Financial Strategy

Supporting documentation for the
2021-31 Long Term Plan Consultation Document

NAPIER
CITY COUNCIL
Te Kaunihera o Ahuriri

FINANCIAL STRATEGY

Our financial strategy sets out the overall financial goals of the Council for the 2021–31 Long Term Plan. The strategy builds on our current financial position by setting out where we want to be positioned during, and at the end of, the Long Term Plan period.

The Local Government Act 2002 (LGA) is the guiding legislation for all councils' planning and activities. The LGA requires that the Long Term Plan period is for a minimum of 10 years and because of the changes in approach the financial strategy only covers 10 years. The infrastructure strategy covers a 30 year period, and informs the financial strategy of the need to fund both operational expenditure and capital beyond the period of the Long Term Plan.

The financial strategy also provides guidance on how we consider and approach funding of expenditure proposals in the current Long Term Plan, and informs all subsequent activity decisions made for the duration of the 2021–31 Long Term Plan.

This strategy outlines the Council's financial vision for the next 10 years and the impacts on rates, debt, levels of service and investments. It will guide the Council's future funding decisions and, along with the infrastructure strategy, informs the capital and operational spending for the Long Term Plan 2021-2031 (LTP).

Executive summary

This proposed strategy is a significant change for the existing strategy contained in the 2018-2028 (LTP). Historically we have not spent enough money on looking after our key assets – under the ground, on the ground, and in our community. Keeping our rates low has been the priority but it has come at a cost. It has started to affect our community wellbeing.

For too long, Napier has taken a short term and conservative view. At the same time we have been a little too ambitious about what can realistically be achieved – setting a huge programme of projects. In addition, our costs are rising due to factors outside our control. These include increases in Government set levies, policies and regulations, as well as rising insurance costs. It's time to face our future. And our future is now.

Our goal now is focus on the essentials and to invest for the longer term so that our situation will not worsen over time. We have a lot to do – replacing ageing assets, fixing infrastructure, and keeping up with an ever-changing environment.

So, how do we afford it? An easy option would be to increase our rates to pay for our plans. But we are committed to keeping our rates as affordable as we can. To achieve the right balance, we've had to make some tough calls on what can be done within the next 10 years. We've taken a hard look at our spending and have cut our costs down. We've had to move some projects out a few years to save money, and we are also looking to borrow $320m to catch up on maintenance and replacement of our key assets. There are consequences to this approach. We're borrowing more than we ever have before and our budget will not break even until 2031.

In addition, we have had the sale of residential properties in the Parklands subdivision to assist as in keeping rates low, from the 2027/28 year we are not expecting any income from this subdivision, and to ensure that we still deliver the same level of service, we are going to be more reliant on rates.

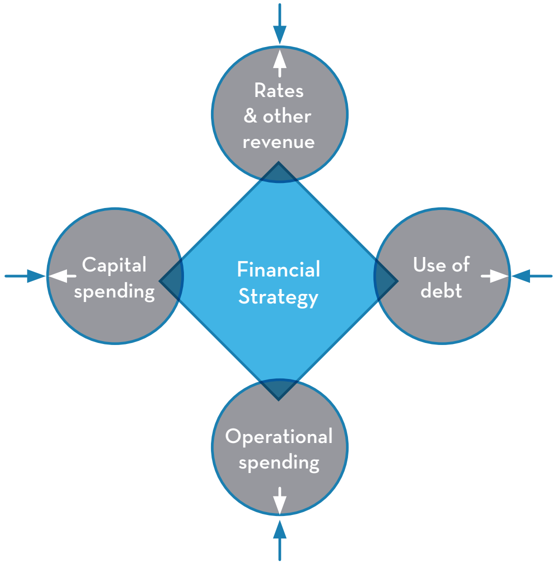
We operate a number of tourism-based facilities and our income from these facilities took a hit, but we have almost returned pre-Covid-19 levels. While there was been a slowdown in the economy due to Covid-19, the City's economy has recovered in part by domestic visitors from other regions. However, we anticipate no income from our interest in the Hawke's Bay Airport until 2025.

Impacts of population growth

In addition, like the rest of country there is strong demand for residential properties, this has then put pressure on the need for additional infrastructure that the Council must build and then recover by use of financial contributions. We are expecting over the 10 year period to see a population increase of just over 6%, and to support that additional population we are expecting a further 1,870 additional residential lots to be created. As part of the Long Term Plan, we have included the necessary infrastructure and operational costs to support the expected increase in both population and number of residential dwellings.

Level of Service

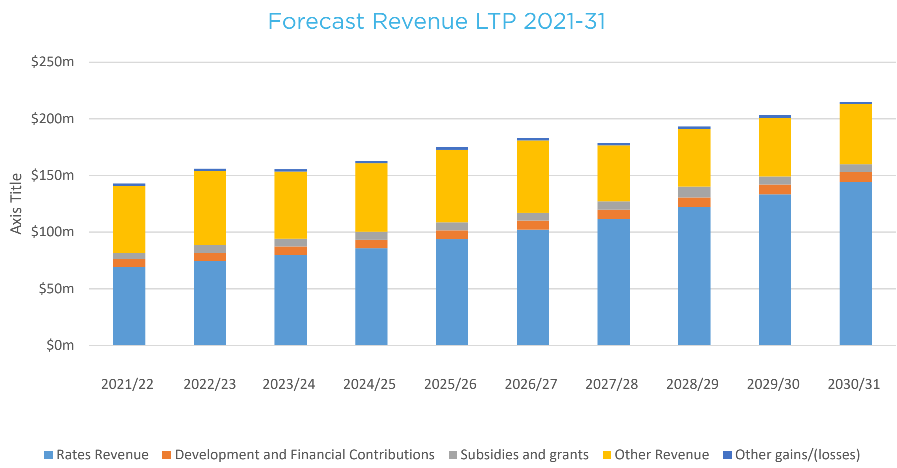
The financial strategy in the last Long Term Plan in 2018 aimed at achieving a balance by trying to deliver affordable rates to the community, minimise Council borrowings and optimise capital spending. This balance can be represented by reflecting the four financial components of rates, operational expenditure, capital expenditure and borrowings as levers, as shown in the diagram below.



The diamond represents the level of service provided by the Council. A larger diamond means an increased level of service (or new services). There is no intention to increase the levels of service, as this will require increased operational and capital expenditure. The proposed strategy is focused on maintaining existing level of service. The diamond is affected by the four levers: rates and other revenue, operational and capital expenditure and debt. Changing only one lever can be achieved without affecting service levels by allowing the other components to adjust.

Rates and other revenue

Having completed a robust Revenue and Financing Policy review, the financial strategy considers the total dollars that are required and the annual increases rather than the allocation of the rates between types of rates and properties that pay rates.



The graph above reflects both increasing rates and total revenue over the period of the strategy, including the impact of the loss of revenue from Parklands subdivision from 2027/28. The rates revenue as a percentage of total revenue increases from 49% to 67% over the 10 year period, and this is predominantly driven by the reduction in other revenues from 41% to 25% as demonstrated in the table below.

Allocation of revenue	2021/22	2030/31
Rates Revenue	49%	67%
Development and Financial Contributions	5%	4%
Subsidies and grants	4%	3%
Other Revenue including Parklands	41%	25%
Other gains/ (increase investments)	1%	1%

Other sources of revenue

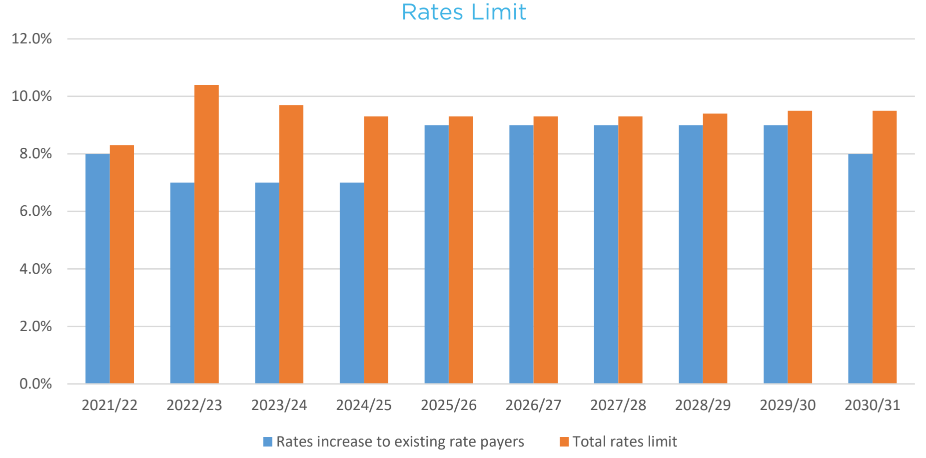
The non-rates revenue that we can draw upon comprises mainly fees and charges, grants and subsidies, and development and financial contributions. Other revenue includes fees and charges, building and resource consent fees, community housing rental income, and library and swimming pool charges. Unlike other local authorities we have significant tourism-based facilities and together with the sale of Parklands properties and some investment income contribute to the other revenue stream.

Rates limits

Council has set itself the following quantified limits on rate increases over the 10 year period. Total rates increases will increase by no more than the Local Government Cost Index (LGCI) plus 6.5% to cover asset renewal costs and debt repayment, together with an allowance of 0.3% for growth in the rating base. The graph and table below demonstrates how we intend to remain within those limits.

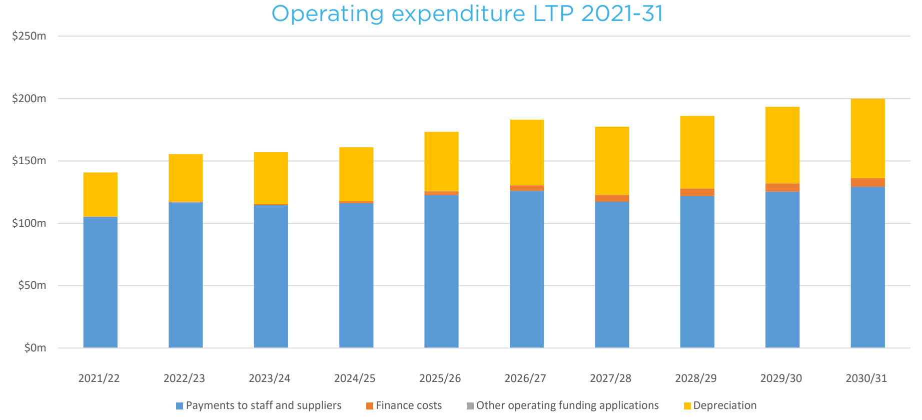
	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
Rates limit	8.0%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
LGCI	0.0%	3.6%	2.9%	2.5%	2.5%	2.5%	2.5%	2.6%	2.7%	2.7%
Growth in rating base	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Total rates limit	**8.3%**	**10.4%**	**9.7%**	**9.3%**	**9.3%**	**9.3%**	**9.3%**	**9.4%**	**9.5%**	**9.5%**
Rates increase to existing ratepayers	8.0%	7.0%	7.0%	7.0%	9.0%	9.0%	9.0%	9.0%	9.0%	8.0%

Note: Rates increases exclude water by meter, rates penalties and rates remissions



Operating expenditure

It is worth noting that the model incorporates capital expenditure. Clearly a significant increase in capital expenditure would require a significant rates increase to fund it, which in turn would affect the other two levers of rates and debt. The proposed capital expenditure is focused on replacing existing assets to maintain levels of service and providing additional capacity for growth. New capital expenditure has resulted in additional operating expenditure, e.g., payments to staff and suppliers to operate the additional capital, together with finance costs and depreciation.



Depreciation

Depreciation is a significant component of operating expenditure:

- Depreciation is recognition of the current use of the asset by residents and ratepayers.
- Depreciation is a charge that today's ratepayers should meet as it provides the funds for renewal of the asset. Applied like this it recognises the key issue of intergenerational equity and will ensure that future generations are not left with an unsustainable fiscal burden. The cash or funding generated by the revenue may be used for present capital needs (including renewals), debt reduction or set aside for future capital needs. This helps ensure sound asset management practice and continuity of service to future generations.
- The Council will steadily increase the amount of depreciation that is rate funded.
- Debt will be used where funds from depreciation, capital subsidy and financial contributions are insufficient to meet the capital programme expenditure.

Logic

Depreciation spreads the capital cost of assets over their useful lives, so that each generation of ratepayers pays for their fair share of use of the asset. By not rate funding, it places an unfair burden on future ratepayers, who have to pay for the asset replacement.

Rate funding depreciation supports the intergenerational equity principle whereby everyone who benefits from use of the asset pays their fair share over the assets' useful life.

By rating for depreciation, we are providing cash to fund the capital renewal programme.

Prudent financial management and a 'balanced budget"

There is a fundamental requirement for prudent financial management contained in section 101 Local Government Act 2002 (LGA) which requires all local authorities to manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently.

The requirement to have a balanced budget is contained with the Local Government Act 2002 and requires all local authorities to set their budgeted revenues at a level to meet that year's budgeted operating expenses, until the authority resolves it is not prudent to do so.

As noted above depreciation is an operating expense and must be included as an expense when considering the requirement to have balanced budget.

The Council acknowledges that it will be running an unbalanced budget in years 1-9 of the Long Term Plan (LTP) because it will not include all depreciation as an expense when setting its revenues in those years. Following the 2020 asset revaluations the total depreciation expense increased significantly and Council does not believe it is appropriate to immediately increase rates to address the impact this has had on Council's ability to balance the budget.

The following fiscal levers will be used to move progressively towards achieving a balanced budget within the life of this LTP:

- fees and charges
- lifting rates revenue
- efficiencies

We acknowledge that we will not achieve this for nine of the next ten years. This is because we believe that setting rate levels to immediately achieve this would be inequitable and extremely hard on ratepayers. The Council continues to believe the gradual changes proposed will result in the best fiscal and sustainable outcome. While rates will be higher than people would like for the next few years, it will enable us to support the capital investment required for the region while maintaining the levels of service that residents expect.

Throughout the Long Term Plan period Council has programmed some significant rates increases, and the Balanced Budget graph shows that over time Council's budgets steadily move closer to balanced that the earlier years and will be fully balanced by year 10.

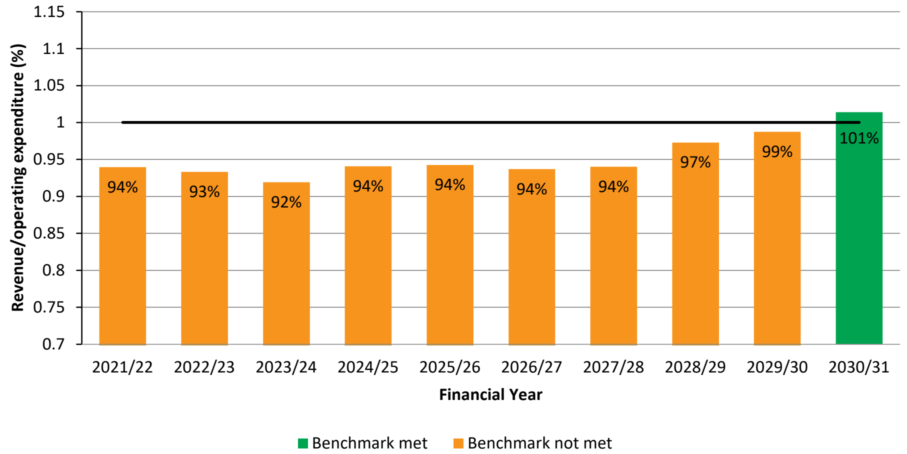
In 2014 the Government introduced the Local Government (Financial Reporting and Prudence) Regulations 2014 (the Regulations) also known as the Prudence regulations. The purpose of the Regulations was not to define what is prudent, nor is it a definitive measure, however it is a test over a period of time that can be measured against other local authorities. This is one of many other measures that local authorities are required to report against both in long-term plans and annual reports. It is considered a useful guide rather than the definitive answer.

The Regulations define a balanced budget as:

- A local authority meets the benchmark for a year if its revenue (excluding financial contributions, financial contributions, vested assets, gains on derivative financial instruments, and revaluations of property, plant, or equipment) for the year exceeds its operating expenses (excluding losses on derivative financial instruments and revaluations of property, plant, or equipment) for the year.

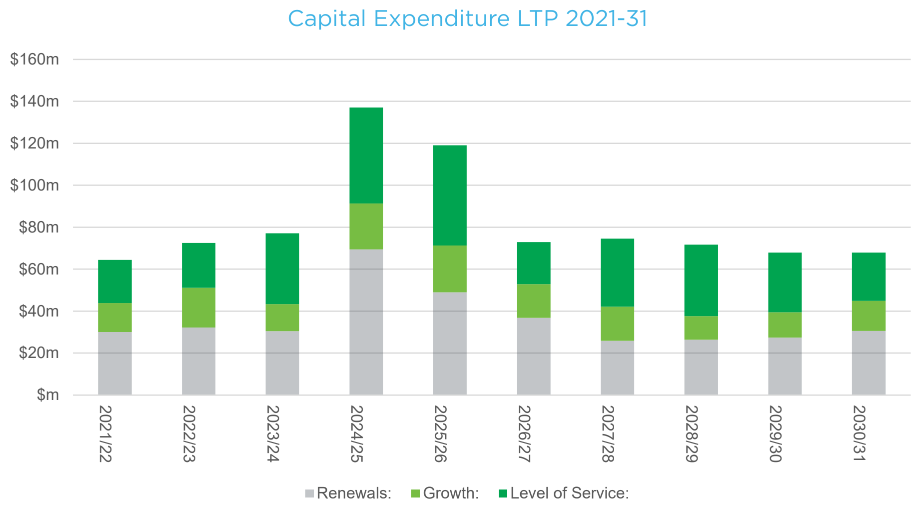
Council has used this as an appropriate tool in setting its proposed financial strategy, however as noted above it must be considered against other measures of prudence.

Balanced Budget



Capital expenditure

As noted in the Infrastructure Strategy we are investing significantly in both replacing existing assets and creating new additional assets to meet both the needs of growth and increasing levels of service.



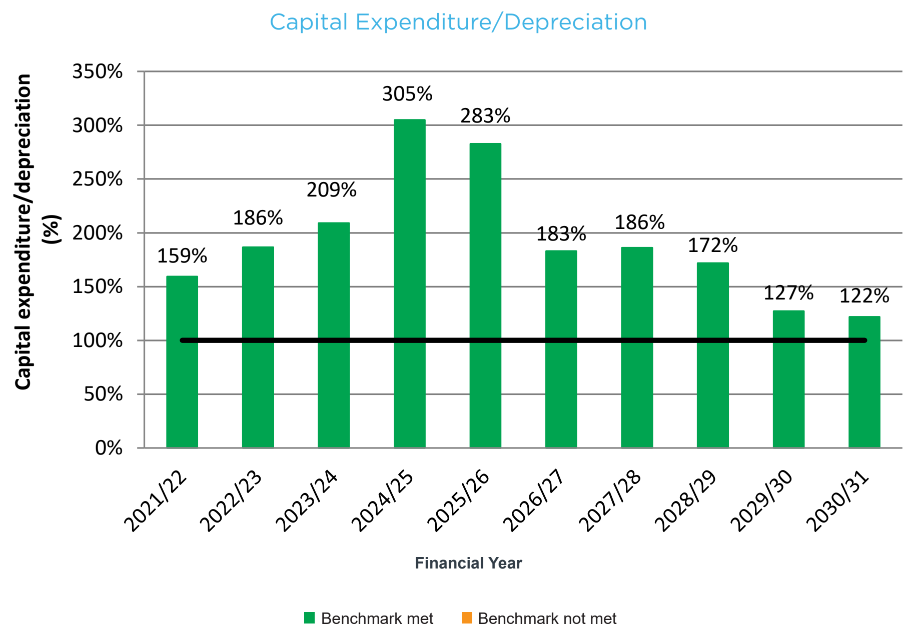
The capital expenditure profile spikes up in 2024/25 and 2025/26 mainly due to two big projects overlapping. They are:

Project	2024/25	2025/26
Napier Library Civic Precinct	$21.6m	$22.2m
Outfall	$31.7m	$9.7m
Total	**$53.3m**	**$31.9m**

If the two projects above were excluded the capital plan profile would be fairly flat at approximately $70m each year.

The total planned capital expenditure spend of $404m for 3 waters for the 10 years makes up about half of the total capital plan ($812m).

All local authorities are required to measure the proposed capital expenditure on essential services against essential services depreciation expense and this is reflected in the graph below. This demonstrates that Council is maintaining its essential services.



Debt

Because of the increase in proposed capital expenditure, and the need to smooth the rates increases over the period of time we are now looking at a significant increase in our overall debt.

	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
Total rates revenue	69,379	74,466	79,903	85,704	93,612	102,248	111,684	122,002	133,283	144,260
Other revenue*	73,532	81,612	75,484	76,965	81,257	81,257	67,034	71,161	70,035	70,871
Total revenue	**142,911**	**156,078**	**155,387**	**162,669**	**174,869**	**182,954**	**178,718**	**193,163**	**203,318**	**215,131**
Financing costs	**336**	**617**	**837**	**1,619**	**3,031**	**4,449**	**5,394**	**6,157**	**6,656**	**6,871**
Gross Debt	**73,960**	**102,380**	**136,860**	**226,980**	**295,540**	**309,780**	**328,510**	**337,140**	**335,230**	**325,480**
Debt to rates	107%	137%	171%	265%	316%	303%	294%	276%	252%	226%
Debt to total revenue	52%	66%	88%	140%	169%	169%	184%	175%	165%	151%
Financing cost to rates	0.48%	0.83%	1.05%	1.89%	3.24%	4.35%	4.83%	5.05%	4.99%	4.76%
Financing cost to total revenue	**0.24%**	**0.40%**	**0.54%**	**1.00%**	**1.73%**	**2.43%**	**3.02%**	**3.19%**	**3.27%**	**3.19%**

*Includes Financial Contributions, Subsidies and Grants, Other Revenue and Other gains/(losses)

In order to borrow money externally, Council must offer some security just like people do with their mortgage. Like most Councils, when required, Council secures our debt by way of a debenture trust deed over its rates income. We generally do not offer assets security for any loan or performance of any obligation under an incidental arrangement. In exceptional circumstances, with prior Council approval, security may be offered as a charge over one or more specific assets.

Return on investments

Napier City holds investments for strategic reasons where there is some community, social, physical or economic benefit accruing from the investment activity. Our primary objective when investing treasury funds is the protection of its investment capital and liquidity of its investments.

Investments and associated risks are monitored, managed and regularly reported back to Council. We are risk averse in our management of cash. In addition, our preferred approach for funds available for long-term investment, is that our investments support the Napier community.

In addition, Council maintains strategic equity investments in Hawke's Bay Airport Authority Ltd and the Omarunui Regional Landfill. Council's objective with these equity investments is to retain local airport ownership and ratepayer control of solid waste disposal facilities. Any investment in the Local Government Funding Agency (LGFA) will be to ensure Napier and other local authorities have access to low cost debt funding. The primary driver of these investments is for strategic reasons.

We have in place control limits that are designed to manage interest rate and maturity risk on the financial investment portfolio. The portfolio comprises both cash and core treasury investments. Cash investments relate to matching investments with our working capital funding requirements and liquidity buffer amount requirements. An important objective of the financial investment portfolio is to match the portfolios maturity term to planned expenditure thereby ensuring that investments are available when required.

The following are the specified targets for returns on our financial and equity investments:

- The targeted minimum return on our financial investments will be the average of the 90-day and one year Government investment rates.
- The target rate of return for Hawke's Bay Airport Ltd is set through the company's Statement of Intent. In general Council expects the company's return on equity to exceed Council's budgeted cost to borrow funds (2% in this LTP). However, as previously noted due to Covid-19, the Council is not expecting a cash return on its investment until 2024/25.
- No specific return on equity is sought from the Omarunui Regional Landfill. This facility is owned jointly with the Hastings District Council for the purpose of meeting both Council's legal obligations relating to the management and disposal of waste. The joint landfill committee uses a full cost accounting model to determine pricing for this facility.