative procedure to propose amendments to its investment policy in the long term plan. At the conclusion of such consultation, the local authority must have resolved to amend its investment policy.

We have read the statements of proposal for all principal shareholding local authorities and confirm that all of them refer to altering the investment policy as part of an amendment to the long term plan. Although we have also considered resolutions passed by most principal shareholding local authorities (not all local authorities have yet completed their decision-making processes), we have not reviewed other aspects of local authorities' consultation processes.

We have not reviewed each principal shareholding local authority's investment policy in its entirety (although we have considered all amendments made to policies). Accordingly, each local authority should satisfy itself that the investment in the LGFA is consistent with its amended investment policy in its entirety.

If a local authority has any concerns that there may be a significant inconsistency, it should use the process in section 80 (identify the inconsistency, the reasons for it, and any intention to amend the investment policy to accommodate the decision to invest in the LGFA).

¹ We base this on our review of the principal shareholding local authorities' statements of proposal.

² Based on principal shareholding local authorities' statements of proposal, only Auckland Council has not used the standard wording as the basis for its amendments.

2. **Is the local authority's participation in the LGFA consistent with the local authority's liability management policy?**

The issues with this point are virtually identical to the analysis above relating to investment policies.

Section 102(2)(b) requires a local authority to adopt a liability management policy. The policy must cover the particular matters set out in section 104. Generally, local authorities will expect to comply with their liability management policies unless there is good reason not to.

Every local authority has amended, or is currently in the process of amending, its liability management policy to enable its investment in the LGFA.³ Almost all local authorities have added a section to their policies specific to participation in the LGFA, using the same standard wording.⁴

Currently, for all local authorities, liability management policies are part of long term plans. Accordingly, to amend the policies, it has been necessary to amend long term plans (due to section 51(3) Local Government Act 2002 Amendment Act 2010). Amendment to the long term plan necessitates the use of the special consultative procedure under sections 83 and 84 (section 93(5)).

Each local authority must, therefore, have used the special consultative procedure to propose amendments to its liability management policy in the long term plan. At the conclusion of such consultation, the local authority must have resolved to amend its liability management policy.

We have read the statements of proposal for all principal shareholding local authorities and confirm that all of them refer to altering the liability management policy as part of an amendment to the long term plan. Although we have also considered resolutions passed by most principal shareholding local authorities (not all local authorities have yet completed their decision-making processes), we have not reviewed other aspects of local authorities' consultation processes.

We have not reviewed each principal shareholding local authority's liability management policy in its entirety (although we have considered all amendments made to policies). Accordingly, each local authority should satisfy itself that its participation in the LGFA is consistent with its amended liability management policy in its entirety.

If a local authority has any concerns that there may be a significant inconsistency, it should use the process in section 80 (identify the inconsistency, the reasons for it, and any intention to amend the liability management policy to accommodate the decision to invest in the LGFA).

3. **Has the local authority consulted on and decided to become a shareholder in the LGFA?**

Section 56(1) requires that a proposal to establish a council-controlled organisation (CCO) must be adopted in accordance with the special consultative procedure before a local authority can establish or become a shareholder in the CCO. The special consultative procedure is that set out in sections 83 and 87.

³ We base this on our review of the principal shareholding local authorities' statements of proposal.

⁴ Based on principal shareholding local authorities' statements of proposal, only Auckland Council has not used the standard wording as the basis for its amendments.

Each principal shareholding local authority must, therefore, have used the special consultative procedure in relation to a proposal to become a shareholder in the LGFA. At the conclusion of such consultation, the Council must have resolved to participate in the LGFA as a shareholder.

We have read the statements of proposal for all principal shareholding local authorities and confirm that all of them refer to the section 56(1) requirement for consultation. Although we have considered resolutions passed by most local authorities (not all local authorities have yet completed their decision-making processes), we have not reviewed other aspects of local authorities' consultation processes.

4. In deciding to participate in the LGFA, has the Council complied with its obligations under section 101 of the LGA 02?

Section 101 sets out some obligations on local authorities in relation to their financial management. The section provides:

101 Financial Management

- (1) A local authority must manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community.
- (2) A local authority must make adequate and effective provision in its long-term plan and in its annual plan (where applicable) to meet the expenditure needs of the local authority identified in that long-term plan and annual plan.
- (3) The funding needs of the local authority must be met from those sources that the local authority determines to be appropriate, following consideration of,-
 - (a) in relation to each activity to be funded,-
 - (i) the community outcomes to which the activity primarily contributes; and
 - (ii) the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals; and
 - (iii) the period in or over which those benefits are expected to occur; and
 - (iv) the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity; and
 - (v) the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities; and
 - (b) the overall impact of any allocation of liability for revenue needs on the current and future social, economic, environmental, and cultural well-being of the community.