Draft Financial Strategy

Dunedin City Council

dunedin

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Why a Financial Strategy?

This Financial Strategy has been developed to guide the Council as it seeks to balance the competing tensions of affordability, maintaining its assets and investing for the future.

This balancing process involves evaluating the impact on affordability of a range of expenditure needs and obligations including:

- the need to maintain, replace and renew core infrastructure
- the obligation under law to build new infrastructure of a higher standard;
- a desire to respond to community aspirations for new and improved community infrastructure.

Financial Strategy at a Glance

- An operating surplus greater than zero over a moving three year period.
- Operating cashflow at 100% of depreciation.
- To provide a working capital ratio of greater than 1. Where current assets include cash on hand and available credit facilities.
- Capital expenditure focus on increasing renewals required for infrastructural assets.
- Core Council debt (term and current portion) below $230 million by 2021.
- Rate increases to be limited to 3% unless there are exceptional circumstances.
- Dunedin City Holdings Limited (DCHL) to provide a consistent and maintainable cashflow at no less than the projected levels over the 10 year period. This may include building up a cash reserve to allow for the commercial reality of the group.
- That investments held by the Council (Investment Property and DCHL) provide a long term moving average return greater than the Council's average cost of capital.
- That the Waipori Fund provides a minimum return over the medium to long-term, equivalent to the weighted average Official Cash Rate plus the consumer price index.

Introduction

Dunedin has set a goal to be one of the world's great small cities. It enjoys an outstanding natural environment and setting plus a fine network of social and cultural infrastructure - for example Moana Pool, Forsyth Barr Stadium, Toitū Otago Settlers Museum, Dunedin Town Hall and convention facilities, and the Dunedin Public Art Gallery. The Dunedin City Council has also recently completed an intensive programme of services infrastructure upgrades, for example extensive water and waste water service level improvements.

These capital projects and upgrades have pushed up debt levels but the city is also now moving into a phase where overall debt levels peak and will begin to track down, allowing the focus to shift to debt reduction. This is aided by the fact that the Council is now in a position where infrastructure renewals, for example pipe renewals, are increasing and can be funded by rates rather than additional new debt.

Dunedin faces some unique challenges and opportunities now and into the future relating to its population, demography and economy.

The city's unique population characteristics include a slower than average population growth, an ageing population with a falling proportion of working age people, less ethnic diversity and immigration, changing household composition, and declining household size.

While Dunedin provides its residents with a great lifestyle, the city is at risk of losing business and people to other centres. Creating an attractive environment – where businesses thrive and residents feel proud – will establish Dunedin as one of the world's great small cities.

The nature of the city's growth has meant that large quantities of network infrastructure were built over a short time period. Assets that were built at the same time generally require renewal at the same time, causing peaks in renewals cost.

Land use is not expected to change to the extent that big increases in debt and operating expenses will be required to service development.

A summary of the key challenges and opportunities for consideration are:

Large capital projects and upgrades have pushed up debt levels, the focus now turns to repaying debt

Dunedin has come through a period of high rates increases, these now need to be limited

- Large asset base
- Levels of service should be maintained. One of the key assumptions in the Financial Strategy and Infrastructure Strategy is that there will be no change to the existing range of services and/or service levels provided by the Council
- In recent years, budgeted income from DCHL to the Council has proven to be unrealistic. This, coupled with stadium-related financial issues, has created a degree of financial uncertainty for the Council when trying to establish budgets. The strategy in place to build cash reserves in DCHL and the recently completed Stadium review provide a greater level of financial certainty for the Council
- Network renewals will occur at a growing rate over the next decade.

It is the Council's view that the implementation of this financial strategy in the 10-year plan is prudent and sustainable.

With the major projects completed, the Council has shifted its focus onto operating in an environment of financial constraint. With rate increases now constrained and affordability in mind, borrowing reducing and greater certainty around both funding from and for DCHL, the DCC will continue providing the services needed to attain the city's vision and meet the growing renewals requirements.

The following sections outline the individual components of the financial strategy.

Operating Surplus and Cashflow

A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's operating expenses, unless the local authority resolves that it is financially prudent to not do so.

The Council approach to this is to show an operating surplus of greater than zero over a moving three year period. Across the period of the plan, projected revenue is more than adequate to cover operating expenditure.

In terms of operating cashflow, the Council's approach is to have an operating cashflow which covers 100% of depreciation. The Council is forecasting an operating cashflow of $53 million in the 2015/16 year which then steadily increases annually to $89 million in the 2024/25 year. Depreciation is forecast to be $54 million in the 2015/16 year, increasing to $69 million in the 2024/25 year. The incremental increases in operating cashflow arise because the Council is signalling additional rates income each year to fund increasing infrastructure renewals expenditure. In addition, because the majority of Council debt is repaid on a table loan basis, this means that when interest expenditure reduces, loan repayments increase. Loan repayments are funded from operating cashflow.

The Council will ensure that there are sufficient cash resources available to meet its obligations. This means providing a working capital ratio of greater than 1, where current assets include cash on hand and available lines of credit. The Council has access to credit facilities of up to $270 million.

Capital Expenditure

Dunedin has recently completed a period of capital development during which a number of large new capital expenditure projects and upgrades were undertaken simultaneously. A small number of large new projects remain in the capital expenditure programme for transportation upgrades, library and community facilities.

Attention has now turned to a renewal programme, for example waste water (sewer) renewals and upgrading under street infrastructure that is more than 100 years old in some places. Generally speaking, this work is to be funded out of rates, rather than borrowing. The Council approach to funding renewals in this way is to avoid the significant longer term cost of borrowing annually for renewals. Further information on the Council's approach to this is discussed in the Infrastructure Strategy.

Debt

Any discussion of Council group debt needs to be balanced with an acknowledgement of its large asset base which includes the Council-owned companies, Waipori Fund and considerable property assets. This means that as the Council addresses debt levels and loans are repaid, the city's debt to asset ratio will also improve.

Forsyth Barr Stadium debt continues to be an important factor in future debt projections. The recent Stadium review has found that the debt which sits with Dunedin Venues Limited (DVL) - who are the current owners of the stadium - is too high. The Council is proposing to transfer $30 million of debt from DVL to the Council. While this has no impact on overall group debt it does affect one of the goals of the Council's previous Financial Strategy which was to reduce Council debt to $200 million by 2021. Bringing that $30 million of debt back to the Council means that target will have to be revised upwards to $230 million.

Gross Debt Limit: Target of $230 million by 2021

The draft budgets forecast the following levels of debt:

Gross Debt Forecast: $ millions

2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
260	249	249	246	238	231	223	207	189	169	149

Dunedin's financial position has been scrutinised by international ratings agency Standard & Poors, which has just reaffirmed the Council's credit rating to AA/Stable/A-1+ from AA/Negative/A-1+. Their report talked about Dunedin's debt burden being high compared to international peers but also acknowledged that debt (including the borrowing of the Council-owned companies) as a percentage of adjusted cash operating revenues is forecast to fall below 140% in 2016, down from 160% last year. Standard & Poors also acknowledged that Dunedin's debt is set to be reduced at a quicker pace. It highlighted the predictable and supportive institutional framework available to local councils in New Zealand, its very positive view of the Council's financial management, and the way that its budgetary performance has improved significantly.

Standard & Poors also noted that Dunedin has no foreign-denominated debt, and its hedging of interest rate risk provides some support to the Council's debt profile.

Importantly, the city also has a large portfolio of assets to support this debt.

Looking ahead the city has no new major approved projects, except for upgrades to the City Library, the proposed South Dunedin Community Library, an upgrade to the central city, cycleways developments and peninsula road improvements. Borrowing around projects such as roading improvements are generally done across 20 years to spread - or smooth - the cost of debt servicing to users over the lifetime of the asset. This is a way in which debt can be used in a positive way so that the cost of new assets is not lumped on one generation during the initial construction or project period.

The Council policy is clear in terms of the use of any surplus funds which will be spent according to the following priority:

- Repayment of debt
- Investment
- Priority projects.

Security for Borrowings

It is the Council's policy to give rates as security. It does give assets as security, however, it is not legal to give water assets, including wastewater and stormwater, as security.

Rates

In the 2014 Residents Opinion Survey Dunedin people made it very clear they wanted the Council to keep rates in check by controlling debt and new spending. It is a message that is being taken to heart in this strategy.

Dunedin has come through a period of high rates increases to fund many of the projects, peaking at a high of 10.4% in 2008/09. Since 2011/12, when rates rose 7.7%, increases have tracked downwards falling to 3% for the 2014/15 year.

This period of high rates increases has been driven by an extensive capital programme, from new projects such as the Forsyth Barr Stadium, to significant upgrades at Toitū Otago Settlers Museum, and the Dunedin Town Hall and conference facilities, which are marketed as the Dunedin Centre. While this work has provided the city with top class venues there have been other key infrastructure redevelopments, such as the city's water upgrade, which has delivered vastly improved drinking water standards for Dunedin.

The aim now is to limit future rates increases to 3%, unless there are exceptional circumstances. The first such exception is the 2015/16 year. The city faces two hurdles which will push rates up by 3.8% for that year. The first is the reduced income stream of $4.5 million from DCHL as they carry out needed capital works. The second relates to an additional $1.51 million funding requirement for the Stadium.

Getting into the position where future rates increases can be expected to be limited to 3% has been brought about as the result of an extensive programme of activity reviews. These reviews have identified ways to improve service delivery and reduce costs by doing things smarter and more efficiently as well as making greater use of technology.

The Council has chosen not to link rates increases to the Consumer Price Index (CPI) but rather to set rates in response to funding requirements as they arise.

While setting annual rates increases based on the CPI offers transparency and simplicity, its major disadvantage is that it constrains capital expenditure on projects that the community may support. As a general rule, new debt funded capital expenditure tends to compress the servicing of that debt into a time frame that is shorter than the life of the asset. What this tends to do is raise rates in the first year of the new debt above a typical operating cost index, such as the CPI or the Local Government cost index. The larger the item of new capital, or the more the number of projects embarked on, the larger the impact.

It is also important to note that the Council's costs for service provision don't increase at the same rate as CPI. This is because the group of costs used to measure CPI are not strictly applicable to an organisation involved in the management of infrastructure.

Allowing elected Councillors to set rates according to their consensus view on what the city needs to spend on gives full effect to the principle that, as elected members, they are there to make decisions as representatives of the community rather than in response to some mathematical index.

Renewal projects, such as pipe renewals, will be paid for out of rates rather than taking on further debt. Dunedin has an aging infrastructure that needs to be addressed. These renewal projects are expected to be a significant driver of the requirement to increase rates in the coming years due to an under investment in this activity over an extended period of time.

The Council has avoided taking an easy path in setting its limits. By imposing on itself rate increases that are lower than today's indicative calculations for years it has set itself a challenging task. The Council is accustomed to identifying more efficient ways of doing things and maximising non-rates revenue sources.

Rate increase limit:
Limit future rate increases to 3% unless exceptional circumstances

The draft budgets forecast the following level rate increases:

Forecast rate increases:

2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
3.8%	4.9%	5.0%	3.6%	3.8%	4.5%	2.3%	3.9%	2.3%	2.7%

Rates limit: the forecast rates incorporating a 3% increase from the 2016/17 year are shown in the table below along with the forecast rates according to the draft budgets.

Rates Forecast: $ millions

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Rates Limit	130	134	138	142	146	150	155	160	165	170
Rates Forecast	130	136	143	148	154	160	164	170	174	179
Savings Required	0	2	5	6	8	10	9	10	9	9

Financial Resilience

Financial resilience is becoming an increasingly important strategic consideration, whether that be the ability to weather a global financial crisis, local economic downturn or a civil emergency. It means being prepared for future challenges and the unexpected.

The Council has, in the past, carried a significant amount of uninsured assets and in the event of a significant earthquake would carry a larger share of the cost of rebuilding. However, as part of the renewal approach for the 2014/15 year the Council has been able to secure insurance for some infrastructure assets (mainly in the 3 Waters area).

In the event of a civil emergency, the Council would fund major infrastructure rebuild via a combination of:

- Insurance cover
- Access to Government funding for infrastructure assets
- Reprioritisation of renewals and new capital expenditure budgets
- An existing line of credit of $5 million
- Access to liquid assets available from the Waipori Fund
- Loan funding in the event of any shortfall.

Investments

While the Council does hold considerable debt, this is offset by the fact that it is also asset rich, holding a range of investments, including Council owned companies, investment property, and the Waipori Fund (a balanced portfolio of fixed interest deposits and equities).

These investments are designed to provide the Council with an ongoing non-rates revenue stream over a long period of time.

Accordingly, the Council's target return on investment is higher than the cost of debt, thereby producing a net financial gain to the city, which in turn provides a subsidy to rates. The estimated cost of debt for the 2015/16 year is 7.3%. In the case of equities, such as those held through the Waipori Fund, it also includes an allowance for inflation to protect their real value.

The Waipori investments in particular have a high degree of liquidity which means the Council would have ready access to cash should the need arise.

Council – Owned Companies

Council-owned companies are an important component in the Council's financial strategy. While they are valuable assets in terms of their capital value, the income (income includes dividends, subvention payments and interest) they generate from their operations are used to keep down the levels of funding required from the city's ratepayers.

In more recent years, the revenue expectations from the companies to the Council have been unrealistic. This, coupled with stadium-related debt pressure, has created a degree of financial uncertainty for the Council when trying to adopt budgets and set rates.

Income from the holding company, Dunedin City Holdings Limited (DCHL), to the Council will continue to be paid but it will reduce by $4.5 million from the 2015/16 financial year. This will give the companies time to invest in their own infrastructure - something which is particularly important in the case of lines company Aurora which has infrastructure that needs to be renewed.

This will also allow DCHL to begin the process of building up cash reserves. This means that when income from DCHL increases again in future years, any future volatility can be absorbed within the group. This will ensure that in the future the city is provided with a steady and predictable income stream. The Council does not expect the current level to change within the next two years but is forecasting an increase over the longer term.

Forecast revenue from DCHL: $ millions

2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
11	11	11	12	12	12	13	13	14	15

Costs associated with Forsyth Barr Stadium are also a key consideration. A review of the Stadium operation and ownership has been completed which proposes additional ratepayer funding for the next 10 years to enable the Stadium to operate on a sustainable basis.

Stadium debt is also being addressed through another proposal to move $30 million of stadium debt to the Council's books. Taking the responsibility for servicing this debt away from the stadium will strengthen its financial viability.

Waipori Fund

Established in 1999, using proceeds from the sale of the Waipori electricity generation assets, the Waipori Fund provides a valuable annual dividend to the Council. The fund value at 30 June 2014 was $74 million.

Objectives

The primary objective of the Waipori Fund is to generate income and increase capital value over the long term, subject to a proper consideration of investment risk.

Subject to the income distribution needs of the fund owner and the provisions for capital protection, a key tenet is to enlarge the Waipori Fund's capital base to protect that base from falls in the value of money. This adjustment to the capital base is described as "inflation adjusting the fund".

Other objectives:

- Provide a non-rates revenue source to the Council
- Provide a source of liquidity should the need arise
- Provide long-term wealth generation for ratepayers
- To hold equity investments as a hedge against inflation - and also provides an offset to other areas of the Council.

Target

The Council envisages a minimum return over the medium to long-term, net of all fees and charges attributable to the Fund, equivalent to the weighted average Official Cash Rate plus the movement in the 'all groups' consumer price index.

Investment Property Portfolio

Objectives

The primary objective of the Investment Property Portfolio is to maximise its return, subject to a proper consideration of investment risk. The portfolio value at 30 June 2014 was $95 million.

A key principle is to invest in properties that will increase in value over time.

Because a significant portion of the portfolio is endowment land, the Council is required to hold the land as an endowment for the general purposes of the City.

Other objectives:

- Provides a non-rates revenue source to the Council
- Diversification outside of the city
- Provides long-term wealth generation for ratepayers.

Target

The long term target for the Investment Property Portfolio is a return which is greater than the Council's overall cost of capital. The draft budgets provide a return of 6% in the 2015/16 year. Over the next 10 years the portfolio will transition towards the target.

This will be achieved according to the following sequence:

- Identify and sell properties that aren't making an appropriate return
- Identify and sell properties with a return less than the DCC's overall cost of capital
- Reinvestment in properties that will provide a target rate of return on investment, along with capital growth.

Surplus Property Sales

Maximising returns and realising under-utilised and non-performing, non-strategic assets

This will be achieved according to the following sequence:

- Sell properties already identified as not being required for operational or strategic purposes
- Identify and sell properties that are not required for operational or strategic purposes, that are not making an appropriate return
- Identify and sell properties that are not required for operational or strategic purposes with a return less than the Council's overall cost of capital
- Reinvestment in properties that will provide a target rate of return on investment, along with capital growth.

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