Financial Strategy

Introduction

The financial strategy sets out the Council's strategic approach to the management of its finances and presents indicative rates and debt levels for the 10 year term of the Long Term Plan.

The purpose of the financial strategy is to facilitate –

- Prudent financial management by the local authority by providing a guide for the local authority to consider proposals for funding and expenditure against; and
- Consultation on the local authority's proposals for funding and expenditure by making transparent the overall effects on these proposals on the local authority's services, rates, debt and investments.

Key Challenges for Otorohanga District Council

Some of the key challenges facing Otorohanga District Council are:

The cost of providing local government services (the local government cost index) has continued to increase at a higher rate than inflation

It appears likely that market prices for many of the goods and services required by Councils will continue to rise at rates in excess of general inflation

The devolution of responsibilities from central government (such as alcohol and gambling regulation) and increased standard requirements (such as building regulation) places more mandatory requirements onto the Council, which ultimately comes at a cost

Local government is a large and complicated business, providing many different services not only for communities now, but into the long-term future

There is significant variation between the financial circumstances of residents and ratepayers in the District; there are some very affluent communities, but others are struggling.

Until recently there appeared to be little potential for significant growth of the population or economy of the District in the short or medium term.

A continuing focus on efficient and cost effective delivery of core services had also progressively eliminated non-essential services and other financial 'fat' from the Council organisation leaving little potential for achieving cost savings without significantly reducing levels of service.

These two factors together resulted in a belief that there was relatively little potential to protect or buffer the District against significant deterioration of local economic conditions if a global recession was to occur.

This situation has however changed relatively quickly with the announcement of three proposed major development projects in the District. This has caused challenges associated with working in an environment of economic and demographic stagnation to be quickly replaced with a different (and more positive) set of challenges associated with accommodating potential rapid population growth.

Financial Management Issues

Generally, the Council is in a sound financial position at the beginning of this plan. There is a low level of debt relative to income, as well as healthy working capital on the balance sheet. By the end of the term of this plan, this position will have improved further, with very little debt and a very healthy working capital position.

There are a number of factors which are expected to impact on the Council's management of the business and its finances over the

2018-28 period. Specifically these relate to economic climate and growth, balancing the budget, intergenerational equity and affordability.

Council Expenditure

Figure 19 identifies the total operating expenditure over the 10 year period for each of the groups of activities the Council provides, while Figure 20 shows the total capital expenditure over the same period and groupings.

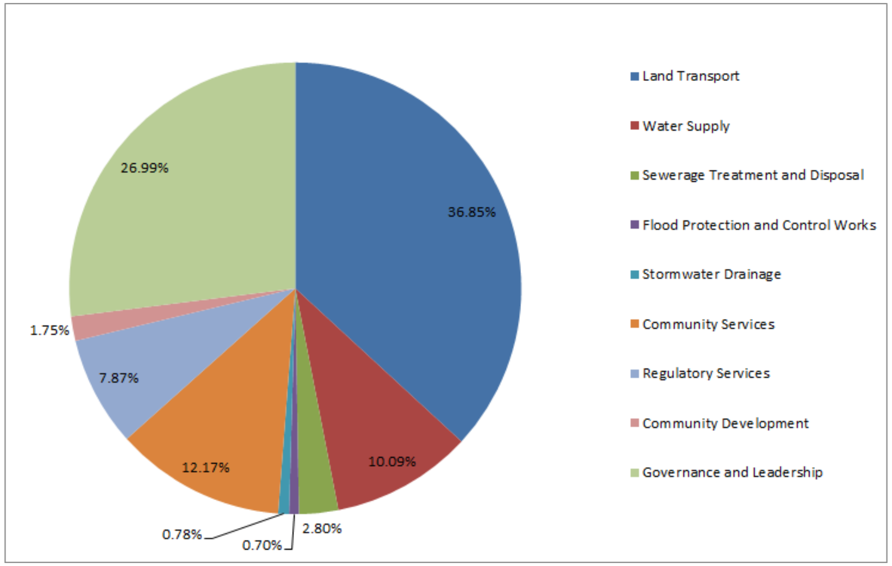

Figure 19 - Operating Expenditure 2018/28

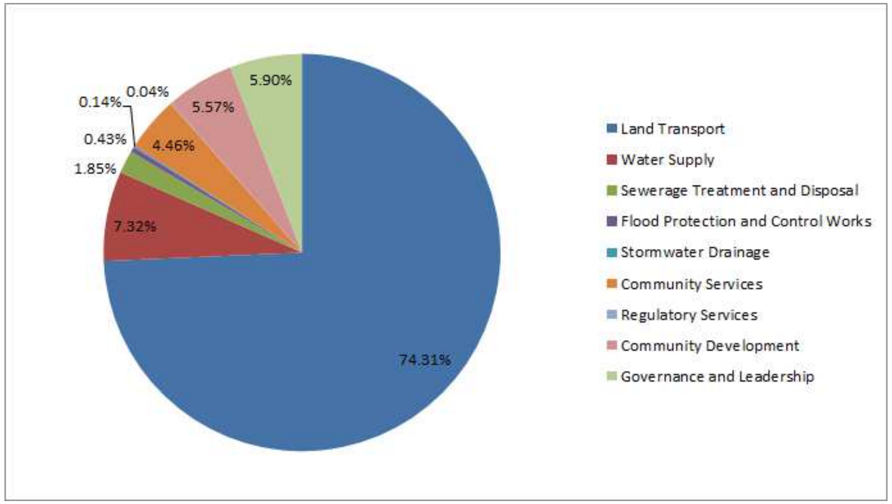

Figure 20 - Capital Expenditure 2018/28

The cost of maintaining activities to continue providing existing services is $270.0 million over the 2018-28 period. The expected capital expenditure on roads, water, wastewater, stormwater and flood protection over this period is $60.4 million as reflected in the 30 year Infrastructure Strategy.

The Council continues to be concerned about the resulting level of rates increases that have been needed to fund the services it delivers, and the impact of these on the district's communities. We are aware that the income levels of some of the residents within the District are generally lower than the New Zealand average and that it is likely that some of our residents on low incomes are reaching their limits in terms of ability to pay.

The Council also wishes to encourage economic activity in our towns, so the affordability of rates to our commercial ratepayers is also a concern.

Balancing these concerns with continued customer expectations for maintained and improved services is a challenge.

Figure 21 below shows the trend for rates, borrowings and capital expenditure which are the key financial aspects of this plan. Inflation is assumed to total 23.2% over the 10 years, which is included in all figures in the plan.

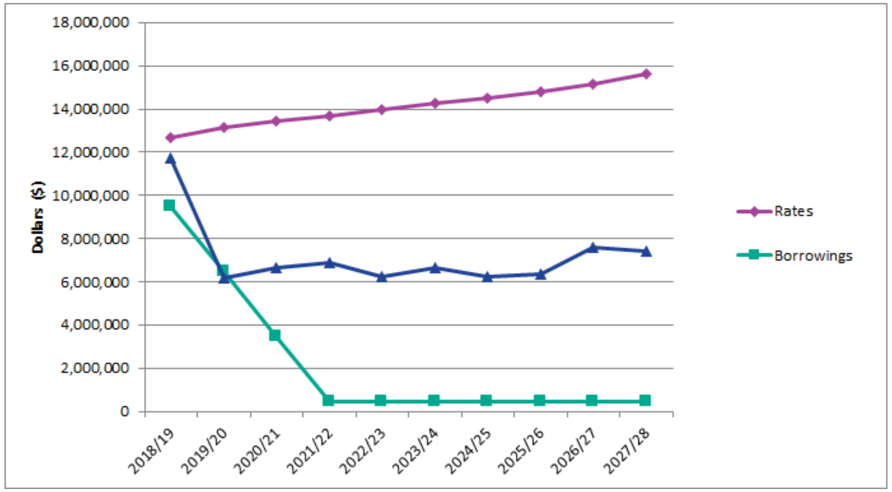

Figure 21 - Rates, Borrowings and Capital Expenditure

The council is forecasting that its operating expenditure will increase from $24.2 million to $30.5 million between 2018 and June 2028. These increases are as a result of:

- Price Increases – inflation and the factors that influence it will mean that it costs more to do business
- Service level increases – in some areas Council will provide a higher level of service in response to either changing statutory requirements or (and to a much lesser extent) the desires of ratepayers and residents
- Little likely opportunity to deliver existing levels of service at lower costs after numerous previous investigations and changes to reduce these costs
- Few opportunities to implement reductions of levels of service that will be acceptable to ratepayers and residents, as a strong focus on delivery of only core 'no frills' services has been in place for some time, and customer surveys have indicated no desire for further reductions in service levels.

Public consultation will be undertaken on the Long Term Plan in the knowledge that there is limited capacity for Council to increase expenditure in certain areas. Potential rates increases need to be kept under control and the overall level of debt maintained within limits contained in the Liability Management Policy, while still adhering to the overall financial strategy adopted by the Council.

The council has assessed the Local Government Act requirements and has adopted strategies to ensure that over the period of the 10-year plan, we continue to maintain a financially sustainable position.

The Council pays for its services from a variety of sources with rates being the largest portion. Figure 22 below shows how the Council's activities are funded.

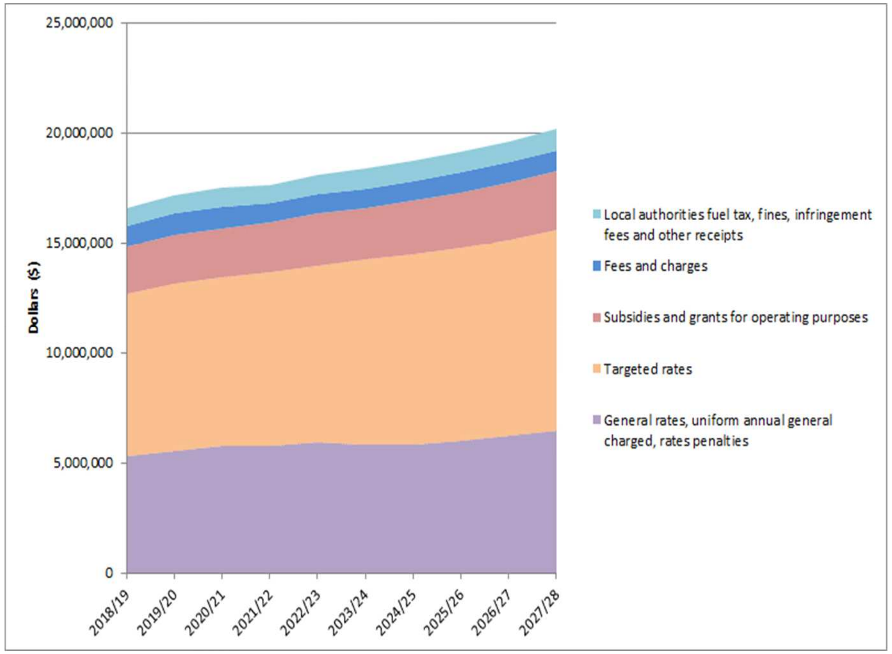

Figure 22 - Sources of Funds

The income sourced from rates is allocated across the various groups of activities as per Figure 23.

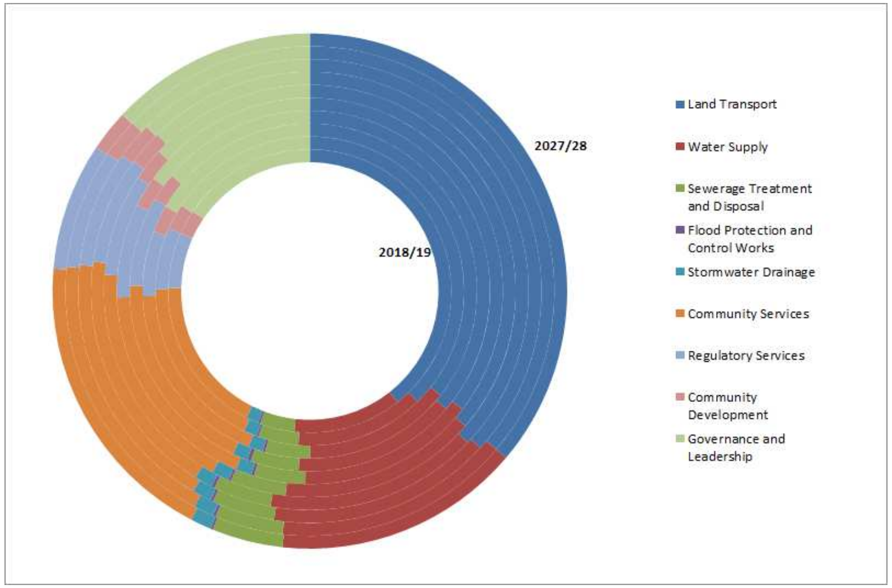

Figure 23 – Rates Income by Group of Activity

Changes in Population - Otorohanga District

As discussed earlier within the document after a long period of relative stagnation, it now appears likely that there will be significant growth of population over the next 4 to 5 years, associated with three proposed major development projects, of which a large expansion of the Waikeria Prison is the most significant.

Accommodating this growth is likely to require some increases of both operating and (more notably) capital costs during the LTP period.

Changes in Land Use - Otorohanga District

As stated previously the backbone of the local economy is agriculture, and the District contains some of the best agricultural land in New Zealand, which puts it amongst the very small quantity of highest productivity agricultural land in the world.

With the land itself being such a valuable resource (the value of which will only increase as world demand for agricultural products rises), and not being in close proximity to any expected centres of very major urban development it appears very unlikely that there will be any significant changes of land use within the District during the term of this LTP. This therefore has very little impact on operating or capital costs.

Proposed Policies and Parameters

The following sections outline some of the actions and policy approaches that have been adopted to respond to the previously identified issues. These include: [2]

- Statements on the council's quantified limits on rates, rates increases and borrowing
- Policy on the giving of securities for its borrowing
- The Council's objectives for holding and managing financial investments

Limits on Rates

Council will endeavour to keep the income required from rates steady as well as creating predictability in the level of rates required.

Currently, the Council funds about 70% from rates because it does not have alternative revenue streams e.g.; significant financial investment funds or investments, and has taken a fairly low risk approach to borrowing.

While the Council will continue its approach of allocating rates as a funding proportion based on who causes and benefits from its activities, it proposes to limit the rates collected each year to a maximum of 75% of total council revenue. Ideally, the Council will seek to reduce the proportion of revenue collected through rates. The Council's Revenue and Financing Policy sets out the sources of funding to be used, and how they will be applied to each activity with a view to achieving this objective.

Council's revenue from rates versus this limit of 75% is shown in the graph below.

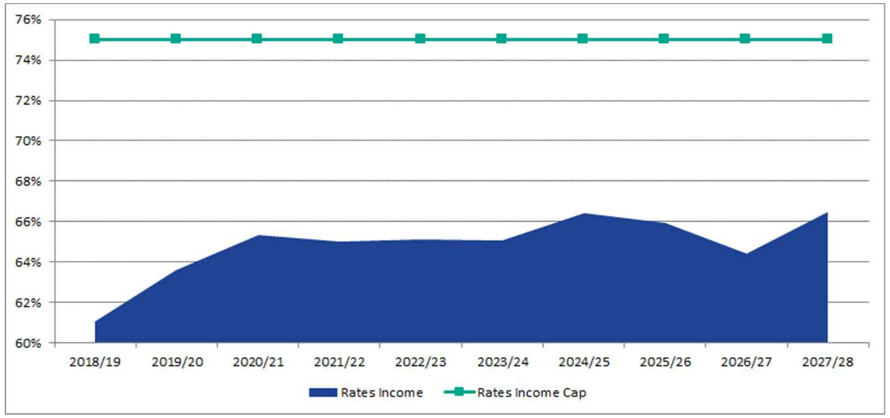

Figure 24 - Limit on Rates Income

Limits on Rate Increases

While the Council will continue to consider affordability issues when setting rate levels each year, it is also required by legislation to include a statement on quantified limits on rate increases. Council has decided that limiting the increase to no more than the forecast % [3] increase of the local government cost index (LGCI) plus 2% for that year reflects the realities of higher local government costs i.e. the cost of doing Council business. It also recognises that from time to

[2] In order to meet the Local Government Amendment Act 2010 requirements regarding financial strategy content

[3] As provided by Business and Economic Research Limited (BERL)

time Council will need to increase the level of service that it is providing to meet, for example, community needs and new resource requirements. Individual properties may experience smaller or larger increases depending on movements in property values, the services that they receive and their location.

This approach will limit the extent to which the Council can undertake new or increased services and projects unless savings can be found elsewhere. As it provides for little contingency, this reflects a conservative approach.

The Council does not intend providing for different rate increase limits for individual community board areas. Rather it will focus on the overall District Rate Requirement movement and then look to prioritise the desires of different communities within the district average.

Table 5 - Rates Increase Limits

	LGCI as a %	Plus 2%	Rate Increase Limit as % of previous year rates income
2017/18	1.8	2.00	3.8
2018/19	2.0	2.00	4.0
2019/20	2.2	2.00	4.2
2020/21	2.2	2.00	4.2
2021/22	2.2	2.00	4.2
2022/23	2.3	2.00	4.3
2023/24	2.3	2.00	4.3
2024/25	2.4	2.00	4.4
2025/26	2.5	2.00	4.5
2026/27	2.6	2.00	4.6
2027/28	2.7	2.00	4.7

This rates limit compared to the projected rates increases can be seen in Figure 25.

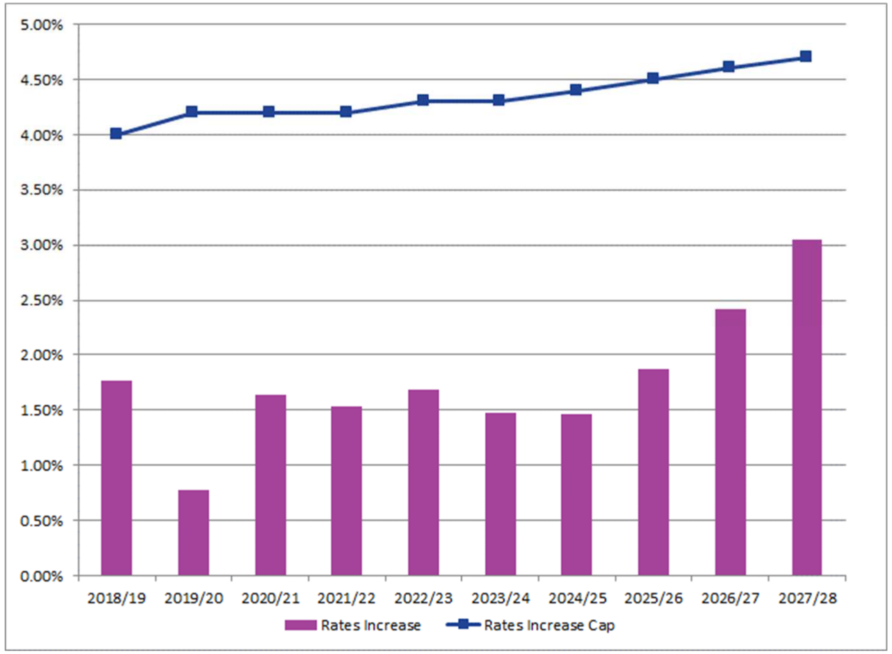

Figure 25 - Rates Increase Limits

The value of all properties within the Otorohanga District Council boundaries is reviewed as part of the three – yearly valuations. These values were published in October 2016, and took effect in 2017/18 for rating purposes.

Limits on Costs of Particular Activities

Council has the ability to provide and maintain existing levels of service to meet the limited additional demand, within the rates and borrowing limits. Should costs increase during this time, Council has mechanisms such as placing limits on costs of particular activities, in order to remain within these stated limits.

Some Council activities have had a history of costs increasing at rates substantially above those of both the rate of general inflation and the rate of general District rates.

One particular example is the operation of the Otorohanga swimming pool, the cost of which has more than quadrupled as a percentage of total District rates over the last 25 years. Council has recently agreed that this trend of increasing cost (driven by both increased levels of service, stricter regulatory requirements and inflation) cannot continue, and has therefore set a limit on the cost of this activity as a percentage of total District rates. If it appears that this limit will be exceeded in any forthcoming year, level of service reductions or other cost saving measures will be required to prevent this occurring.

The setting of this limit has already had a beneficial effect on controlling the cost of this activity, and it is possible that a similar approach could be adopted for other activities that have an unacceptable trend of increasing cost in relation to the overall costs of Council.

Debt and Interest

Council wishes to continue taking a conservative approach to managing its finances. This includes borrowing within its ability to service and repay that borrowing while adopting less conservative borrowing limits to provide the flexibility to fund projects deemed to be of benefit (acknowledging that borrowing capacity does not have to be fully utilised).

Council has set a conservative Debt Limit of Net Debt as percentage of Total Revenue of 100%. Net debt is defined as the borrowings owed by Council less any cash on hand or in short term deposits.

This ratio was developed with reference to the ratio required to borrow from the Local Government Funding Agency of 175% and the expected borrowing needs of Council over the next 10 years. Council has set the debt limit at considerably less than the LGFA requirement but this is considered prudent for a small Council.

Details on how the Council's debt is managed are set in its Liability Management Policy which is publicly available.

Figure 26 below shows Council's proposed Net Debt/ Total Revenue ratio over the 10 years of the LTP. Note that where cash on hand exceeds money owed, the ratio has been set at 0 for ease of understanding.

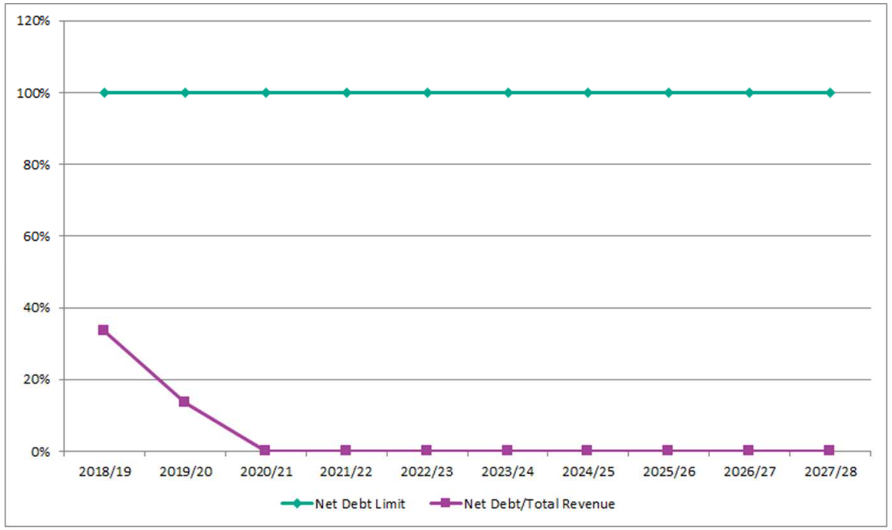

Figure 26 - Limit on Debt

The Council also utilises internal borrowing which is not subject to the above limits.

Securities for Borrowing

Council borrowings are secured over annual rates on every rateable property situated within the Otorohanga District.

Under the Debenture Trust Deed, the Council offers deemed rates as security for general borrowing programmes

From time to time, security may be offered over specific assets within Council approval or infrastructural assets where special rating provisions apply

The Securities Act 1978 and the Securities (Local Authority Exemption) Amendment Act allow council to issue debt securities to raise funds for Capital Investment. Any issue of debt securities must be approved by Council and will be in compliance with the Securities Act 1978 and the Securities (Local Authority Exemption) Amendment Act.

Financial Investments and Equity Securities

In keeping with the Council's objective to adopt a conservative approach to managing its finances, any surplus funds are usually used for debt repayment rather than financial investment. It does not intend to undertake financial investments for the purpose of generating significant returns, now or in the future. As such, the Council does not seek to hold financial investments other than those that are short term surpluses.

In relation to equity (shares in stocks) for investment purposes, the Council will only hold these for strategic purposes such as holding equity in shared services to help councils provide services more efficiently.

Forecast equity investments reflect Council's shares in the following entities:

- Waikato Regional Airport
- Balance Agrinutrients
- NZ Local Government Insurance Corporation Ltd
- Local Government Funding Agency
- Local Authority Shared Services

The Council is primarily concerned with the protection of its investment. The Council recognises that as a responsible public authority, any investments that it does hold will be low risk. It also recognises that lower risk generally means lower returns.

While the Council acknowledges that the amount of return on financial investment is the responsibility of the lender and therefore outside of the Council's control, it is required by law to identify targets for the returns received on its investments and equity securities. In keeping with the Council's objective to invest in a secure, low risk vehicle which will result in lower return in investment but does not compromise on the principle, its quantified financial investment target is to achieve a return equivalent to the five year government stock rate. As at the time of writing this LTP, this is 2.29%. Targeting returns for equity securities is not applicable.

Other Sources of Income

Council will endeavour, where possible, to maintain and maximise the income coming from other sources. These other sources include subsidies available, including NZTA subsidy and grants for capital projects. Other sources of income are from user fees and charges, particularly with regards to regulatory areas. Again, these will be maximised where possible, reflecting the user pays philosophy.

Balanced Budget Requirement

Section 100 of the Local Government Act 2002 states:

1) A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses.
2) Despite subsection (1), a local authority may set projected operating revenues at a different level from that required by that subsection if the local authority resolves that it is financially prudent to do so, having regard to:
    a) the estimated expenses of achieving and maintaining the predicted levels of service provision set out in the LTP, including the estimated expense associated with maintaining the service capacity and integrity of assets throughout their useful life; and
    b) the projected revenue available to fund the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life;
    c) the equitable allocation of responsibility for funding the provision and maintenance of assets and facilities throughout their useful life; and
    d) the funding and financial policies adopted under section 102.

Council has decided not to fund depreciation on the following assets, while this does not comply with the legislation, it is acceptable providing appropriate community consultation has taken place.

- Community Facilities – Depreciation has not been funded on some of these assets as they are considered non-strategic and will not be replaced once they are no longer useful.
- Roading – Council has made a decision to not fund depreciation on the basecourse and subbase for sealed and unsealed roads for the NZTA portion of funding (assumed to be 58%). Given the nature of these assets, the replacement of these is highly likely to be funded at the prevailing funding assistance rate by NZTA, so funding this is not deemed necessary by Council.
- Waipa Rural Water Supply – After consultation with the Water Supply Committee the decision was made not to fund depreciation. It was considered that the scheme was relatively new with minimal renewal work required over the next 20 years and consumers had also paid a capital contribution to join the scheme. It is envisaged that sustaining current income levels over the term of the LTP will result in sufficient surpluses to fund desired capital expenditure.

	2018/19 $	2019/20 $	2020/21 $
Community Facilities			
Community Halls	28,868	28,868	30,456
Kawhia Community Centre	15,919	15,919	16,795
Kawhia Housing for the Elderly	12,224	12,683	13,637
Otorohanga Housing for the Elderly	69,104	71,911	76,841
Land Transport	629,293	629,293	668,939
Waipa Rural Water Supply	46,374	47,040	50,200

Link between Financial Strategy and Financial Statements

The financial strategy talks about conservative times ahead for the Council, however we are showing a profit in our Statement of Comprehensive Income. The profit being shown is not true profit in terms of money over and above expenditure, as it contains subsidy received from NZTA for roading capital projects, as well as money from funding depreciation that is put aside to fund future capital projects.

Review

The Financial Strategy will be reviewed three-yearly as part of the ten year planning process.