NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

KĀPITI COAST DISTRICT – BEING A PRINCIPAL SHAREHOLDING LOCAL AUTHORITY IN LOCAL GOVERNMENT FUNDING AGENCY

The Council has decided to become a "Principal Shareholding Local Authority" in the New Zealand Local Government Funding Agency Limited (LGFA), which is a council–controlled trading organisation (CCTO). This decision was made after Council separately consulted on this issue as a proposed amendment to the 2009 LTCCP in September 2011 and a separate Statement of Proposal on this issue was included in the Draft 2012 LTP adopted on 5 April 2012.

During the consultation process there were no substantial submissions received objecting to the council joining the LGFA as a shareholder and using the LGFA to lower council's cost of borrowing.

LGFA was established on 1 December 2011 by 18 local authorities and the Crown to enable local authorities to borrow at lower interest margins than would otherwise be available. LGFA has been recognised in the Local Government Borrowing Act 2011, which has modified the effect of some provisions in the Local Government Act 2002.

All local authorities are able to borrow from LGFA, but different benefits apply depending on the level of participation.

Principal Shareholding Local Authorities are those which invest capital in the LGFA, and are expected to receive a return on that capital. The Council will be investing $100,000 to become a shareholder, with $100,000 being the minimum investment allowed. As a Principal Shareholding Local Authority, the Council is also required to subscribe for uncalled capital in LGFA which would have to be paid up in the event that LGFA required more capital. The Principal Shareholding Local Authorities is also required to agree to source a certain proportion of their borrowing needs through LGFA for an initial period.

Generally all local authorities borrowing from LGFA are required to enter into a guarantee in favour of LGFA's creditors, and enter into certain equity commitments. Local authorities which enter into these commitments without being Principal Shareholding Local Authorities are referred to as Guaranteeing Local Authorities.

Any local authority that borrows from LGFA will be required to provide LGFA with subordinated debt (borrower notes, to the value of 1.6% of the total amount borrowed). These borrower notes will be held by the local authority while the borrowing is outstanding and may in certain situations convert to redeemable preference shares in LGFA.

Local authorities which borrow from LGFA, without entering into the guarantee will be limited in the amount that can be borrowed, and may be required to pay significantly higher funding costs.

Further information on the LGFA, its structure and how it operates follows.

The Purpose of the Local Government Funding Agency (LGFA)
The New Zealand Local Government Funding Agency Limited (LGFA) is a incorporated company established to enable participating local authorities (Participating Local Authorities) to borrow at lower interest margins than they would otherwise pay.

Rationale for LGFA
New Zealand Local Authority debt market

New Zealand local authorities face a number of debt related issues. First, local authorities have significant existing and forecast debt requirements. Secondly, pricing, length of funding term and other terms and conditions vary considerably across the sector and are less than optimal. This is due to:

(a) Limited debt sources – Local authorities' debt funding options are limited to the banks, private placements and wholesale bonds (issuance to wholesale investors), and, to a lesser extent, retail bonds. Increasing local authority sector funding requirements and domestic funding capacity constraints have the potential to further negatively impact pricing, terms and conditions and flexibility of the local authority sector debt.

(b) Fragmented sector – There are 78 local authorities. Individually, a significant proportion of these local authorities lack scale.

(c) Regulatory restrictions - Offshore (foreign currency) capital markets are closed to local authorities (other than Auckland Council) and the compliance process for local authority retail bond issuance is burdensome and generally restricts issuance to a six month window.

Addressing the local authority debt issues

Each of these issues needs to be addressed to rectify this situation. This was not likely to happen without an intervention like LGFA for the following reasons:

(a) The New Zealand debt markets (at least in the foreseeable future) are likely to maintain the status quo.

(b) Individually, a majority of local authorities will not be able to attain significant scale (except organically in the long-term).

(c) At a sector level it may be possible to address the issue regarding regulation, but regulators are likely to remain reluctant to significantly ease restrictions on financial management across the sector without gaining significant comfort as to the sophistication of the financial management of all local authorities. Even if this issue was addressed by regulators, this change alone would be insufficient to provide a major step change.

LGFA has been established because the homogenous nature of local authorities, the large sector borrowing requirements, and the high credit quality / strong security position (i.e. charge over rates) of local authorities, created the opportunity for a centralised local authority debt vehicle to generate significant benefits.
There are numerous precedents globally of successful vehicles which pool local authority debt and fund themselves through issuing their own financial instruments to investors. Such vehicles achieve success through:

(a) "Credit rating arbitrage" – Attaining a credit rating higher than that of the individual underlying assets (local authority borrowers) and therefore being able to borrow at lower margins.

(b) "Economies of scale" – By pooling debt the vehicles can access a wider range of debt sources and spread fixed operating costs, thereby reducing the $ cost per $ of debt raised.

(c) "Regulatory arbitrage" – The vehicles can receive a different regulatory treatment than the underlying local authorities, improving their ability to efficiently raise debt (e.g. through access to offshore foreign currency debt markets).

The offshore precedents are typically owned by the local authorities in the relevant jurisdiction (often with central government involvement), and that is the case for LGFA also.

How LGFA Operates

Basic structure of LGFA
LGFA is a limited liability company (and a council-controlled organisation) established in order to borrow funds and then on-lend those funds to local authorities at lower interest margins than those local authorities would otherwise pay to lenders in the absence of LGFA. For a number of reasons discussed below, it is expected that LGFA will be able to borrow at low enough interest margins to be able to do this.

LGFA's shares are held entirely by central government and local authorities. Central government currently holds 20% of the paid-up ordinary shares in LGFA, with the remaining 80% being held by local authorities (Principal Shareholding Local Authorities).

The Principal Shareholding Local Authorities contribute capital and, as compensation for their capital contribution, may receive a return on this capital. However, the over-arching objective is that the benefit of LGFA to local authorities is delivered through lower borrowing margins, rather than through dividends passed to shareholders.

As discussed below, it is possible that, in some circumstances, local authorities outside the Principal Shareholding Local Authority group will hold redeemable preference shares in LGFA.

Design to minimise default risk
One of the things which is critical to LGFA being able to deliver its anticipated benefits is it holding, and maintaining, a high credit rating (to achieve the credit rating arbitrage referred to in paragraph (a)). Consequently there are a number of features of LGFA intended to provide the protections for creditors which rating agencies require before agreeing to a high credit rating. These features are described in paragraphs 15 to 32 below.

Before agreeing to a high credit rating, rating agencies consider the risks of both short term and long term default. Short term default is where a payment obligation is not met on time. Long term default is where a payment obligation is never met. In many cases short term default will inevitably translate into long term default, but this is not always the case – a short term default may be caused by a temporary liquidity problem (i.e. a temporary shortage of readily available cash). On incorporation, LGFA was assigned a long-term foreign currency credit rating of AA and a long-term local currency credit rating of AA+ by Fitch Ratings.

Features of LGFA designed to reduce short term default risk
When a local authority borrows, the risk of short term default, although low, is probably significantly higher than its risk of long term default. In the long term it can assess and collect sufficient rates revenue to cover almost any shortfall, but such revenue cannot be collected quickly. Consequently, there is a risk that inadequate liability and revenue management could lead to temporary liquidity problems and short term default.

The principal asset of LGFA will be local authority debt, so such temporary liquidity risks are effectively passed on to LGFA. Consequently, the rating agencies look for safeguards to ensure that liquidity problems of a Participating Local Authority will not lead to a default by LGFA.

There are two principal safeguards that LGFA has or will put in place to manage short term default (liquidity) risk:

(a) It will hold a certain amount of cash and other liquid investments (investments which can be quickly turned into cash).

(b) It has a borrowing facility with central government which allows it to borrow funds from central government if required.

It is expected that these safeguards will sufficiently reduce any short term default risk.

Features of LGFA designed to reduce long term default risk
There are a number of safeguards that LGFA has or will put in place to manage long term default risk, the most important of which are set out below:

(a) requires all local authorities that borrow from it to secure that borrowing with a charge over that local authority's rates and rates revenue (Rates Charge).

(b) LGFA will maintain several sources of equity to safeguard its capital adequacy.

(c) LGFA will require most, or possibly all, Participating Local Authorities (Guaranteeing Local Authorities) to guarantee the obligations of LGFA.

(d) LGFA will hedge its exposure to interest rate and foreign currency fluctuations to ensure that such fluctuations do not significantly affect its ability to meet its payment obligations.

(e) LGFA has risk management policies in place in relation to its borrowing and lending designed to minimise its risk. For example, it will impose limits on the percentage of lending which is made to any one local authority to ensure that its credit risk is suitably diversified.

(f) LGFA will ensure that its operations are run in a way which minimises operational risk. It has done this from commencement of operations by outsourcing its operations to the New Zealand Debt Management Office (NZDMO) (which is a part of The Treasury). NZDMO manages the capital raising for central government, and has robust processes in place to manage operational risk. It is possible that at some point the operations function will be moved from NZDMO, but this will not be done unless LGFA is satisfied that it has alternative robust processes in place.

Additional detail in relation to the features referred to in paragraphs (a) to 19(c) is set out below.

Rates Charge

All local authorities borrowing from LGFA are required to secure that borrowing with a Rates Charge. Many, but not all, local authorities have a Rates Charge in place already.

This is a powerful form of security for LGFA, because it means that, if the relevant local authority defaults, a receiver can assess and collect sufficient rates in the relevant district or region to recover the defaulted payments. Consequently, it significantly reduces the risk of long term default by a local authority borrower.

From a local authority's point of view it is also advantageous, because, so long as the local authority does not default, it is entitled to conduct its affairs without any interference or restriction. This contrasts with most security arrangements, which involve restrictions being imposed on a borrower's use of its own assets.

Sources of equity

LGFA has several sources of equity to safeguard its capital adequacy:

(a) Central government and the Principal Shareholding Local Authorities have contributed initial equity as the issue price of their initial shareholding.

(b) Each Principal Shareholding Local Authority is required to hold uncalled capital which is equal in amount to its paid up equity contribution (Uncalled Capital). The Uncalled Capital is able to be called by LGFA if it determines that there is a risk of imminent default if the call is not made.

(c) Each Participating Local Authority will, at the time that it borrows from LGFA, contribute some of that borrowing back in the form of subordinated debt (Borrower Notes), which in certain circumstances may convert to redeemable preference shares in LGFA.

(d) In addition to the equity contributions made in conjunction with borrowing, all Guaranteeing Local Authorities are required to commit to contributing equity in certain circumstances. It is expected that calls on any such commitments will be limited to situations in which there is a risk of imminent default by LGFA.

Guarantee
Most, if not all, Participating Local Authorities will be required to enter into a guarantee (Guarantee) when they become a shareholder in, or borrower from, LGFA. Under the Guarantee, the Guaranteeing Local Authorities guarantee the payment obligations of LGFA to its creditors.

The purpose of the Guarantee is to provide additional comfort to lenders and other creditors (and therefore credit rating agencies) that there will be no long term default, though it may also be used to cover a short term default if there is a default which cannot be covered using the protections described in paragraphs 0 to 0 above, but which will ultimately be fully covered using the rates charge described in paragraphs 0 to 0.

The Guarantee will only ever be called if LGFA defaults. Consequently, a call on the Guarantee will only occur if the numerous safeguards put in place to prevent an LGFA default fail.

If any such default did occur, and the Guaranteeing Local Authorities were called on under the Guarantee, they could potentially be called on to cover any payment obligation of LGFA. Such payment obligations may (without limitation) include obligations in the following situations:

(a) A failure by LGFA to pay its principal lenders.

(b) A failure by LG FA to repay drawings under the liquidity facility with central government.

(c) A failure by LGFA to make payments under the hedging transactions referred to in paragraph (d).

Guarantee risk shared
While all Guaranteeing Local Authorities are jointly and severally liable for the entire LGFA debt guaranteed, claims against individual councils will initially be based on their proportion of the total Annual Rates Income of all Guaranteeing Local Authorities.

Benefits of being a Guaranteeing Local Authority
If a Participating Local Authorities is not a Guaranteeing Local Authority their borrowings are only allowed to reach a limited level, currently $20,000,000. Such local authorities may also be required to pay higher funding costs, either by paying higher interest margins or through some other mechanism.

Guaranteeing Local Authorities will, therefore, have the benefit of not having this low limit on borrowing, and paying lower funding costs.

Rates Charge
Guaranteeing Local Authorities are required to provide a Rates Charge to secure their obligations under the Guarantee and their obligations to contribute additional equity.

Characteristics designed to make borrowing from LGFA fair for all Participating Local Authorities
The principal risk involved with LGFA is that Participating Local Authorities will default on their payment obligations, which could, in turn, result in LGFA defaulting on its payment obligations. The greater this risk is, the less attractive participation in LGFA is for all Participating Local Authorities.

The Participating Local Authorities do not create this risk in equal amounts. There are some that carry a greater default risk than others, and therefore contribute disproportionately to the overall risk of LGFA. Those local authorities are also the local authorities that would be likely to pay the highest interest margins if they borrowed outside LGFA, and so potentially benefit the most from the establishment of LGFA.

To avoid, or at least minimise, what is effectively cross subsidisation of the higher risk local authorities by the lower risk local authorities, different interest margins are likely to be paid by different local authorities when they borrow from LGFA, with those carrying the higher default risk paying the higher interest margins.

Viability of LGFA dependent on participation levels
The modelling and other analysis done by Cameron Partners and Asia Pacific Risk Management prior to the establishment of LGFA suggests that LGFA will be viable (in that it will deliver sufficient benefits to justify its establishment and continued existence) if:

(a) LGFA maintains a high enough credit rating; and

(b) sufficient funds are borrowed through it to obtain the economies of scale benefits referred to in paragraph (b).

Consequently, the participation of sufficient local authorities, both initially as Principal Shareholding Local Authorities (to contribute initial capital) and in meeting their on-going borrowing requirements through LGFA is critical.

Principal Shareholding Local Authorities have contributed $20 million by way of paid-up initial capital contributions.

Principal Shareholding Local Authorities are also required to meet a certain proportion of their borrowing needs through LGFA for an initial period, to ensure that the critical amount of utilisation is achieved.

Summary of transactions a Council will enter into if it joins LGFA
If a Council joins LGFA as a Principal Shareholding Local Authority, it will:

(a) subscribe for paid-up shares in LGFA to provide it with capital (see paragraphs 0 and 24(a));

(b) subscribe for Uncalled Capital in LGFA (see paragraph 24(b) above);

(c) commit to providing additional equity to LGFA under certain circumstances (see paragraph 24(d) above);

(d) commit to meeting a certain proportion of its borrowing needs from LGFA;

(e) borrow from LGFA;

(f) subscribe for Borrower Notes (see paragraph 24(c));

(g) enter into the Guarantee (see discussion in paragraphs 25 to 31 above);

(h) provide a Rates Charge to secure some or all of its obligations to LGFA and LGFA's creditors (see discussion in paragraphs 0 to 0 and 32 above).

If a Council joins LGFA as a Guaranteeing Local Authority, but not as a Principal Shareholding Local Authority, it will enter into the transactions described in paragraph 40, other than those described in paragraphs 40(a) and (b).

If a Council participates in LGFA, but not as a Guaranteeing Local Authority (and therefore also not as a Principal Shareholding Local Authority) it will only enter into the transactions described in paragraph (e), (f) and (h).

Local Authority Costs and Benefits

The costs and benefits to a Participating Local Authority will depend on whether it participates as a Principal Shareholding Local Authority, a Guaranteeing Local Authority, or simply as a borrower.

Benefits to local authorities that borrow through LGFA
It is anticipated that LGFA will be able to borrow at a low enough rate for LGFA to be attractive because of the three key advantages LGFA will have over a local authority borrower described in paragraph 0. That is – exploiting a credit rating arbitrage, economies of scale and a regulatory arbitrage.

In addition, LGFA will provide local authorities with increased certainty of access to funding and terms and conditions (including the potential access to longer funding terms e.g. 10 yrs+).

The potential savings for a local authority in terms of funding costs will depend on the difference between the funding cost to that local authority when it borrows from LGFA and the funding cost to the local authority when it borrows from alternative sources. This difference will vary between local authorities.

The funding costs each local authority pays when it borrows from LGFA will be affected by the following factors, some of which are specific to the local authority:

(a) the borrowing margin of LGFA;

(b) the operating costs of LGFA;

(c) any price adjustment made by LGFA for that specific local authority as a result of:
   (i) the credit quality of the local authority;
   (ii) the size of the borrowings of that local authority from LGFA; and
   (iii) the local authority being a Guaranteeing Local Authority or not.

A diagram which shows what will affect the amount of any funding cost savings is set out as Annex 1.

Costs to local authorities that borrow through LGFA
The costs to Participating Local Authorities as a result of their borrowing through LGFA take two forms:

(a) First, there are some risks that each Participating Local Authority will have to assume to participate, which create contingent liabilities (i.e. costs which will only materialise in certain circumstances).

(b) Secondly, there is some cost associated with the Borrower Notes.

Risks

The features of LGFA structure described above which are included to obtain a high credit rating are essentially steps which remove risk from lenders to make their residual risk low enough to justify the high credit rating. These features remove risk, in part, by transferring it to Participating Local Authorities.

These risks are that:

(a) in the case of Guaranteeing Local Authorities, a call is made under the Guarantee (see discussion in paragraphs 25 to 31 above);

(b) in the case of Guaranteeing Local Authorities, a call is made for a contribution of additional equity to LGFA (see paragraph 24 above); and

(c) in the case of all Participating Local Authorities, LGFA is not able to redeem their Borrower Notes (see paragraph 24 above).

Each of these risks is discussed in the paragraphs indicated next to the relevant risk. For the reasons set out in those discussions, it is anticipated that each of the risks is low.

Cost of Borrower Notes
As discussed in paragraph 24(c), all Participating Local Authorities will be required to invest in Borrower Notes when they borrow from LGFA. This carries a cost in addition to the risk referred to in paragraph (c), because the investment in Borrower Notes will, in most cases, be funded by borrowing from LGFA, and the cost of this funding will be higher than the return paid on the Borrower Notes.

It is anticipated that the Borrower Notes will pay an interest rate equal to LGFA's own cost of funds. Any interest payment is likely to be capitalised until maturity.

Cost/benefit analysis for the investment by Principal Shareholding Local Authorities
In addition to those costs and benefits that all Participating Local Authorities are expected to receive in relation to their borrowing from LGFA, Principal Shareholding Local Authorities will also hold shares in LGFA (Establishment Shares).

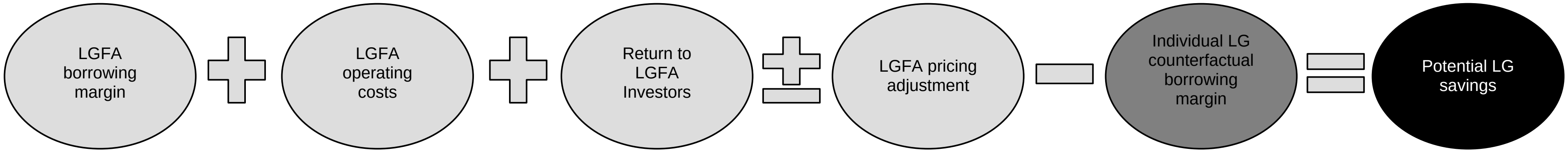
Establishment shares will pay a discretionary annual payment, which is an amount up to LGFA's own cost of funds plus 200 bps[1].

[1] A "bp" is a "basis point", which is a term that means "0.01%". 200 bps therefore refers to 2% of the amount invested.

While it is the intention for LGFA to always pay the proposed annual payment on the Establishment Shares, this payment will not be made, or will be reduced, if the performance of LGFA means that LGFA does not consider it appropriate to make the payment.

Any local authority investor in Establishment Shares will also be required to subscribe for the same amount of Uncalled Capital in LGFA. This Uncalled Capital can be called at the discretion of LGFA under certain circumstances to ensure the on-going viability of LGFA. Once called the Uncalled Capital will have the same characteristics as Establishment Shares. This is an additional risk (and therefore contingent cost) for Principal Shareholding Local Authorities. Uncalled Capital is discussed in paragraph 24(b) above.

ANNEX 1
DIAGRAM SHOWING FACTORS AFFECTING POTENTIAL SAVINGS



Performance Monitoring

The performance of the LGFA will be monitored by the Shareholder Council, a group consisting of the original tight 9 principal shareholding Councils together with the Bay of Plenty Regional Council.

The Kāpiti Coast District Council will be comparing the interest margins achieved for this Council's borrowings through the LGFA with the interest margins available from the financial markets and reporting to the Corporate Business Committee on a regular basis.

An Information Memorandum, describing the arrangements in more detail, is attached as Appendix 1, and forms part of this proposal. A number of terms which are used in this proposal are defined in that Information Memorandum.