

Report No:	RCN11-11-08
File No:	
Date:	21 November 2011
Decision Required	

REPORT SUMMARY

Report to: Tasman District Council
Meeting Date: 24 November 2011
Report Author: Murray Staite, Corporate Services Manager
Subject: Local Government Funding Agency Scheme –
RCN11-11-08

EXECUTIVE SUMMARY

Since the last update that was provided to Council further significant progress has been made with the Local Government Funding Agency (LGFA) proposal:

- The enabling legislation for the LGFA has been passed with support from all parties in Parliament;
- Ten more local authorities have joined the list of councils seeking to participate as principal shareholders in the LGFA at inception, bringing the total number up to 19;
- A near-finalised set of legal agreements has been developed to give affect to the LGFA structure based on the principal elements of the structure that formed the basis of the earlier statement of proposal and public consultation. Simpson Grierson have acted as legal advisers to the nine major councils, including Tasman District Council, that have sponsored the LGFA proposal and a copy of their legal review of the agreements is included as Attachment one to this report.
- A shadow board of directors has been formed for the LGFA and the board has ratified a draft statement of intent (SOI) accompanied by three-year summary financial forecasts.

Simpson Grierson's review of the agreements has included consideration of the sponsoring councils' consultation and decision-making obligations as well as further general compliance matters. Staff are comfortable that the review has not highlighted any substantive inconsistencies between the structure as it is now reflected in the agreements and the structure that was reflected in the original statement of proposal.

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On this basis staff are also satisfied that the six matters relevant to demonstrating compliance with the requirements of the Local Government Act 2002 (that Simpson Grierson have included by way of a compliance checklist as Appendix B in Attachment One) have been addressed.

The only two substantive matters that are yet to be confirmed concern confirmation of a credit rating for LGFA that is equivalent to that of the Crown and confirmation that a satisfactory agreement has been reached with the government's debt management office (NZDMO) to enable LGFA to outsource a significant component of its treasury management operation to the NZDMO. Both matters are expected to be confirmed shortly and must be confirmed prior to council executing final documentation.

DRAFT RESOLUTION

That the Tasman District Council:

- a) receives and notes the contents of the Local Government Funding Agency Scheme Report (RCN11-11-08); and
- b) confirms the previous "in principle" decision, and acts on it by authorising the taking of all necessary steps to become a Principal Shareholding Local Authority in the LGFA, including the following:
 - subscribing for shares in LGFA with an aggregate issue price of up to \$2,500,000;
 - subscribing for uncalled capital in LGFA of up to \$2,500,000;
 - entering into guarantees of the obligations of LGFA and other local authorities;
 - committing to borrow at least 80% of the Council's indebtedness over the next 3 years from the LGFA;
 - subscribing for Borrower Notes;
 - committing to providing additional equity to the LGFA under certain circumstances if required; and
- c) authorises the Acting Chief Executive to execute, and in the case of any deeds, authorises the Mayor and another elected member to execute, all documents in such form as the Acting Chief Executive confirms as necessary or appropriate to execute to give effect to b); and
- d) confirms the appointment of the initial directors of LGFA, despite this process being inconsistent with the Council's policy on the appointment of directors, for reasons set out and addressed in the report, and
- e) confirms the appointment of Corporate Services Manager Murray Staite as a member of the LGFA Shareholder's Council.

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Subject: Local Government Funding Agency Scheme – RCN11-11-08

1. Purpose

- 1.1 To report on the final details of the Local Government Funding Agency (LGFA) scheme, and to recommend that the Council confirms its previous in principle decision to participate in the LGFA as a principal shareholding local authority and authorise the steps necessary for this to occur.

2. Background

- 2.1 At its meeting of 23 February 2011, the Council considered the pros and cons of participating in the LGFA and passed the following resolutions:

THAT the Tasman District Council:

a) Receives and notes the contents of the local government funding agency scheme report RCN 11-02-13

and:

b) Approves the proposal to join the local government funding agency scheme as a principal shareholding local authority and related amendments to the treasury management policy, and that the proposal be subject to the special consultative process in accordance with the Local Government Act in conjunction with the 2010 and 2011 Annual Plan process.

- 2.2 At its meeting of 9 June 2011, the Council considered results of the special consultative procedure on its proposal to participate in the LGFA as a principal shareholding local authority, and passed the following resolutions:

THAT the Tasman District Council:

a) receive and notes the contents of the Local Government Funding Agency Scheme Report (RCN11-06-07); and

b) approves in principle, subject to a separate staff report on the final details of the funding scheme, the proposal to join the Local Government Funding Agency Scheme as a Principal Shareholding Local Authority. (Abridged)

- 2.3 The resolution also adopted amendments to Council's Treasury Management Policy to enable participation in the LGFA as a principal shareholding local authority.
- 2.4 Significant progress has been achieved with the LGFA work program since Council was last updated. Key milestones are summarised below:

Enabling legislation	The Local Government Borrowing Bill has been passed with cross party support.
Government shareholding	Cabinet has approved the Crown making a \$5 million investment in LGFA, which will equate to approximately 20% of the voting shares.
Legal documentation	A set of legal agreements to give effect to the LGFA structure have been completed. These documents reflect the principles of the structure that formed the basis of public consultation. Simpson Grierson have reviewed these documents and provided a legal opinion for the benefit of principal shareholder councils which is contained in Attachment 1 to this report.
Shadow board of directors	Following a recruitment process run by the establishment board, a shadow board of directors has been appointed. A summary of the director appointment process along with director profiles has been included as Attachment 4 to this report.
Draft Statement of Intent (SOI)	An initial SOI has been completed and is provided in Attachment 3 to this report. This document records the intentions of the board and includes a set of 3 year summary financial forecasts, key performance targets, dividend policy, governance matters and reporting arrangements.
19 Councils ready to invest in the LGFA	19 councils have confirmed their interest and preparedness to become principal shareholders in the LGFA at its inception. These 19 councils account for approximately 73% of local government sector debt. The 19 are: Tight 9: Auckland Council, Christchurch City Council, Greater Wellington Regional Council, Hamilton City Council, Tasman District Council, Tauranga City Council, Wellington City Council, Western Bay of Plenty District Council and Whangarei District Council; Plus: Bay of Plenty Regional Council, Hastings District Council, Kapiti Coast District Council, Masterton District Council, New Plymouth District Council, Otorohanga District Council, Selwyn District Council, South Taranaki District Council, Taupo District Council and Waipa District Council.
Service level agreement with NZDMO	The NZDMO is the government's debt management office within the Treasury. Draft service level agreements are currently being completed with the NZDMO to secure their delivery of treasury support services to LGFA.
Shadow credit rating	Rating assessment processes have been conducted with the major international credit rating agencies. Based on these processes the shadow board is confident LGFA will obtain a credit rating equivalent to that of the Crown.
Chairman's letter	Craig Stobo, Chair of the LGFA establishment board has written to Mayors and Chief Executives of the 19 councils preparing to become principal shareholders at the inception of LGFA. A copy of this letter has been included as Attachment 4.

3. Matters to be Considered

- 3.1 The LGFA proposal has reached the stage where the new entity is ready to launch. The Crown and 19 local authorities, including Tasman District Council, are now being asked to subscribe for capital in the new entity. Accordingly, it is appropriate to report back to the Council on the final details of the LGFA scheme to enable the Council to decide whether to act on its previous in principle decision to participate as a principal shareholding local authority.
- 3.2 The initial evaluation of the LGFA scheme undertaken earlier this year concluded that the proposal offered attractive financial benefits and that the risks that arise from the structure are well understood and able to be appropriately managed by the LGFA board and executive.

Statement of Intent

- 3.3 Attachment Three to this report contains a draft Statement of Intent (SOI). This is provided for information purposes at this stage as the formal process necessary to support the adoption of the LGFA's first SOI can only occur once the company is formally incorporated. This will however be one of the first tasks of the LGFA board on incorporation and, as a shareholder, Council will have an opportunity to formally consider and comment at that stage.

LGFA Business Plan

- 3.4 A further review of the LGFA business plan has been completed on the basis of near finalised legal agreements and a draft SOI which incorporates the results of a detailed and robust business plan exercise for the LGFA. This evaluation has also been completed after considering the impacts of the recent downgrading of the New Zealand credit rating.
- 3.5 The financial projections included within the LGFA's draft SOI are believed to be based on a realistic set of assumptions regarding the LGFA's two key value drivers being its overhead operating cost structure and interest rate margins.
- 3.6 Of these two key drivers, interest rate margins are the hardest to accurately predict as market conditions will impact on margins over time. To a large extent however, delivery on interest rate margin expectations will come down to the skill of the LGFA board and its executive team and will be dependent on their ability to market the benefits of the LGFA to investors. With a credit rating for LGFA equivalent to that of the crown, and with local government debt representing such solid underlying security, the board and executive have a very real opportunity to succeed with this endeavour.

- 3.7 An additional value driver for LGFA concerns the volume of lending to the local government sector. If loan volumes are not of sufficient size then LGFA could potentially struggle to cover its operating costs and to provide pricing benefits to borrowers.
- 3.8 The structure that was originally proposed provided for shareholder councils to provide a commitment to utilise LGFA for a certain percentage of its borrowing requirements. In the case of Tasman District Council 50% was considered appropriate.
- 3.9 The feature now reflected in the final documentation contemplates a commitment of 80% of shareholder councils term borrowing requirements for a three-year period and it is this feature that enables shareholders and the board to have a high degree of confidence that the LGFA's lending volumes will be of sufficient size in the critical early years.

Pricing benefits

- 3.10 In the original assessment of pricing benefits, it was concluded that 0.40% represented the likely long-term benefit for Council in terms of reduced borrowing margins. Based on the consideration of current financial market conditions and the intentions of the LGFA board as communicated through the draft SOI this figure remains a relevant, and if anything, conservative measure of the long term pricing benefits. Factors relevant to making this determination include:
- a) LGFA's financial forecasts are underpinned by commitments from local government shareholders to utilise LGFA for a fixed percentage of their borrowing requirements over the next three years. This goes a long way to securing the scale LGFA requires in its start-up phase to be viable and to provide pricing benefits to councils.
 - b) As LGFA grows, these pricing terms should improve. Based on the recent business modelling exercise which the LGFA establishment board have undertaken and endorsed by the shadow board, while LGFA need to charge a margin on their loans of at least 0.40% from day one, this declines to 0.25% by June 2014 and close to 0.15% by 2019.
- 3.11 In respect of these assessed pricing benefits it is worthy reflecting on where pricing margins could be in the absence of the intended launch of LGFA. Recent evidence suggests that the relative narrowing of margins councils are currently achieving the market's anticipation of the LGFA launch. There is therefore a risk that if the LGFA is not successfully launched, margins for all council borrowers could increase again.

Guarantee

- 3.12 As a principal shareholder, Council will be required to enter into a guarantee arrangement whereby it will guarantee the payment obligations of the LGFA. Under the terms of this guarantee, in the event that a call is made on the guaranteeing councils, each council's share of any liability is assessed in direct proportion to each council's respective rating revenue base.
- 3.13 As a principal shareholder, Council would also have a contingent liability in respect of its uncalled capital in the LGFA which will be equal to the final level of paid up capital that Council subscribes to. This is a maximum of \$2.5 million but this may well be scaled back depending on the level of participation from councils outside of the nine main sponsoring councils.
- 3.14 The evaluation of the risks that arise under the guarantee and uncalled capital arrangements has focused firstly on the likelihood of an event occurring that could trigger a call for additional capital and secondly, the consequences of such an event, having regard to the various mitigating factors inherent in the proposed LGFA structure. The risks are also noted in the advice from Simpson Grierson (Attachment Two). This evaluation is summarised in the following table:

	Likelihood of Occurrence	Consequences and Mitigations
Temporary shortfall of readily available cash	Low	Minimal consequence owing to a significant standby funding line in place with the NZ Debt Management Office (NZDMO)
Default of a local authority which has borrowed funds from the LGFA	Very low (it is believed that no local authority has ever defaulted on its debt obligations)	The consequence of a local authority default are significantly mitigated by the requirement for local authority borrowers to provide a rates charge. Under a rates charge there are very clear statutory provisions which provide a receiver with clear powers to collect the funds owed from that particular local authority under a special rating assessment procedures
Default by the LGFA caused by an event other than an underlying local authority borrower.	Very low	The sorts of operational risk that would cause this event cannot be completely eliminated but they can be managed. The LGFA will be subject to comprehensive governance processes. The LGFA will adopt appropriate and prudent internal risk management policies and procedures. These will include the contracting of the NZDMO to carry out certain aspects of LGFA's operational requirements that include back office settlements, systems, borrowing, investing, hedging and treasury risk management.

Governance

- 3.15 The LGFA establishment board recently completed a recruitment process to agree on an initial board of directors for LGFA. An initial shadow board of

directors has been confirmed and upon incorporation they will become the LGFA's first board of directors. As provided for in the shareholders agreement, the board reflects a majority of independent directors and the first rotation of directors will occur at the 2013 annual meeting.

- 3.16 In terms of overall board composition, alongside four independent directors, including the chair, are two non-independent directors who are Mark Butcher, Treasurer Auckland City Council and Paul Anderson, General Manager, Corporate Services Christchurch City Council. Both Mark and Paul have been members of the LGFA establishment Board along with Craig Stobo as Chair, Matthew Walker and Eugene Bowen of Local Government NZ. Their role as directors on the shadow board reflects their relevant skill sets as well as a desire to ensure that the LGFA board has some sector representation as well as strong input from independent directors. Their role on the board also ensures a degree of continuity is maintained in terms of establishing a new board while at the same time retaining much of the knowledge that has been developed through the establishment board's work.

Shareholder Council

- 3.17 An important feature of the LGFA that distinguishes it from many other CCOs is the lack of a single majority shareholder. Initially the Crown would be the largest shareholder with an approximate 20% shareholding and as many as 19 local authorities owning approximately 80%.
- 3.18 It has been recognised that this shareholding structure creates challenges for the LGFA board in terms of managing multiple shareholders. It also creates challenges for shareholders in seeking to ensure that both robust performance monitoring processes and effective mechanisms to facilitate clear communication of shareholder issues to the board are in place. In response to these issues, the shareholders agreement provides for a shareholders council to be established that upon establishment of the LGFA is intended to comprise one representative from each of the nine major sponsoring councils as well as one representative from the Crown. The intention is for this group to comprise of suitably qualified and experienced council staff as well as one representative for the Crown.
- 3.19 Matthew Walker of Hamilton City Council has been nominated to the role of chairman by representatives of the main nine councils, as well as the Crown.
- 3.20 The role of the Shareholders Council will be to:
- Review the performance of the company and its board and report to shareholders on these matters on a regular basis,
 - Make recommendations to shareholders concerning the appointment and removal of directors;
 - Make recommendations to shareholders on any other matters which required shareholder approval or consideration from time to time, including the initial and ongoing annual adoption of the SOI;

- Endeavour to ensure that shareholders are fully informed on matters concerning the company and to act as a co-ordination point on decisions required by shareholders with respect to governance of the LGFA
- 3.21 It is a recommendation of this report that Council's Corporate Services Manager be Tasman District Council's representative on this group.

Dividends

- 3.22 The board's intention in respect of its dividend policy is recorded in the draft SOI (Attachment Three). Section 6 of the SOI states:

The board's intention will be to pay a dividend that provides an annual rate of return to principal shareholders equal to LGFA cost of funds plus 2.00% over the medium term recognising that, to assist in the start up period, the initial expectation will be for no dividend for the part period to 30 June 2012 and a dividend equal to 50% of the target dividend in the two periods to 30 June 2014 to be paid. Therefore the intention is to pay at least the full target dividend until the target dividend return is achieved as measured from commencement, including consideration of the time value of money at the target annual rate of return.

- 3.23 This dividend policy represents a change from our earlier advice that the LGFA could be in a position to pay full dividends from inception. This change reflects, in part, the impact of changes in the market in anticipation of the LGFA which has seen council borrowing margins compress. The change also reflects the board's view that the long-term interests of the shareholders are better served by paying a lower dividend through the start up phase of the LGFA in order to support better pricing for borrowers. Staff concur with this view.

4. Financial/Budgetary Considerations

- 4.1 Participation in the LGFA as a principal shareholding local authority will require the Council to invest a maximum of \$2.5 million in the LGFA. Given the expected commencement of the LGFA and the requirement to present a final report to Council before participation, no allowance other than narrative was made in the final 2011/2012 Annual Plan.
- 4.2 It is proposed that this investment be kept within a closed account and as free cash flow permits the debt be repaid. The original intention that the LGFA cover its cost by the receipt of dividends over the medium term remains unchanged and consequently the raising of debt to finance this investment will not result in a cost to ratepayers.
- 4.3 Council will also be required to commit to borrow at least 80% of the Council's debt through the LGFA for the next three years. It is expected that LGFA

pricing will be competitive in the period but there may be cheaper rates available. As an investor in LGFA, the Council has an interest in ensuring that it can trade into a position where dividends will flow and the primary objectives of the LGFA are achieved. In the circumstances this "utilisation commitment", which is part of the total package of arrangements for the establishment of the LGFA, is regarded as within the scope of the Council's statutory obligation to act prudently and in a manner that promotes the current and future interests of its community.

- 4.4 Based on Council's current debt and using the debt profile contained within the 2009-2019 LTCCP, annual interest savings are expected to be close to \$350,000 for 2012/2012, rising to \$840,000 by 2018/2019. Over the next seven years savings are expected, in total, to be over \$4 million dollars.

5. Options

5.1 Option 1 – Participate in the LGFA as a principal shareholding local authority

Council could confirm its previous in principle decision and commit to participating in the LGFA as a principal shareholding local authority. This will necessarily require it to authorise elected members and officers to sign the necessary documents.

5.2 Option 2 – Do not participate in the LGFA as a principal shareholding local authority

The Council could reverse its previous in principle decision and decide not to participate in the LGFA as a principal shareholding local authority. If the Council were to choose this option, it would be appropriate (at a later meeting) to consider whether the Council should participate in the LGFA in some other way (eg as a borrower at levels below those required of guaranteeing and non-shareholding borrowers) or if the Council should not participate at all.

6. Decision-making

- 6.1 In making its decision, the Council must comply with the decision-making requirements in sections 76 to 81 of the Local Government Act 2002.
- 6.2 In particular, section 77 requires the Council to identify the reasonably practicable options for meeting its objective and to analyse those options against certain criteria in section 77(1)(b). Much of the Council's record of its compliance with section 77 is set out in the previous two reports to the Council on this matter, being RCN11-02-13 and RCN11-06-07 (and in the information provided with the special consultative procedure).

- 6.3 Finally, section 78 requires the Council to consider the views and preferences of interested and affected persons in making its decision. Relevant views and preferences were identified and considered as part of the special consultative procedure on the Council's proposal to become a principal shareholding local authority. Council staff consider that there have not been any material changes to the LGFA Scheme since undertaking the special consultative procedure that would warrant further consultation before the Council proceeds to decide whether to confirm its "in principle" decision to participate in the LGFA as a principal shareholding local authority.

7. Appointment of Directors

- 7.1 The 'tight 9' councils, led by the LGFA Establishment Board (comprising Craig Stobo (shadow chair of the LGFA), Mark Butcher from Auckland Council, Paul Anderson from Christchurch City Council, Matthew Walker from Hamilton City Council, and Eugene Bowen from Local Government New Zealand), have identified a shadow board of directors for the LGFA. An outline of the process followed and profiles for the six shadow directors are set out in Attachment Four).
- 7.2 Council staff are satisfied that the shadow directors meet the criteria for selection of directors in the Council's policy on appointment of directors (made under section 57 of the Local Government Act 2002).
- 7.3 However, there is an inconsistency with the Council's policy. The process for appointment set out in the policy has not been followed in identifying the shadow board of directors. The reason for this is because the policy deals primarily with CCOs for which the Council and Nelson City Council are the shareholders; it does not cater for a scenario where the Council is one of 19 shareholders.
- 7.4 Section 80 of the Local Government Act 2002 allows the Council to make a decision that is significantly inconsistent with a policy, provided that it clearly identifies the inconsistency, the reasons for it, and any intention of the Council to amend the policy to accommodate the decision.
- 7.5 Council staff recommend that the existing director appointment policy not be amended given that the LGFA appointment process is a one-off special case.

8. Significance

- 8.1 This is not a significant decision according to the Council's Significance Policy because it is simply the completion of a decision-making process about the Council's participation in the LGFA. The Council has already agreed in principle to participate, subject to a further report on the final details of the LGFA scheme, following undertaking of a special consultative procedure on

its proposal to participate in the LGFA as a principal shareholding local authority.

9. Recommendation/s

9.1 That the Council adopts the suggested draft resolutions.

10. Timeline/Next Steps

- 10.1 If the Council chooses to adopt the suggested draft resolutions, then elected members and officers would proceed to sign the necessary documentation shortly after.
- 10.2 It is anticipated that the LGFA will be established on 1 December 2011, and commence operating after that.
- 10.3 It is expected to take several years to transition Council debt to the LGFA however, considerable work is required over the next few months to ensure that the appropriate amount of debt is transferred to effect the savings noted earlier in the report and to ensure the viability of the LGFA itself

11. Draft Resolution

That the Tasman District Council:

- a) receives and notes the contents of the Local Government Funding Agency Scheme Report (RCN11-11-08); and**
- b) confirms the previous “in principle” decision, and acts on it by authorising the taking of all necessary steps to become a Principal Shareholding Local Authority in the LGFA, including the following:**
 - subscribing for shares in LGFA with an aggregate issue price of up to \$2,500,000;**
 - subscribing for uncalled capital in LGFA of up to \$2,500,000;**
 - entering into guarantees of the obligations of LGFA and other local authorities;**
 - committing to borrow at least 80% of the Council's indebtedness over the next 3 years from the LGFA;**
 - subscribing for Borrower Notes;**
 - committing to providing additional equity to the LGFA under certain circumstances if required; and**
- c) authorises the Acting Chief Executive to execute, and in the case of any deeds, authorises the Mayor and another elected member to execute, all**

documents in such form as the Acting Chief Executive confirms as necessary or appropriate to execute to give effect to b); and

- d) confirms the appointment of the initial directors of LGFA, despite this process being inconsistent with the Council's policy on the appointment of directors, for reasons set out and addressed in the report, and**
- e) confirms the appointment of Corporate Services Manager Murray Staite as a member of the LGFA Shareholder's Council.**

Attachments:

- 1 Simpson Grierson legal advice to all principal shareholding local authorities on establishment issues
- 2 Simpson Grierson legal advice to Tasman District Council
- 3 LGFA Draft Statement of Intent
- 4 Letter from LGFA Chair to the Mayor and Chief Executive – Summary of LGFA Board appointment process and director profiles