

Local Government Funding Agency – extracts from the paper to the AGM – November 2018

There are two proposed changes to the Foundation Policies requiring shareholder approval by Ordinary Resolution.

1. Measurement of council compliance with LGFA covenants at the group level:

Currently LGFA tests each council borrower's compliance with either the Foundation Policy or Lending Policy covenants at the parent council level i.e. it excludes any debt, revenue or interest payments made by a subsidiary entity from the calculations. This might not reflect the most accurate representation of a council's financial position if the council delivers some of its services or activities or holds assets through a subsidiary entity.

It is proposed that a council can apply to the LGFA Board to be tested at the group level rather than at the parent level for compliance with LGFA covenants. It is important to note that:

- The Foundation Policy Covenants (if the council had an external credit rating) or Lending Policy Covenants (if no external credit rating) would still apply to the council regardless of being measured on a parent or group basis.
- The Senior Manager Credit and External Relationships would provide analysis and recommendation to the LGFA Board for consideration as to whether they should approve the request.

- Dunedin City Council ("DCC") borrows via a CCTO subsidiary company, Dunedin City Treasury Limited. This is one reason why DCC has not become a member of LGFA.

To ensure that LGFA does not bear any additional risk than that incurred with lending to a parent council, it is proposed that LGFA could lend to a CCO provided;

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- The parent council (or group of shareholding councils) of the CCO must each be a guarantor of the loan in favour of LGFA.
- LGFA will only lend to a CCO if:
 - there is uncalled capital from the parent council that is at least equal to the financial obligations of the CCO; or
 - there is a guarantee from the parent council in respect of the CCO.
- LGFA will undertake credit analysis on the CCO as well as the parent council.
- The CCO would be subject to LGFA Board approval before borrowing.

- To provide certainty to the council, the testing at the group level would apply for the life of the existing loans from LGFA.
- We expect that this will apply to only a small group of councils and our current expectation is that only Auckland Council would wish to have their covenants calculated at group level.

2. Lending to Council Controlled Organisations ("CCOs"):

Currently LGFA only lends to the parent council and not to any other related entities. This is not ideal as;

- Several councils borrow and on-lend to CCOs e.g. Christchurch City Council, New Plymouth District Council, Rotorua District Council, Marlborough District Council and Auckland Council have previously borrowed and on-lent to Christchurch City Holdings Limited, New Plymouth Airport, Rotorua Regional Airport, Marlborough District Council Holdings and Watercare respectively. The proposed changes will provide the councils with greater flexibility in structuring their borrowing and on-lending activities.
- LGFA cannot currently lend to multiple owned CCOs. While there are currently very few of these entities which have borrowings, they may become established in the future e.g. jointly owned water companies.

- The LGFA Board would apply bespoke financial covenants to the CCO taken into consideration factors such as the ownership structure, cashflow and balance sheet quality and what activity or services the CCO is delivering on behalf of the parent council shareholder(s).

Why is LGFA proposing these changes to the Foundation Policies?

We are proposing these changes because of feedback from member and non-member councils. LGFA has built a successful track record of continuous improvement and evolving to meet council needs e.g. short dated lending and bespoke lending.

Auckland Council delivers a large amount of services through Watercare and Auckland Transport and is analysed on a group basis by the credit rating agencies.

There are some council members who currently borrow and on-lend to their CCO subsidiaries, so this proposal will give them the option to streamline the borrowing process and provide more flexibility in how they structure their borrowing.

Is there more risk for LGFA guarantors?

No as regardless of being measured on a group or parent basis the council must remain compliant with the LGFA covenants and we have recourse over rates revenue as security.

No as a CCO who borrows from LGFA will have the benefit of a parent council guarantee or uncalled capital. LGFA would negotiate lending documentation with each CCO and LGFA would undertake credit analysis of the CCO as well as the parent council or councils.

Why would the LGFA Board grant bespoke covenants to CCOs?

While councils are very similar to each other, there can be significant differences between CCOs. In addition, CCOs also do not have rates revenue. Therefore, the LGFA Board, following advice from LGFA management and external legal advisors, would need to negotiate bespoke covenants with the CCO. While covenants may vary between CCOs, the underlying recourse remains the uncalled capital or parent guarantee.

Could a Council Controlled Trading Organisation ("CCTO") borrow from LGFA?

Currently under section 62 of the Local Government Act 2002 a council cannot give any guarantee, indemnity or security in respect of the performance of any obligation by a CCTO. For a CCTO to borrow under this proposed structure, uncalled capital could be used, or the parent council could continue to borrow from LGFA and on-lend to the CCTO.

Will the proposed changes make it easier for councils to borrow more or to avoid a covenant breach?

No as the LGFA Board approves the testing of a council at the group or parent level. The LGFA Board will consider whether a move to testing at the group level will weaken the credit profile of the council before deciding on the change. Regardless of the basis for measurement, the LGFA Board expects all council borrowers to maintain sufficient headroom under the LGFA covenants.