# Proposed Changes to S&P Local Government Ratings Methodology

**As part of its cyclical review process, Standard & Poor's (S&P) released a consultation document outlining changes to its rating methodology used to rate Non-US Global Local/Regional Government entities (LRGs) i.e. Councils. The consultation period runs until 27 March 2019. Once the methodology is finalised, the changes will become effective immediately.**

The proposed methodology largely focuses on simplifying, consolidating and clarifying the existing 'factor approach' to rating LRGs. The current methodology is being revised from seven factors to five. S&P believe there will only be limited impact on the ratings within the scope of this methodology. The proposed factor methodology is as follows.

Contigent Liabilites has been absorbed as part of this measure.

**Ecoconmy**
20%

**Financial Management**
20%

**Budgetary Performance**
20%

**Liquidity**
20%

**Debt burden**
20%

Budgetary Flexibility has been absorbed as part of this measure

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**In our view, there are four key areas of focus that will likely impact the New Zealand Local Government sector under the proposed methodology.**

Any adjustment to the 'Budgetary Performance' assessment will likely happen within the rating band (rather than between bands).

Tax Supported Debt of Consolidated Revenues

500%

Key focus on 12 – 18 months of committed debt accessibility

## Budgetary Flexibility

Budgetary flexibility would no longer be an individual factor within the rating assessment. It would become a qualitative adjustment to the overarching 'Budgetary performance' assessment. This will generally only impact outliers – i.e. councils that are able to adjust or increase rates (positive), cut spending, or those that do not have high levels of flexibility (negative). The impact of this change will vary from council to council depending on individual metrics.

## Contingent liabilities

Contingent Liabilities would no longer be an individual factor, and would instead be considered within the 'Debt Burden' assessment. In the context of New Zealand, contingent liabilities largely reflects on-lending activity or guarantees that Councils provide to their Council Controlled Organisations and Trading Organisations (including other entities they support). Further, S&P will look to explicitly include liabilities relating to lease obligations in the Debt Burden measure as well. Note S&P have been fully consolidating the largest councils' group activities already, but have not explicitly separated it from other debt obligations in the past.

The overall size of contingent liabilities will be combined with a qualitative assessment of the risk that these contingent liabilities will materialise. So while a council may provide a large amount of on-lending, if that entity is highly likely to repay or can support the debt in their own right, the likely adjustment to the score will be low. Again, the likely impact would be an adjustment within the ratings band.

## Overrides

S&P has revised its measurement of a number of overrides. Where tax supported debt is more than 500% of consolidated operating revenues, S&P is likely to lower the outcome by one notch. Under existing methodology (currently ~270%). S&P also seek to adjust a ratings outcome by one notch if the deficit after capital amounts is more than 25% of adjusted revenues (currently 23%).

Where both of these thresholds are breached, the outcome would be a downgrade of two notches, though S&P consider the credit profile compared with peers and would reduce this to one notch where there was indication of a stronger credit profile.

We think this change will likely have little impact on the majority of the sector. Councils with high debt levels may be able to increase their debt marginally and remain within the current ratings band. This will be assessed in the context of debt serviceability.

## Liquidity

Globally, New Zealand has one of the highest local government debt burdens. A very positively-weighted sector system for rates revenue and a robust framework allows the sector to support this burden. Other jurisdictions tend to hold more assets to support liquidity.

Under the proposed methodology, the liquidity ratio calculation has changed such that S&P will be focusing on the next 12 – 18 months of committed debt accessibility. This translates to councils requiring either ready assets to support liquidity or a contract in place to raise debt (i.e. pre-funding through the LGFA) rather than just an intention or the ability/capacity to do so over the 12 month period from review date.

In our view, Councils should pay close attention to the alignment of their existing practices and debt maturity profile with S&P's liquidity requirements.


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