Chairperson and Members
COUNCIL

18 AUGUST 2016

Meeting Status: **Public**

Purpose of Report: For Information

TREASURY MANAGEMENT ANNUAL REVIEW

PURPOSE OF REPORT

1 This report provides an annual overview of the Council's treasury management activity and seeks Council approval for the debt funding maturity profile.

DELEGATION

2 Only the Council can make this decision.

BACKGROUND

3 The Treasury Management Policy (the policy) was reviewed by the Corporate Business Committee in April 2015 (report Corp-15-1535 refers). This policy sets out a framework for the Council to manage its borrowing and investment activities in accordance with Council objectives, and incorporating legislative requirements.

4 As adopted, the policy has largely separated reporting requirements out, but does provide for regular reporting to the Council. While the majority of this reporting is by way of the quarterly financial report to the Corporate Business Committee, the expectation for an annual report to the Council is retained.

5 This is the annual report, providing an overview of activity for the past twelve months.

DISCUSSION

Treasury performance

6 Until October 2015 the Council minimised its cash balances in order to keep debt levels at the lowest possible levels. Day to day cashflow requirements were managed through use of the line of credit facility (essentially an overdraft); and the targeted use of short term commercial paper.

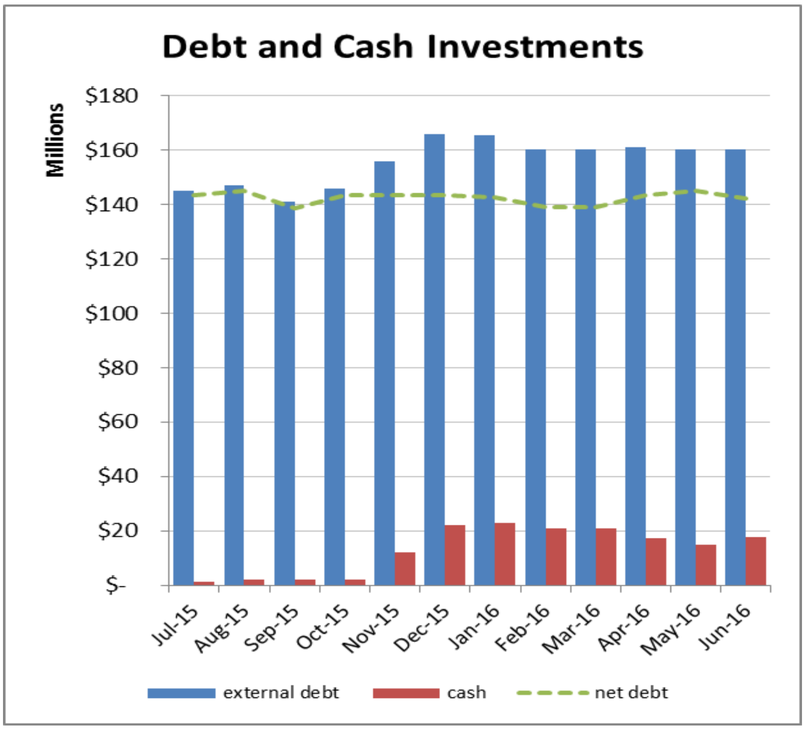
7 A revised strategy was advised to the Corporate Business Committee in October 2015, which saw the introduction of a prefunding programme. The policy allows prefunding debt requirements up to 18 months in advance, including refinancing. Market conditions have been favourable for this approach, where the Council draws down debt early and is able to invest the funds for a positive net return. Day to day cashflow requirements are subsequently met by drawing down on the cash, rather than using the line of credit facility.

8 A key objective in commencing this approach was to prepare for managing a concentration of liquidity risk. The Council has $60 million of debt maturing in December 2017. This is just over 40% of the total net debt. If the Council were to wait until that maturity date before refinancing, it is exposed to the risk that market conditions are unfavourable at that time, and is forced to refinance a significant portion of its debt portfolio at high interest rates.

9 Assessment of the Council's treasury management is in the context of this new treasury strategy, and considers four reporting areas, which are covered in the following sections.

Cash/debt position

10 The following graph demonstrates the implemented strategy. Debt was drawn in two tranches of $10 million, in November and December 2015. One tranche was prefunding $10 million of debt that matures in December 2016, while the second tranche was prefunding the current year's requirements.



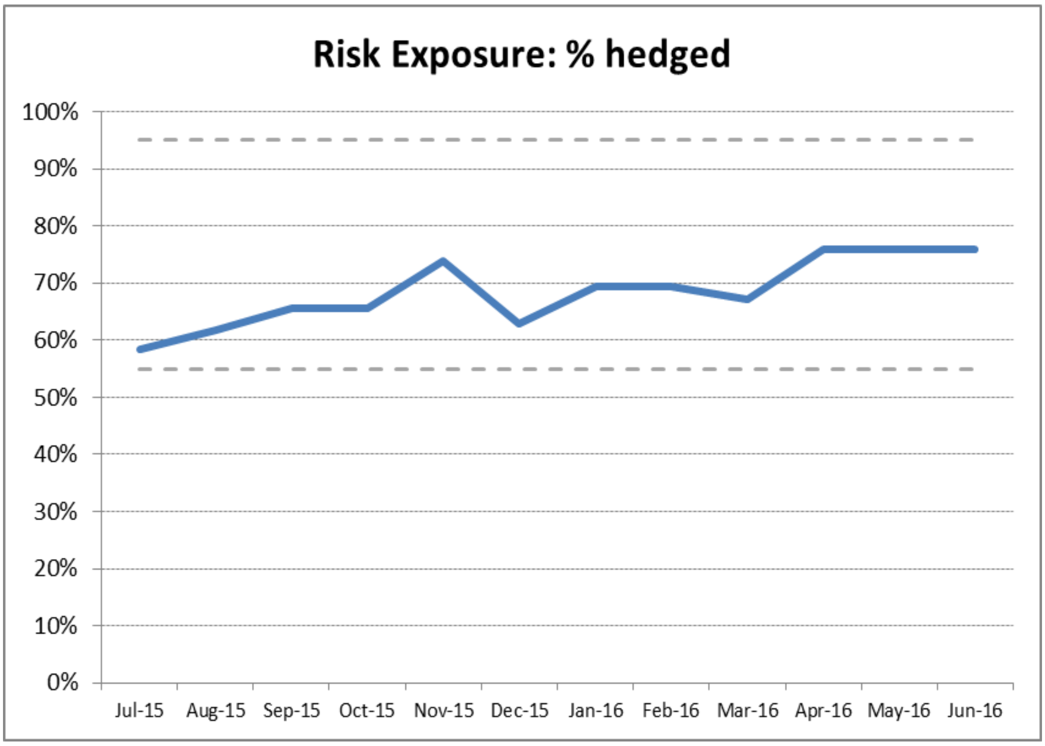
11 Net debt of $142 million has tracked lower than budget, resulting in slightly more cash on hand than planned as at 30 June 2016. Given market conditions, $5 million of this prefunding has been reinvested until December 2017 and will contribute to the $60 million refinancing due at that time.

Risk exposure position

12 The policy requires the Council to fix between 55% and 95% of its projected debt levels for the next 24 months. In doing so, the total amount hedged (fixed) must not exceed the actual external debt level at any time. The reason for requiring a majority of Council debt to be fixed is to minimise exposure at any one time to interest rate fluctuations. The Council would have difficulty absorbing adverse interest rate movements. A 1% increase in interest rates on $142 million in debt would equate to additional interest expense of $1.42 million per annum.

13 Interest rate fixing does however also reduce the ability to benefit interest rate reductions. The objectives of any strategy are therefore to smooth out the effects of interest rate movements, while being aware of the direction of the market, and to be able to respond accordingly.

14 The following graph shows the fixed portion over the last twelve months. Having between 60% and 75% hedged secures most of the Council's current debt, but leaves headroom for future debt to be hedged when appropriate.



15 The current interest rates are low, and market expectations are for the current state to remain for the next three years. Debt funding requirements over the next year will be able to capitalise on these lower interest rates.

Risk management performance

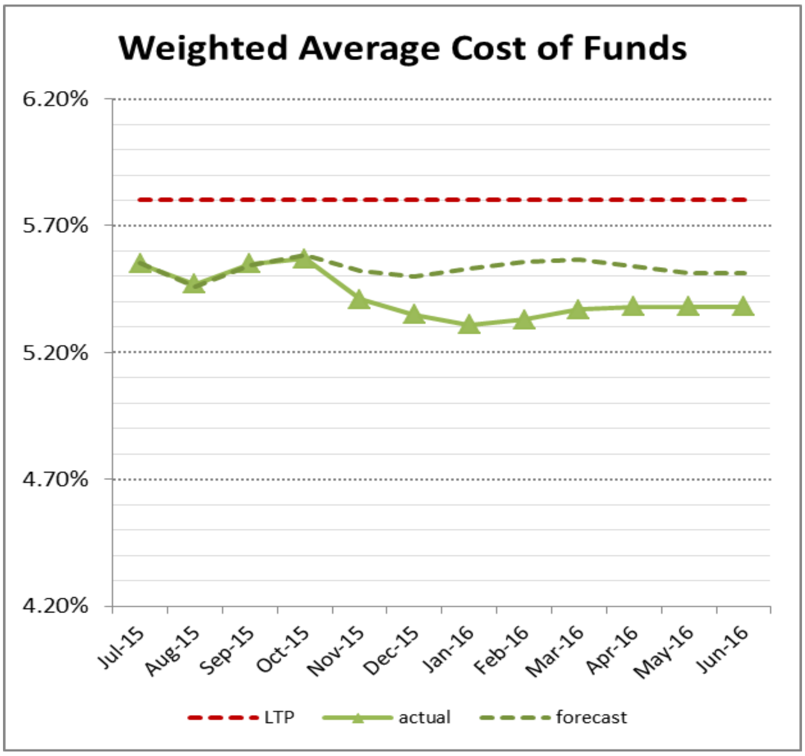
16 The following table shows the Council's interest income and expense for the year, along with the weighted average cost of borrowing.

Interest	Full Year Actual $000's	Full Year Budget $000's	Full Year Variance $000's
External Interest Expense	8,332	8,116	(216)
less: Interest Received	(472)	(216)	256
Net Interest Costs	7,860	7,900	40
Weighted Average Cost of Borrowing	5.42%	5.80%	0.38%

17 To provide some context, the cost of borrowing was set at 5.80% during the setting of the 2015-35 Long Term Plan. The reduction in interest costs that resulted in an actual weighted average cost of borrowing of 5.42% is in the order of $500,000 for the year.

18 In the year since the Long Term Plan was set, interest rates have reduced significantly. During 2015/16, borrowing costs were revised down in recognition of this improvement, as well as reflecting any known timing differences in the capital expenditure programme and cashflow requirements.

19 The following graph shows the cost of borrowing each month. The forecast was the expected average borrowing cost prior to implementing the prefunding strategy. This clearly shows the benefit that flowed from the prefunding strategy, which has been as much as 0.23%.



20 Current forecasts are for the cost of borrowing to further improve in coming years. This will depend on actual market conditions, both locally and globally.

ISSUES AND OPTIONS

Issues

Treasury management policy compliance

21 With one exception, the Council has been compliant with its policy throughout the year.

22 The policy for the management of funding and liquidity risk sets minimum and maximum limits for the proportion of debt maturing in each of three 'buckets'. The purpose of this is to ensure the Council does not concentrate its maturities into a single date. The buckets are:

Period	Minimum	Maximum
0 to 3 years	10%	70%
3 to 5 years	10%	60%
5 years plus	10%	50%

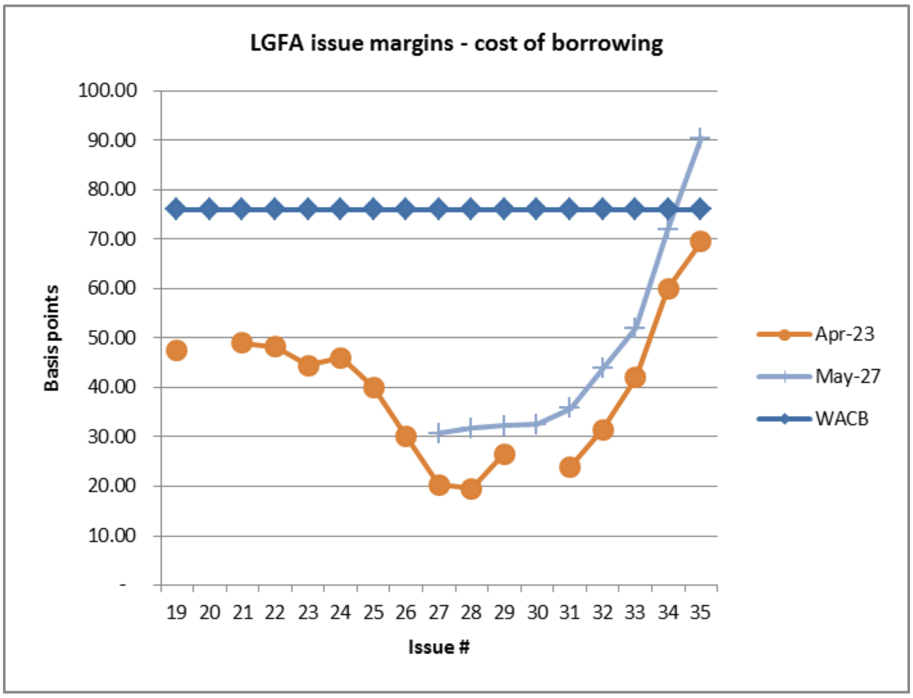
23 The Council holds $20 million of debt with a maturity date of May 2021. In May 2016 this debt moved down from the 5+ years maturity bucket into the 3-5 year maturity bucket. This is 11% of the Council's total debt profile at this time. This change caused the 5+ bucket to reduce from 19% of total debt to 8% - below the minimum 10% policy limit.

Cause

24 The cause of the non-compliance was a change in market conditions that lead to an intended transaction not being completed.

25 In October 2015 a paper to the Corporate Business Committee proposed two actions with the intention of rebalancing the Council's debt profile (report Corp-15-1717). The first was pre-funding of the December 2016 maturity. This was transacted in November 2015, with the purchase of April 2020 maturity debt.

26 The second action proposed was not transacted. This proposal was to exchange a portion of the December 2017 maturity with a future dated maturity – often labelled a 'blend and extend' transaction. This was the transaction that was intended to be in the 5+ bucket – either a 2023 or a 2027 maturity. The reason this transaction did not proceed was the sharp increase in borrower costs at that time. The increase is shown in the following graph.



27 Long term borrower margins climbed significantly. For example, the 2027 maturity rose from 44 basis points in September 2015 (the time of writing the report to Council) to 90 basis points in February 2016. The swap curve also steepened between September and December, with long rates rising while shorter rates reduced. The impact was to make the cost of this transaction less attractive.

28 The side-effect from not completing the second transaction has been this temporary period where the Council's debt is outside the policy limits for the 5+ bucket. To provide context, the minimum additional amount that should be in the 5+ bucket is an extra $4 million.

29 The Treasury Management Policy requires the Council to approve a maturity schedule that is outside of the policy limits. Accordingly, this paper asks the Council to approve the maturity schedule.

Options

Exchange a short-dated maturity

30 The Council could have sold a portion of its 2017 maturity, and purchased a longer dated maturity. As already noted, this transaction was not undertaken, as it would have cost the Council in terms of having to borrow at unattractive interest rates, in order to meet a policy limit.

Approve the temporary non-compliance

31 The other option is to approve the temporary non-compliance, noting that debt levels were restored to policy limits in July 2016. This is the recommended option.

CONSIDERATIONS

Policy considerations

32 The Council's fixed rate policy (covering the amounts hedged in each bucket) allows for a profile that is outside the agreed limits for up to 3 months. This situation has highlighted that a similar policy may be beneficial for the debt maturity limits.

33 The Treasury Management Policy is to be reviewed on at least a triennial basis, with a final report presented to the Audit and Risk Subcommittee. When the policy was adopted in April 2015, it was noted that more frequent reviews may be undertaken on an as-needs basis. One driver for changes would be market conditions changing, should those changes create unforeseen outcomes. Another driver is the application of the policy in practice, which can (and has) identified a number of minor improvements that are warranted, as above. These changes will be the subject of a report to the Audit and Risk Subcommittee.

Legal considerations

34 There are no legal considerations required by this report.

Financial considerations

35 All financial considerations have been covered as part of this report.

Tāngata whenua considerations

36 There are no tāngata whenua considerations required by this report.

SIGNIFICANCE AND ENGAGEMENT

Degree of significance

37 This matter is considered to have a low level of significance under Council policy.

Publicity

38 There are no publicity issues to be considered at this stage.

RECOMMENDATIONS

39 That the Council notes the treasury management performance over the 2015/16 financial year

40 That the Council approves the debt maturity profile for the 2015/16 financial year

Report prepared by	Approved for submission	Approved for submission
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