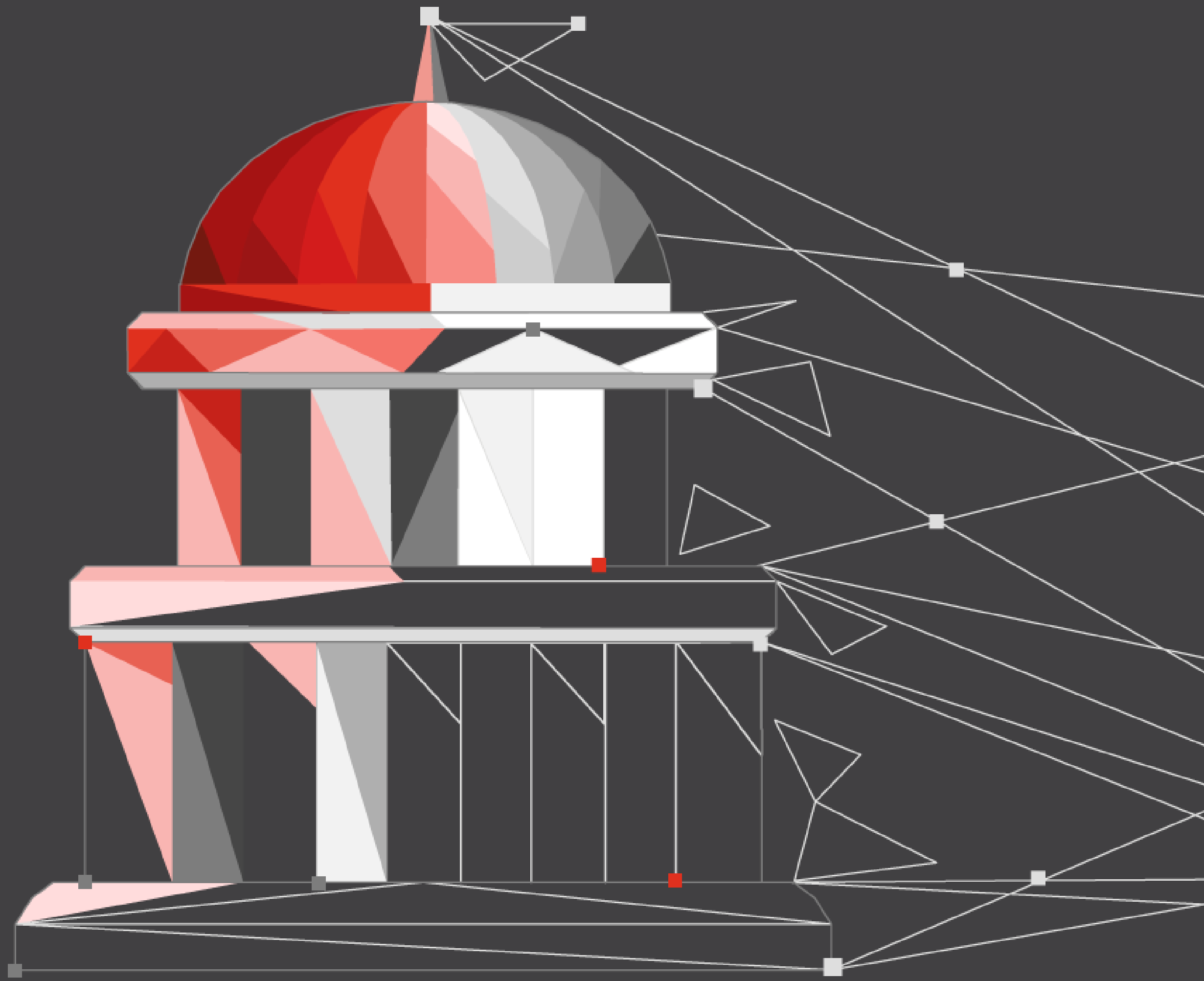

Rebuild New Zealand: local government

Focus on infrastructure

September 2020

Rebuild New Zealand: local government

Prior to COVID-19 local government faced a number of pressures including ratepayer affordability and, for high growth councils, financing capacity. Following the impact of the pandemic, the sector has now been asked to shoulder a significant burden of responsibility in New Zealand's economic response – particularly in relation to deploying stimulus into the economy. In part, this country's ability to rebuild is tied to the success of local government. This creates an immense opportunity for the sector to invest in local communities, be a catalyst for external investment and reshape itself to better deliver wellbeing outcomes.

While the pandemic has adversely impacted local government revenues, a significant component of the sector's investment and future narrative relates to three waters reform (drinking water, wastewater and stormwater) – an initiative accelerated by central government. It will undoubtedly be the biggest change to local government in the last 30 years, and one of the most significant opportunities.

The reform should be carefully considered with a post-COVID lens, including what the form and role of local government is going forward.

With the sector expected to begin public consultation on their 10 year strategies (Long Term Plans) early next year, the time to replan and rethink their approach to the future is now.

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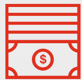
In this report we examine broad-based infrastructure issues and speak to how local government can assist with rebuilding New Zealand in the wake of COVID-19.

Ongoing challenges facing local government

Local government currently spends about $5.5bn per annum on capital projects with almost half spent in Auckland. Of that capital spend, about one third is spent on transport and one third on three waters. The remaining third is put towards other initiatives such as city and town centre development, parks and recreation facilities.

This is funded through a combination of 'revenue' sources including rates (general and targeted), subsidies and grants, development contributions and fees and charges (such as consenting fees), and in some cases, income from council owned investments. On average, rates make up about 50% of local government revenue. While rates revenue is typically highly reliable, other forms are more closely correlated to the performance of the wider economy.

Pre COVID-19 local government was facing a number of challenges, both financial and non-financial. These are likely to be exacerbated by the pandemic. The most pressing challenges currently faced, in addition to COVID-19, include:



Navigating funding, financing and affordability: Councils across New Zealand are in vastly different financial positions. But, one common challenge is affordability. While some councils are clearly debt constrained, debt is not the panacea it is sometimes made out to be. Certain projects are simply unaffordable under the current local government framework. While debt is a useful tool that enables costs to be spread over time (particularly for projects with large upfront capital costs) projects still need to be funded. This puts an additional burden on ratepayers. When the burden is too great, innovative solutions must be found. This requires detailed value creation and value capture analysis, including exploring complementary commercial opportunities. These tools and approaches are a departure from how local government has traditionally faced these challenges.

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Operating within a highly fragmented delivery model: New Zealand currently has 67 territorial authorities and 11 regional councils. Institutional settings mean that responsibility for the supply of many services is highly fragmented. This creates challenges for holistic regional decision-making and also reduces scale, limiting the ability to attract market expertise and innovation. Services that suffer from segregation issues include three waters, waste, transportation and urban development. The sector is looking to address this through collaborative partnerships e.g. Future Proof (Hamilton to Auckland Corridor) and SmartGrowth (Western Bay of Plenty). These are positive steps.

However, even with these collaborative partnerships the statutory responsibilities of local authorities can't be avoided, these include the requirement to only service certain geographic areas and provide certain types of services (e.g. regional councils are responsible for train services but not train stations). Three waters reform will tackle regional investment directly, by removing responsibility for two or three waters from territorial authorities and amalgamating them into a small number of new multi-regional entities. The proposed model for this is yet to be developed and there are risks to the reform, particularly around community representation and affordability, but if executed well, it has the ability to bring holistic decision-making and scale to the water sector.

Without legislative change or fundamental reorganisation of the local government sector, councils will need to continue leveraging regional relationships to bring about similar outcomes in other activities.

> Three waters reform will tackle regional investment directly...

Working with the urban development model: This model is challenging for local government. Essentially, it requires councils to invest in bulk infrastructure (such as roading and water infrastructure) to support urban development upfront, then carry debt on their balance sheet until costs can be recovered over time. This is done through the progressive charging of development contributions and other sources. Cost recovery only occurs near the end of the development cycle leading many high growth councils to become highly indebted. Central government has recently provided new tools to assist, including through the Infrastructure Funding and Financing (IFF) Act and the Urban Development Act. Both allow for the financing of infrastructure outside of local government balance sheets. These models are innovative and will require close collaboration between central and local government. To see the benefit, the sector must invest time and resources.

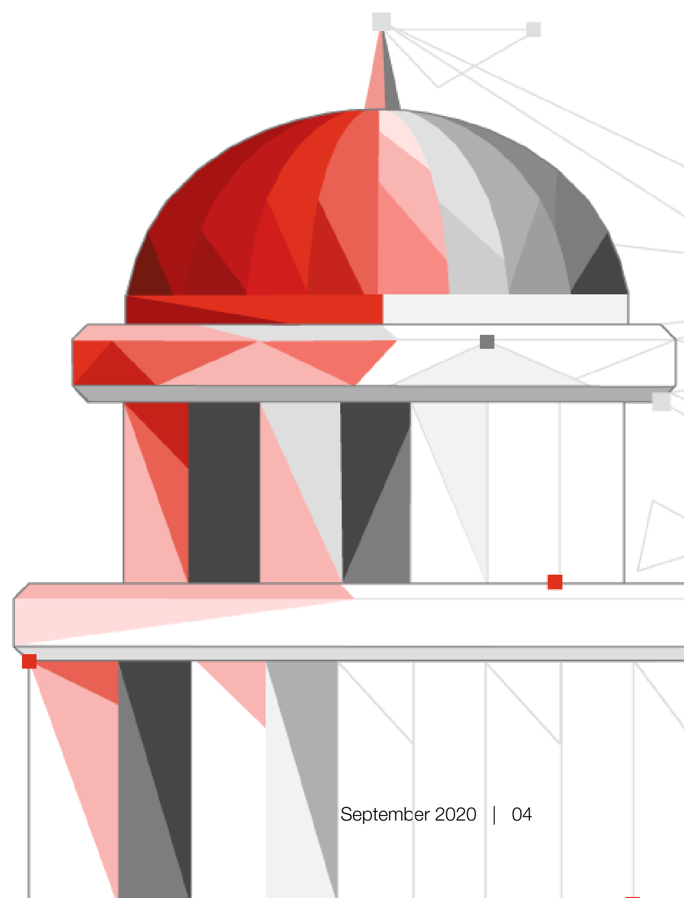
How has COVID-19 affected local government?

Financial impact.
Councils that are particularly reliant on non-rates revenue, are experiencing high growth and are already heavily indebted, will be hit the hardest. They will need to make difficult decisions on where to reduce expenditure in line with their loss of income. Other councils (primarily those serving rural and provincial New Zealand) are forecasting more limited financial impact.

The overall financial impact on local government is still uncertain. In July 2020 the Local Government Funding Agency (LGFA) estimated that revenues for the sector would fall somewhere between 2.3% and 11% in the 2021 financial year. This is equivalent to an annual reduction of between $355m and $1.5bn – a significant range.

The housing market.
High growth council revenues are tied to the performance of the housing market because of their reliance on development contributions and building and resource consent fees. These councils are typically also highly indebted, having invested in infrastructure upfront. This makes future planning and funding challenging as they are reliant on the performance of the housing market.

Non-rates revenue.
Other non-rates revenue is more closely linked to general economic activity and the overall performance of the economy. Lockdowns will continue to have an impact on these revenues, particularly those generated from local government investments e.g. ports and airports which have typically been relatively self sustaining. The impact of COVID-19 may mean that some businesses will be seeking new capital from their owners. We have seen Auckland Airport raise $1.2bn without Auckland Council participating – significantly diluting Auckland Council's ownership. COVID-19 has greatly reduced dividend income, with any equity dilution likely to impact the distributions Councils' receive going forward.



How is local government responding?

The sector has four main levers available to offset the financial implications of COVID-19:

1 **Increase borrowings (or raise borrowing ratios)**

Lower revenues impact financial covenants, most notably debt to revenue ratios. The Local Government Funding Agency (LGFA) has recognised this and provided relief for its more highly indebted members through short and long-term changes to covenants. For the FY21 and FY22 financial years maximum debt to revenue (for councils with a credit rating of 'A' or higher) will move from 250% to 300%. This will provide critical short-term relief for a small number of councils and avoid covenant breaches.

Longer term support for the sector will be through a permanent increase in the debt to revenue covenant of 280%. This will release over $2.6bn of additional funding headroom to these highly rated councils. However, this number represents less than 5% of the projected ~$55bn 10 year capital spend reflected in existing LTPs. Additionally, due to factors such as population growth and changing regulatory standards, this LTP figure may underestimate the actual investment required. Taking advantage of these covenant changes must also be considered against potential credit rating downgrades, which are assessed independently of LGFA covenants and impact on the cost and flexibility of borrowing.

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> The post-COVID world means the drivers of balance sheet separation are no longer the same.

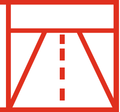
As we come up to 10 years since the beginning of the LGFA, the time may be right for the sector to rethink how it borrows and the role that central government plays. Our highest growth and biggest GDP producing areas are approaching their borrowing limits. So, as a nation we need to ask ourselves – should we constrain the engine rooms of our economy in this way?

The central government response to increasingly constrained local authority borrowing capacity over the past few years has focused on balance sheet separation, with the development of tools such as IFF, as well as proposed new three waters entities. The post-COVID world means the drivers of balance sheet separation are no longer the same. Instead of looking at separation simply to free up debt capacity, local and central government need to weigh up the cost of establishing the Special Purpose Vehicles (SPVs) (or other entities) required to enable balance sheet separation, along with the risk of future consolidation, versus the cost of alternative approaches to enabling greater borrowing by local authorities.

Central government already provides a level of support to local government, borrowing through its shareholding in the LGFA and provision of liquidity and interest rate swap facilities. However, it could play a larger role in enabling additional borrowing for our biggest and highest growth councils. One potential solution could be to guarantee local government borrowing over and above prudent LGFA covenant levels. By charging a fee for this (recognising the low level of default risk) taxpayers would be equitably compensated while councils would be able to continue to support growth initiatives, resulting in additional flow on benefits for central government such as GST and income tax receipts. While tweaking covenant levels may provide a short term fix, it is clear that for many councils a longer term solution is required.

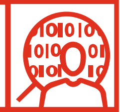
> ...the financial impacts of COVID-19 mean that councils need to re-examine what are core and non-core assets, and explore options for releasing capital.

2 Reducing capital expenditure (capex)



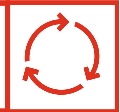
Capex reductions may mean a shift in focus, from projects in council capital programmes (LTPs and Infrastructure Strategies), to those that are funded through central government stimulus. Much of the stimulus funding is project based and subject to certain selection criteria. For councils that have reduced or deferred their capital programmes as a result of COVID-19, the offsetting stimulus funding may not necessarily be directed at the same projects, resulting in a change to capital programmes. This is potentially problematic for the nation, as councils are often best placed to understand what is really needed in a particular region.

3 Reducing operating expenditure (opex)



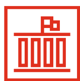
Opex reductions provide an opportunity for councils to take a critical look at themselves (like we are seeing across the corporate sector) and ask – what is their core purpose? And, what is the most efficient way to use limited revenue to deliver on their statutory obligations, including wellbeing? Historically, local government has been reluctant to release assets. At the same time they have struggled to deliver new assets critically needed by their communities. COVID-19 provides not only the impetus but the political protection to assess what assets are most essential to the delivery of their statutory requirements and, what can be recycled to fund other investments.

4 Asset recycling



The sector has accumulated over $150bn in assets on its collective balance sheet. But, the sector has traditionally been reluctant to sell assets, even where the sale proceeds are reinvested in the community (i.e. asset recycling). Much of the current local government asset base comprises core community infrastructure that is quite rightly owned and controlled by councils. However, the financial impacts of COVID-19 mean that councils need to re-examine what are core and non-core assets, and explore options for releasing capital. Assets sales are not the only option, structures such as concession arrangements can release capital without councils losing ultimate beneficial ownership of the underlying assets. These arrangements can also be structured to retain elements of control regarding how the assets are operated and managed. In a post-COVID-19 world traditional views on asset ownership need to be tested.

How can local government contribute to rebuilding New Zealand?



Utilising central government investment: This includes investments from the Provincial Growth Fund, the funding of several transportation projects through the New Zealand Upgrade Programme and the three waters reform, as well as direct COVID-19 stimulus through the 'shovel ready' infrastructure development initiative.

While this investment is clearly welcomed, it won't be easy to deliver. Capital delivery teams are already stretched and must now deliver more in an environment where the contractor market is also under pressure. New ways of delivering projects will be required. Any change in approach should focus on delivering faster, with less resource required from local government, while maintaining a strong emphasis on project outcomes, price transparency and value for money. Local government also has the opportunity to use sustainable procurement practices to deliver much broader outcomes than the project itself. Incorporating outcomes such as local contractor/sub-contractor representation, education and training, and iwi involvement are all possible through more enlightened procurement models.

Embracing alliance models: Recently, we have seen greater use of alliance models to deliver infrastructure in a more collaborative way while achieving speed, cost, environmental and health and safety benefits. Notable examples include the Wynyard Edge Alliance, which is currently delivering the infrastructure for the 36th America's Cup and Watercare's Enterprise Model, a $2.4bn long term partnership between Watercare and the construction sector to deliver drinking and waste water infrastructure across greater Auckland. The challenge for the sector will be how to apply these learnings to smaller scale projects to deliver similar benefits.

Focusing on governance: Doing things differently will require a greater focus on governance, including project controls and risk management. Critical to this will be establishing:

Clear governance frameworks: A governance framework will establish the different individuals and groups required to deliver the project. The framework should complement the organisation's strengths and be designed so as to address the specific project risks.

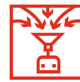
Definitive roles, responsibilities and accountabilities: Once a framework has been established, each group or member within the governance framework should have a clear understanding of their role, responsibilities and level of accountability and delegation.

Project Controls: Project controls should be established to measure progress and success. Key areas of focus include risk, financial, quality, communications and programme. Project controls define the information flow through the governance framework.

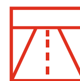
Risk Management: Managing risk is one of the key elements which governance should be structured for, and the project controls must reflect this.

Stakeholder Awareness: Project governance should consider the needs of all stakeholders associated with the project, and establish a proactive plan to communicate with them.

> Once delivered, assets will need to be maintained, in some cases operated and eventually refurbished and replaced.



Investing now to limit future costs: Once delivered, assets will need to be maintained, in some cases operated and eventually refurbished and replaced. With the influx of capex into councils, this places additional strain on already stretched local government finances in terms of both capex and opex. Consideration should be given to how investment can be made now to limit these costs in the future. This may include increasing the design life, automation or replacing existing assets that have high ongoing costs. Whole of life costs need to be front of mind.



Considering additional infrastructure: Local government needs to be prepared for the wider implications of the nationwide investment in additional infrastructure resulting from the COVID-19 stimulus. If successful, these projects should generate regional growth, which in turn will require additional supporting infrastructure (e.g. infrastructure to support housing and economic development). Long Term Plans should reflect this opportunity, including consideration of new funding tools. Failure to cater for it means that this once in a generation opportunity may not be fully realised.

A new look local government

In the medium term local government could look quite different than it does today. Councils are likely to be leaner and more agile. There is also likely to be greater regional cooperation and integration of services. Following the three waters reform, transportation and waste are clearly the next opportunities for reform across the sector.

If local government adapts appropriately and stimulus packages are implemented well, our communities should be happier, healthier and more productive. But, this will not be achieved by following the status quo. The most positive outcomes for the sector will come about if local government leads with one voice.

Contact us

PwC works closely with councils and infrastructure agencies to undertake a range of advisory projects for both the core organisation and associated entities including trusts and CCOs. As well as our traditional expertise in financial accounting, tax, assurance and risk we actively advise local government clients in a wide range of other areas including funding and financing strategy, business case development, operating model and organisational design, transformation change and efficiency programmes, cost take out and efficiency, digital, ICT and asset management.

Being involved with councils from Invercargill to Kaikohe, and everywhere in between, the members of our local government team are always happy to share their insights and provide support when needed. We'd welcome your thoughts on the observations made in this paper.

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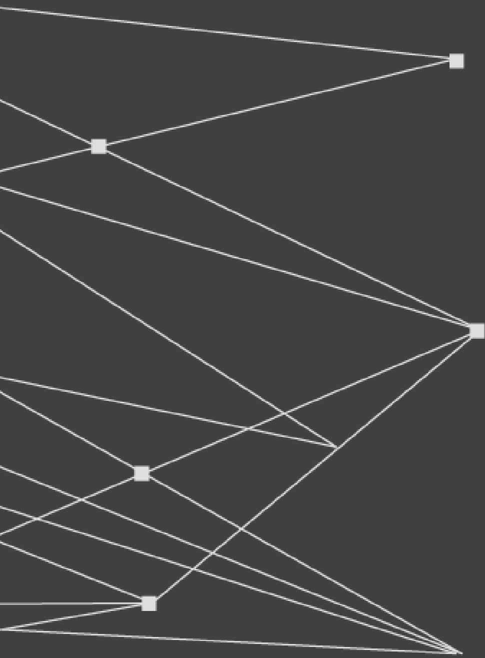

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