The Treasury

Infrastructure Funding and Finance Information Release

December 2019

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Report: Urban Growth Agenda: Infrastructure Funding and Financing

Date:	13 June 2018	**Report No:**	T2018/1087
		File Number:	SH-17-1-1

	Action Sought	**Deadline**
Minister of Finance (Hon Grant Robertson)	Discuss this paper with officials Refer the report to the Minister for the Environment and the Associate Minister for Transport Agree to the recommendations	Friday 29 June
Minister of Housing and Urban Development and Transport (Hon Phil Twyford)	Discuss this paper with officials Agree to the recommendations	Friday 29 June
Minister for Local Government (Hon Nanaia Mahuta)	Discuss this paper with officials Agree to the recommendations	Friday 29 June
Minister of Infrastructure (Hon Shane Jones)	Discuss this paper with officials Agree to the recommendations	Friday 29 June

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
Amelia East	Senior Advisor, Infrastructure and Housing Projects	[39]	[39]	√
Stacey Wymer	Manager, Infrastructure and Housing Projects	[39]	[39]	

Actions for the Minister's Office Staff (if required)

<u>All Ministers</u>

Arrange with Treasury a meeting to discuss this paper

Return the signed report to Treasury

<u>Office of Hon Grant Robertson</u>

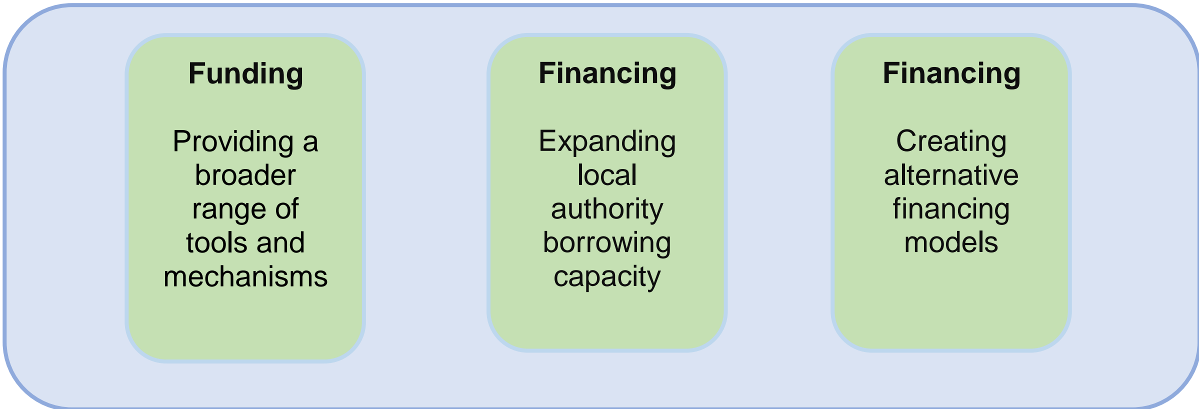
Refer this report to the other Urban Growth Agenda Ministers: the Minister for Environment and the Associate Minister for Transport

Executive Summary

1 This report sets out a recommended approach towards easing constraints on the funding and financing of local infrastructure. Accessing the capital required to meet the upfront cost of the infrastructure is the "financing" component, whilst "funding" refers to the revenue streams that pay off the capital cost over time.

2 This report forms part of the cross-government work on the Infrastructure Funding and Financing (**IFF**) pillar of the Urban Growth Agenda (the **UGA**). The main objective of the UGA is to improve housing affordability, underpinned by affordable urban land. This report therefore focuses on the funding and financing of housing and urban related infrastructure (three waters, transport) for high-growth councils.

3 The focus of our work under the IFF pillar is to enable responsive infrastructure provision and appropriate cost allocation, including the use of project financing and access to financial capital. We aim to reform infrastructure funding and financing in the following three ways:



4 It has proven difficult for local authorities to provide robust analysis of their infrastructure deficit. However, to provide an indication of the scale of investment required, in Auckland the estimated cost of new bulk infrastructure to service greenfield areas alone is $20 billion over the next 30 years.

5 Financing is the key constraint, yet even once we have addressed the constraints to accessing financing, we still require a revenue stream to repay that borrowing. Availability of funding streams, pricing and affordability will always be fundamental to any solution.

6 The existing funding and financing constraints are a mix of:

- Technical barriers: these are "hard" constraints, either regulatory or legislative, that prevent local authorities being able to fund or finance infrastructure; and
- Behavioural issues: these are the "soft" constraints that influence the behaviour and practice of local authorities.

7 Many of the technical barriers will require legislative change. However, even if the technical barriers are addressed, the behaviour of local authority elected officials could still constrain infrastructure provision. Local authorities report that they are often faced with strong opposition to borrowing more due to a perception from communities that future repayment obligations will result in rates increases.

8 We think it is therefore likely that a degree of central government financial support is required to achieve the objectives of the IFF pillar (and, in particular, to incentivise local authorities to address the financing constraints). [38]

[38]

9

Funding

Providing a broader range of tools and mechanisms

10 Revenue streams are always necessary to fund infrastructure investment, regardless of what financing mechanism is chosen. We therefore sought to identify how we could improve the funding toolkit.

11 The Government has already commissioned several workstreams on the issue of funding, including the Local Government Funding Inquiry, the UGA Transport Pricing Pillar, the Three Waters Review, and work investigating value capture. Accordingly, for the purposes of this report, we have focussed on identifying any other gaps or assessing if there is any benefit in fast tracking existing work programmes.

12 In general, our assessment is that the existing funding tools are generally fit for purpose, but not used or priced optimally, and work on new funding tools is already underway in the majority of the areas that require attention.

13 However, we do think one area to fast track is assessing the extent to which local authorities are constrained by existing legislation in recovering the full cost of infrastructure for new development[1]. This work would look at development contributions (DCs) from two perspectives. The first would look at the potential to use targeted rates to complement DCs in a manner that would incentivise development and shift risk away from all ratepayers to those benefitting from particular infrastructure investments. The second would be a fundamental review of the DC system. This would look at the question of risk more widely and the extent to which local authorities could or should be compensated for the risk of providing infrastructure ahead of demand through the DC system.

[1] This issue will otherwise be assessed as part of the Productivity Commission review into Local Government Funding, which is due to be completed by the end of 2019.

14 We also think that incentivising the use of funding tools and reviewing who has access to them is an important area of discussion. We cover this in more detail within the section on creating new alternative financing models.

Recommended action: Fast-track work to unblock constraints on cost recovery.

Officials see an opportunity to fast-track work on identifying and removing legislative constraints to the full recovery of infrastructure costs. This work could include:

- An assessment of the extent to which development contributions actually recover the full cost of new infrastructure.
- Understanding how targeted rates could complement development contributions in fully funding infrastructure for new developments.
- An assessment of the underlying causes of any under-recovery of costs (legislative or behavioural).

Financing

Expanding local authority borrowing capacity

15 The supply of infrastructure is currently hindered by financial constraints on high growth local authorities, which provide most local infrastructure. We therefore looked to see whether we could ease these constraints to allow local authorities to borrow and build more infrastructure.

16 There are several constraints which limit the borrowing capacity of local authorities: contractual requirements to meet Local Government Funding Agency (LGFA) borrowing covenants; a focus on maintaining their credit ratings to minimise borrowing costs, and the financial prudence regulations set out in the Local Government (Financial Reporting and Prudence) Regulations 2014 (the Benchmarking Regulations)[2]. The LGFA covenants are the immediate binding constraint, with most local authorities able to borrow at least twice as much before they would breach the debt servicing ratios within the Benchmarking Regulations.

17 We note the risk of increased debt levels for local authorities (councils in financial distress, demands for Crown support), yet our analysis shows that local authorities could borrow more, on a sustainable basis, in the absence of these constraints. We therefore support the relaxing the constraints in a controlled manner to less conservative levels.

18 There are obvious financial benefits to such an exercise. Relaxing the LGFA covenants, for example, could free up at least $2 billion of additional debt capacity immediately for Auckland Council, and up to $250 million for some high growth councils. However, addressing these constraints will be complex and require shareholder[3] agreement to amend the LGFA covenants and supporting regulatory changes to amend the Benchmarking Regulations would be desirable.

19 Capital recycling (i.e. selling assets) is another way to increase financing capacity. A full discussion of opportunities for capital recycling is beyond the scope of this report, [38]
[38]
[38]
[38] Auckland Council also owns 22.4% of Auckland airport, with a market valuation of $1.86 billion in June 2018.

[2] The Benchmarking Regulations contain 7 benchmarks for financial management by local authorities yet for the purpose of this paper, we are focussed on the debt servicing benchmark within the Benchmarking Regulations which requires borrowing costs for high-growth local authorities to be less than 15% of revenue.

[3] It would take an ordinary resolution of more than 50% to pass any change in the covenants – of which Central Government is a 20% shareholder and the remaining 30 shareholding councils hold 80%.

20 [33] [38]

[33] [38]

Recommended action: Review the financial prudence provisions.

Officials recommend that Ministers direct DIA to review the debt servicing benchmark of the Benchmarking Regulations, with the intention of removing it entirely

Recommended action: Investigate opportunities for capital recycling.

Officials recommend that Ministers direct Treasury to conduct an assessment of opportunities for capital recycling across local government to create an evidence base of what assets might be suitable for such a programme.

Creating alternative financing models

21 We investigated whether creating alternative financing models (that were not subject to local authority borrowing constraints) could enable more infrastructure investment. Whilst this could take a while to achieve, it would most likely be a more enduring solution and have a larger impact than expanding local authority borrowing.

22 There are a range of alternative financing models that could increase the provision of infrastructure. They would essentially be new delivery vehicles that are either owned by local authorities, the Crown or third parties (including developers) with an ability to borrow/issue bonds and set user charges or taxes.

23 We consider that alternative financing models should be explored because:

- They will allow for a much greater quantity of debt to be leveraged from revenue streams than would be possible through a local authority;
- It makes the viability of the project the determinant of whether to proceed, removing the trade-offs which local authorities often have to make when allocating capital;
- It provides greater rigour in the allocation of risk and costs to the appropriate parties; and
- It allows viable projects to proceed outside of the local government framework.

24 We believe that these alternative financing models are feasible if you are able to:

- secure a long-term secure revenue stream for the delivery vehicle that will provide the infrastructure. This could be a user-charge (most applicable for water), or a tax or broad-based charge (most applicable for transport); and

- establish an effective separation from the general balance sheet of the local authority ('ring-fencing'). The achievement of separation will depend on the ownership of the asset, the ownership of the revenue stream, and the allocation of risk across the parties to the investment.

25 Securing long-term revenues for new delivery vehicles would require the creation of powers to allow them to tax or charge for access to infrastructure services and ability to set long-term revenues. This would require legislative change and need policy discussions about who has the power to set levies or charges and to whom they are accountable.

26 Effective ring-fencing depends on the accounting, legal and rating treatment of any new delivery vehicle. Particularly due to uncertainty of the latter, no alternative financing model has a guarantee of success and we consider that only through trialling these new models on live projects will we understand whether these models will deliver the outcomes that we are seeking.

27 We therefore recommend a process of engagement with high-growth local authorities to explore how different delivery vehicles could support specific projects in each jurisdiction before commencing with some pilot projects and legislative change as a parallel process.

28 There are also two live proposals we think have merit exploring immediately (although they are still longer-term work programmes).

- Auckland Council has proposed to use an alternative financing model for the **Central Interceptor**[4]. [34]
  [34] and the Council estimates this model could release up to $1.2 billion of capital. Officials see value in exploring the application of the Council's model to the Central Interceptor, and we could also examine the application of the model to Auckland Light-Rail.

- **Cameron Partners** has a [25]
  [25]

[4] The Central Interceptor project involves construction of a new wastewater tunnel proposed to run between Western Springs and the Mangere wastewater treatment plant in Auckland and link sewers conveying wastewater to the tunnel. The main tunnel will be approximately 13 kilometres long and will provide additional capacity to the network to accommodate population growth in Auckland and to reduce overflows to the Waitemata and Manukau Harbours during wet weather.

Recommended action: Investigate legislative change to enable alternative financing models. Legislative change is necessary to enable alternative financing models – for example to allow local authorities to strike multi-year rates, and to enable new entities the ability to set and charge user charges or broad based taxes. Should Ministers agree with these principles, officials can provide further advice on what a programme of legislative change would entail.

Recommended action: Develop pilot projects to test new methods of accessing finance. Officials recommend that Treasury partner with local authorities to investigate and pilot alternative financing models. A pilot process will allow officials to identify promising pathfinder projects and modes of delivery that could be rolled out further.

Recommended action: Work with Auckland Council on the Central Interceptor Project and Auckland Light Rail to assess its suitability as a pilot project.
Officials recommend that Treasury work together with Auckland Council on the Central Interceptor project and revert back with whether we support this project as a SPV, to include any amendments to the structure and any impact on the Crown's balance sheet. We recommend that work also begin on assessing how the alternative models for accessing finance might be applied to Auckland Light Rail.

[25]

Strategy

29 We have identified a range of constraints to the funding and financing of infrastructure, yet it is likely that some form of Crown financial support will be necessary for success. This is because the levers for change are not totally within the sphere of influence of central government, and we will need incentives to help change the behaviours of local government.

30 Influencing the behaviour of local authorities is likely to be most successful if technical change is combined with incentives to partner. The overall approach could take the form of an arrangement between central and local government to partner. Developing a clear understanding of the forms of support central government is willing to consider, and developing a negotiation strategy, will be important in the overall success of the IFF programme.

31 We haven't in this report pursued the option of central government fully funding local infrastructure provision on the basis that it is inconsistent with existing institutional roles and responsibilities, could undermine local accountability, may impact the current Budget Responsibility Rules and could have material fiscal implications that could crowd out delivery of other central government priorities, [34]
[34] We do however acknowledge this is likely to be the only solution that could provide immediate change.

Connected Work Programmes

32 This report largely focuses on the current system and constraints, however there are a number of other work programme and projects underway that may significantly alter current settings and also address some of the constraints:

- The Three Waters Review;
- Infrastructure Institutional Settings Review (IISR);
- Urban Development Authority (UDA);
- Local Government Funding Review (LGFR);
- The UGA Pillars; and
- Value Capture.

Recommended action: Integration with connected work programmes
We also recommend Ministers direct officials to ensure work on the Three Waters Review, IISR, UDA, LGFR, UGA pillars and the IFF are well integrated including reporting through to Ministers where appropriate.

Next steps

33 We would like to discuss the recommendations in this report with Minsters. Subject to Ministers' decisions on the proposed directions set out in this report, additional budget and resources will be required to take workstreams forward.

34 We have already identified two fiscally neutral options for funding this work: a) transferring any unused funding from the Social Housing Reform Programme (SHRP) MCA, or b) transferring funding from the $600 million that has been appropriated for Crown Infrastructure Partners.

35 Ministers have also indicated that they wish to hold a stakeholder event to discuss the options set out in this report with stakeholders. We are currently working with your offices on an agenda for that event, and to arrange a suitable time and venue.

Consultation

36 Treasury has consulted with DIA, MBIE, MfE, MoT and NZTA. All agencies support the recommendations in this report. DPMC have been informed.

Recommendations

We recommend that you:

a **agree** to meet with officials to discuss this report

Agree/disagree.

Funding

b **note** that the majority of work on new or existing funding tools are being actively managed by other workstreams.

c **direct** the Treasury and DIA to undertake targeted engagement with high growth councils around the legislative and behavioural constraints to recovering the cost of infrastructure for new developments through development contributions and targeted rates, and to report back to Ministers with options for legislative reform.

Agree/disagree.

Financing: Expanding Local Authority Borrowing

d [33]

Agree/disagree.

e **direct** Treasury officials to commence a work programme with local authorities and the LGFA investigating easing the LGFA debt covenants

Agree/disagree.

f **direct** DIA to review the debt servicing benchmark of the Benchmarking Regulations with the intention of removing it entirely

Agree/disagree.

g **direct** Treasury to undertake a full assessment of capital recycling opportunities across the local authority sector

Agree/disagree.

Financing: Alternative Financing Models

h **note** that there is a need for legislative change should Ministers wish to create alternative financing models

i **direct** Treasury, DIA and MBIE officials to report back on the scope of a legislative reform programme to enable new alternative financing models such as SPVs

Agree/disagree.

j **direct** Treasury officials to undertake targeted engagement with Auckland, Hamilton, Tauranga, Queenstown and Wellington councils and report back to Ministers with options for alternative financing model pilot projects

Agree/disagree.

k **direct** Treasury officials to work immediately with Auckland Council on assessing the suitability of Central Interceptor Project as a pilot project

Agree/disagree.

l **direct** Treasury and NZTA officials to begin on assessing how alternative financing models might be applied to Auckland Light Rail

Agree/disagree.

m [25]

Agree/disagree

Strategy

n **note** that a package deal may need to be struck between central and local government to encourage behavioural changes in the sector, which may include central government financial support

o **agree** to discuss with Treasury officials the appetite for crown support and what form it might take to enable the facilitation of the IFF work programme

Agree/disagree

p **note** that the only approach likely to effect immediate change to infrastructure provision will be full central government funding and financing local infrastructure

q **note** that Officials will not consider central government funding and financing local infrastructure unless it receives specific instructions from Ministers to consider this

r **agree** that if Ministers wish to take the IFF work programme forward, resourcing and budget will be required

Agree/disagree

s **note** that Ministers have signalled that they wish to hold a stakeholder event to discuss the outcomes of this report once decided

Connected Workstreams

t **direct** Treasury, DIA, MBIE, MfE, MoT and NZTA officials to ensure work on the Three Waters Review, Infrastructure Institutional Settings Review, Urban Growth Pillars, Local Government Funding Review, Urban Development Authority and the IFF are well integrated including reporting through to Ministers where applicable

Agree/disagree.

Recommendation for the Minister of Finance

u **agree** to send a copy of this report to the other Urban Growth Agenda Ministers: the Minister for the Environment and the Minister of Infrastructure

Agree/disagree.

Stacey Wymer
Manager, Infrastructure and Housing Projects

Hon Grant Robertson
Minister of Finance

Hon Phil Twyford
Minister of Housing and Urban Development and Transport

Hon Shane Jones
Minister of Infrastructure

Hon Nanaia Mahuta
Minister of Local Government

Purpose

37 The purpose of this report is to:

- outline the constraints on the funding and financing of housing and urban infrastructure for high growth local authorities;
- set out a recommended approach towards easing constraints on the funding and financing of local infrastructure; and
- seek decisions from Ministers on the way forward.

Background

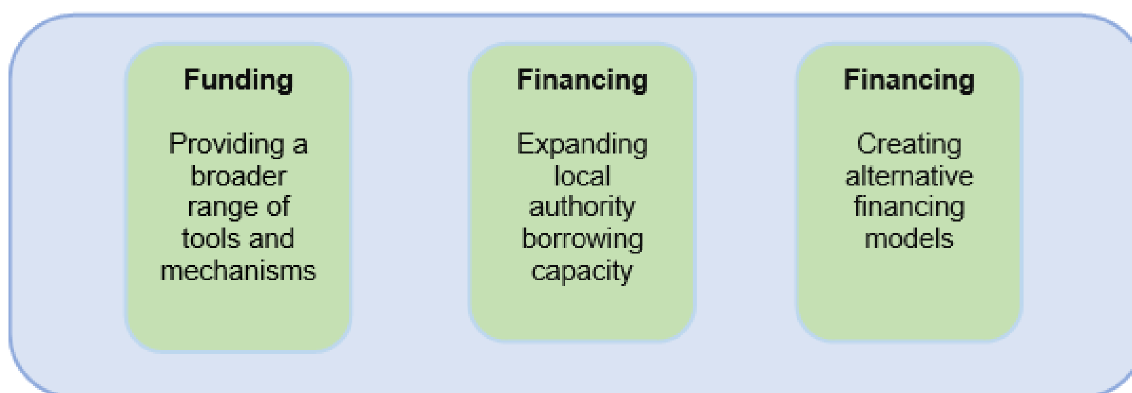
38 This report is part of the cross-government work on the Infrastructure Funding and Financing (**IFF**) pillar of the Urban Growth Agenda (the **UGA**).

39 The IFF workstream has been led by Treasury in conjunction with other agencies and is the first pillar of the UGA. The main objective of the UGA is to improve housing affordability, underpinned by affordable urban land.

40 The focus of our work on the IFF pillar is to enable responsive infrastructure provision and appropriate cost allocation, including the use of project financing and access to financial capital. It aims to reform infrastructure funding and financing in the following three ways:

- Objective 1: Providing a **broader range of funding tools and mechanisms**;
- Objective 2: Ensuring financing is available through **expanding local authority borrowing capacity**;
- Objective 3: Ensuring financing is available through **creating alternative financing models**;

which together are the **"IFF Objectives"**.



41 The IFF Objectives are purposefully broader than those proposed in the agreed UGA Cabinet paper to provide a fuller suite of options for Ministers and better reflect the actionable work-streams of the IFF. In particular Objective three is broader than stated in the UGA Cabinet paper[5] to enable consideration of alternative financing models to be made available to parties other than developers and to both brownfield and greenfield developments.

[5] Which was "making long term debt finance available to developers willing to take on the commercial risk, with the debt serviced by revenue from the new properties in a development".

Overview of constraints to the provision of infrastructure

42 The supply of infrastructure is constrained by financial restrictions on local authorities, which provide most local infrastructure.

43 But the challenge of providing infrastructure is magnified by underlying issues of institutions and incentives. These include:

- Infrastructure investments tend to be large, lumpy and irreversible, with long lead times and the risk of stranded assets if forecast demand does not eventuate;
- The misalignment of costs and risks creates a strong disincentive for local authorities to invest in infrastructure ahead of anticipated demand pressures and instead to provide infrastructure on a just-in-time basis;
- A financing structure that puts minimising the cost of borrowing as the supreme financing priority and removes the ability of individual local authorities to move beyond very conservative debt limits. This can become an absolute barrier to investment, but also leads to significant competition for available financing between growth infrastructure and other investment aspirations;
- A funding structure which leaves existing ratepayers carrying the risk of financing and funding, at least in part, as providing for growth often involves expenditure both at the margin and at the network level; and
- The fact that many major infrastructure investments have multiple purposes, and are not exclusively to provide for growth, means that funding is constrained by the ability of the local authority to fund and finance the non-growth component of the investment.

Key matters for Ministers when considering the recommendations in this report

44 There are no easy solutions for Ministers in dealing with the constraints on funding and financing of infrastructure. This is because dealing with the constraints largely sits outside the control of central government and so central government will need to incentivise change.

45 The existing funding and financing constraints are a mix of technical constraints and behavioural issues.

46 Legislative change is needed to address most of the technical constraints. Addressing technical constraints alone is likely to have only limited benefit. Central government will need to incentivise local government to address behavioural issues.

47 Funding and financing go hand in hand: you cannot decouple one from the other. Whilst financing is currently the main bottleneck to infrastructure provision in New Zealand, we will always need a funding stream to pay back the costs of a project.

48 Whilst there is no shortage of private capital[6], there will always be a limit on the revenue stream to repay it. Availability of revenue streams depends as much upon the affordability to pay, as the ability to identify and target through a funding tool.

49 It is not possible to predict how successful we will be in addressing the behavioural or technical constraints associated with the IFF Objectives at a theoretical level. These need to be tested in a 'live' environment.

50 Ministers have choices around:

- How to deal with financing constraints – either through dealing with constraints within the existing framework (expanding local authority borrowing capacity) and/or through pursuing alternative financing models and the sequencing of these options.
- Level and method by which central government financial support is provided. The greater the level of central government financial support, the more quickly the constraints on financing may be relaxed. However, this will need to be balanced against the impact to the Crown and whether it provides an enduring solution, or simply a short-term solution.
- [38]

Connected Work-streams

51 This report largely focuses on the current funding and financing system and constraints. However (in addition to the other connected UGA pillars), there are a number of other work programmes and projects underway that may significantly change current settings and address some of the constraints, and to which the IFF may also influence:

52 **Three Waters Review** (due to report to Cabinet in October 2018)
Ministers are considering options including the agglomeration of water service delivery into 3 – 5 entities nationally, separate from local authorities. Agglomeration on this scale with the associated balance sheets and water revenues would be a far reaching, long term and systemic change. The results of this review may assist in reducing the financing constraints in the water sector. The impact on local authority balance sheets and finances, and how that would affect local authority ability to invest in transport infrastructure would also need to be assessed. The IFF work will also be a key input into decisions around the funding/financing of the new three waters service delivery vehicles.

[6] The constraint is the ability to access and use private capital for local infrastructure provision, hence the recommendation for new delivery vehicles

53 **Infrastructure Institutional Settings Review (IISR)** (due to report to Cabinet in July 2018)
The Minister of Infrastructure has asked the National Infrastructure Unit (NIU) within Treasury to look at the adequacy of central and local government institutional settings that support infrastructure investment decision-making. The objective of this review is to assess and recommend improvements that ensure that central government and local government procure the right infrastructure in the right places at the right time. The results of this review may assist with the project selection, allocation of resources, procurement and use of any tools to which the IFF creates.

54 **Urban Development Authority (UDA)** (due to report to Cabinet in July 2018)
The Minister of Housing and Urban Development is proposing new legislation to establish and empower a national UDA. To enable the UDA to deliver complex urban development projects, it requires amongst other things, funding and financing powers. The UDA is likely to utilise any funding and finance tools created by the IFF.

55 **Local Government Funding Review (LGFR)** (due from the Productivity Commission in late 2019)
In May 2018, Cabinet directed the Productivity Commission to conduct an inquiry into local government funding and financing. The scope of the inquiry includes the adequacy of the current funding tools and the use of these tools.

56 **The UGA Pillars** (update report to Cabinet in July 2018)
The IFF is part of the UGA work programme, which has key dependencies with the other four pillars: Urban Planning; Spatial Planning; Transport Pricing and Regulatory reform. One example is the potential for Spatial planning to better inform where development will/will not occur, which in turn can inform what infrastructure is needed and prioritised. The IFF pillar then provides the means to apply new and refined tools to ensure the necessary infrastructure can be progressed. The IFF programme can only go so far in addressing the goals of the UGA and wider reform is needed to address underlying incentive issues.

57 **Value Capture**
Several agencies (in particular MBIE, MoT and NZTA) are exploring the possibilities of value capture tools to fund infrastructure.

58 We will ensure work on these interdependent work-streams are well-integrated including reporting through to Ministers where applicable. This includes the other pillars of the UGA. We will look to see that decisions from the various workstreams are fed into the LGFR.

Funding Overview

59 Funding refers to the revenue streams that pay off the infrastructure investment. Pricing is important when trying to recover the costs of infrastructure.

60 The most common ways of funding infrastructure are through taxes (development contributions and general/targeted rates) or user charges. A third option is to capture ‘windfall gains’ from infrastructure. This is based on infrastructure investment creating economic value, most commonly by increasing the value of the surrounding land.

61 Local authorities already have access to a range of tools for funding infrastructure. These existing tools are generally fit for purpose. However, local authorities have made mixed use of these tools – and typically under-recovered the costs of growth infrastructure – often due to ratepayer preferences for lower rates (as referenced in the 2015 Productivity Commission Review: Using Land for Housing).

62 The reliance on general rates for funding infrastructure means there is a finite amount available to fund infrastructure, which needs to be prioritised and allocated through political processes and is therefore subject to behaviour of elected members.

63 For local authorities at or near debt constraints, the ability to leverage new funding is also highly constrained which dis-incentivises local authorities to increase rates.

64 By way of example, if Auckland Council imposed a rate increase that generated $50m, this would provide $125m borrowing capacity[7]. However, credit rating agencies permit much higher ratios for standalone local utilities (up to 1400%). Many NZ local authorities combine features of utilities and core local authorities, yet maintain leverage ratios that correspond to the more conservative end of the spectrum.

65 If local authorities were able to fully leverage at this upper rate, a $50m rate increase could support borrowing in excess of $700m. We explore how greater leverage of funding (regardless of the funding tool to collect the revenues) could be achieved in the section on creating alternative financing models.

Existing funding workstreams

66 The Government has already commissioned several workstreams on the issue of funding. Accordingly, for the purposes of this report, we have focussed on identifying any gaps in the existing work programme, as well as areas where there could be benefit from fast-tracking existing work.

67 The key funding issues currently being worked on outside of the IFF are: a) adequacy and use of existing funding tools and the overall affordability of local charges and b) work on developing new revenue streams.

Adequacy and use of existing funding tools

68 In May 2018, Cabinet directed the Productivity Commission to conduct an inquiry into local government funding and financing. The scope of the inquiry includes:

- The cost pressures and funding sustainability issues facing local authorities.
- The affordability of rates for communities and households over time.
- The extent to which local authorities can fulfil their current roles today and into the future without significant change to the funding and financing system.
- The identification of alternative funding tools to complement local body rates.

69 The results of this Inquiry will be an important input into achieving the IFF aim of a broader range of tools and mechanisms to enable housing and urban infrastructure to be funded.

[7] Due to the requirements of local authorities which require debt as a percentage of revenue to remain below 250%

Developing new revenue streams

70 There are three obvious gaps in the local government revenue streams: congestion charging, visitor levies and value capture. However, there are already existing work programmes focussed on developing these specific new revenue streams:

- **The UGA Transport Pricing Pillar** is exploring how congestion charging could improve the performance of the transport network.
- A number of agencies are considering **Value Capture** mechanisms, including MoT/NZTA (for light rail) and MBIE (for the UGA in general). This will include an assessment into the sale of Development Rights.
- The Government will consult on an **International Visitor Conservation and Tourism Levy** in June 2018. The levy will be between $25 and $35 per visa or Electronic Travel Authority application and is expected to generate revenues of $59 - $83 million in 2020.

Objective 1: Providing a broader range of tools and mechanisms

71 The objective for funding within the IFF is to provide a **broader range of tools and mechanisms** to enable housing and urban infrastructure to be funded. We have attached at Appendix 1 our detailed assessment of funding tools and mechanisms. We also cover access to funding tools within the third objective.

72 In general, our assessment is that the existing funding tools are broadly fit for purpose and work on new funding tools is already underway in the majority of the areas that require attention. There is little benefit in the IFF duplicating or trying to accelerate these work programmes.

73 However, having assessed the main funding tools, we do think one area to fast track is assessing the extent to which local authorities are constrained by existing legislation in recovering the full cost of infrastructure for new developments.

74 This work would look at development contributions (DCs) from two perspectives. The first would look at the potential to use targeted rates to complement DCs in a manner that would incentivise development and shift risk away from all ratepayers to those benefitting from particular infrastructure investments. The second would be a fundamental review of the DC system as after 15 years, we believe a fundamental review is justified. This would look at the question of risk more widely and the extent to which local authorities could or should be compensated for the risk of providing infrastructure ahead of demand through the DC system.

Recommendations for action for IFF Objective 1

Officials considers there is benefit in fast-tracking work on identifying and reviewing legislative constraints to the full recovery of infrastructure costs. This work could include:

- An assessment of the extent to which development contributions actually recover the full cost of new infrastructure.
- Understanding how targeted rates could complement development contributions in fully funding infrastructure for new developments.
- An assessment of the underlying causes of any under-recovery of costs (legislative or behavioural)

Financing Overview

75 Financing refers to raising capital needed to pay for infrastructure. In this context, the primary method of financing is borrowing. The ability to borrow requires a funding stream to repay that borrowing.

76 The supply of infrastructure is currently hindered by financial constraints on high growth local authorities, which provide most local infrastructure. Typically local authorities have financed infrastructure through debt borrowing and have repaid the loan over time through rates/taxes.

77 There are two broad approaches to easing the local authority financing constraints:

- Objective 2: Ensuring financing is available for viable projects through **expanding local authority borrowing capacity**; and
- Objective 3: Ensuring financing is available for viable projects through **creating alternative financing models**.

78 Table 1 outlines the implications of these two approaches. We have assessed this against a comparison of fully funding/financing infrastructure investment through central government.

79 Beyond the assessment in Table 1, we have not undertaken further work on central government directly funding infrastructure on the basis that it is inconsistent with existing institutional roles and responsibilities, could undermine local accountability, may impact the current Budget Responsibility Rules and could have material fiscal implications that could crowd out delivery of other central government priorities. Yet, we do acknowledge that this is the only approach that could provide immediate change and is a short-term choice for Ministers.

Table 1

	Expanding local authority borrowing capacity	Creating alternative financing models	Fully funded/financed by Central Government
Speed of implementation	Medium – can be done without legislative change but requires changes to LGFA covenants and behavioural change from local authorities	Slow – legislative change required	Fast
Scale of opportunity	$2 billion for Auckland Council (one-off) Up to $250 million for other high growth councils. (one-off)	Significant – ability to leverage will be significantly greater than from expanding local authority borrowing capacity	Could be significant – but will need to be considered against the current Budget Responsibility Rules and would have material fiscal implications that could crowd out delivery of central government priorities
Likelihood of success	Key uncertainty is about local authorities willingness to borrow more	Key uncertainty regards what is required to ring-fence the debt from a rating agency perspective.	High
Replicability/scalability	Replicable up to any new debt limit	Yes	Medium – subject to fiscal constraints
Alignment with the UGA	Depends on behavioural change	Yes	No
Complexity and risk to local government	Varies from council to council	Moderate – not proven in a New Zealand environment	Low
Risk to Central government	Moderate – intractable local government issues tend to become a central government problem	High – not proven in a New Zealand environment and will need to be carefully managed to ensure risk isn't left with central government	High - inconsistent with existing institutional roles and responsibilities, could undermine local accountability
Central Government support	[38]	Likely to be necessary in practice	Solely reliant on central government support
Provides Incentives to Ensure Net Beneficial Projects proceed	Few	Good	Poor

80 The different approaches will suit different infrastructure projects. For infrastructure that can be fully funded by the revenue it generates, an alternative financing model is likely to be a preferential structure. However, for infrastructure projects that have an element of public good, the beneficiaries cannot be identified and/or targeted, provision through local government is likely to be the best solution.

81 Even though we are not recommending full funding/financing infrastructure through central government, we do think central government support has a role to play in supporting objectives of the IFF. [34]
[34]
[34]

Objective 2: Ensuring financing is available for viable projects through expanding local authority borrowing capacity

82 Many councils in New Zealand cite debt constraints as a barrier to infrastructure provision. Being debt constrained means that the local authority's ability to borrow to finance capital expenditure is compromised in the absence of generating additional revenue.

83 There are a range of technical factors and behavioural issues that constrain borrowing by councils.

84 The **technical factors** include:

- The LGFA borrowing covenants – which require debt as a percentage of revenue to remain below 250%.
- The financial prudence regulations of the Local Government Act – which discourage borrowing costs rising above 15% of revenue.
- The financial strategies set by each local authority as part of its Long Term Plans.

85 The LGFA covenants establish hard upper limits on the ability of local authorities to increase debt levels, while the financial prudence regulations reinforce a cautious approach to debt on the part of local authorities.

86 The **behavioural issues** include the desire of local authorities to retain strong credit ratings (which assists in minimising the cost of borrowing) and the self-imposed limits set up by local authorities within their financial strategies. These behaviours are a consequence of ratepayer preferences for low debt and low rates.

87 Appendix 2 provides further detail on each of these factors including rationale for the position taken, technical ability to change and the implications of doing so.

The current debt position of high growth councils

88 In considering local authorities' ability to sustain higher debt levels, we have assessed key fiscal metrics of the high-growth local authorities. The results are set out in Table 2.

Table 2

Local Authority	Debt Levels ($b) Current and Projected Peak	Debt to Revenue Ratio	Debt Interest Expense to Revenue Ratio	Debt to Revenue Ratio in Financial Strategy	Current Credit Rating
		Max: 270% (to maintain credit rating) Max: 250% (LGFA covenants)	**Max: 15%**	**Max: Self Imposed**	
Auckland Council	Currently: $8.7 Max:: $12.6 (2027/28)	Current: 203% Max: 260% (2020/21)	Current: 10.9%	265%	AA
Hamilton City Council	Currently: $0.43 Max: $0.76 (2022/23)	Current: 205% Max: 225% (2020/21)	Current: 9%	230%	AA-
Tauranga City Council	Current: $0.44 Max: $0.98 (2027/28)	Current: 210% Max: 233% (2021/22)	Current: 9%	250%	A+
Queenstown Lakes District Council	Current: $0.17 Max: $0.45 (2024/25)	Current: 100% Max: 215% (2024/25)	Current: 5.2%	250%	AA-
Wellington City Council	Current: $0.65 Max: $1.2 (2027/28)	Current: 115% Max: 162% (2027/28)	Current: 5.5%	175%	AA

89 The table shows that Auckland, Hamilton and Tauranga are all at or near their respective debt constraints. Queenstown is the only high-growth council to have relatively low debt levels. We have included Wellington, whilst not formally a high-growth Council, in our assessment due to the indication from Ministers that they are keen to work with Wellington Council on their infrastructure requirements.

The ability of high growth local authorities to sustain higher levels of debt

90 We also used the fiscal metrics in the table above to assess whether high growth local authorities can sustain higher levels of debt. Ensuring the ongoing sustainability of local authority debt is a critical element of any consideration of increased borrowing by the sector. Debt sustainability is important because it ensures the ongoing provision of local services, limits debt servicing expenditure, supports economic activity and limits risk to central government.

91 At an in-principle level, local authorities should sustainably be able to borrow significantly more, taking into account factors such as: maintaining an investment grade credit rating (no lower than BBB-)[8], interest costs as a percentage of revenue [9]and leverage ratios of comparable entities.

[8] ***Credit ratings***: Investment grade is defined as BBB- or greater. [33]
[33]

[9] ***Debt Interest servicing expenses***: These as a proportion of revenues for local authorities remain well below 15% even for the relatively more indebted high growth local authorities

92 However, without detailed analysis of the financial projections of each local authority, we are unable to provide precise guidance around the maximum level of debt that each local authority could sustainably incur. Even after undertaking such an exercise, it would be subject to a significant amount of uncertainty.

93 [38]

94 We therefore believe it is best to take an incremental approach. [38]
[38]

Benefits of expanding local authority borrowing capacity

95 Table 3 gives an indication of the additional borrowing that could be incurred if the current debt to revenue ratio of 250% were increased:

Table 3

Debt to Revenue Ratio	300%		350%		400%	
Year	2019	2028	2019	2028	2019	2028
	$m	$m	$m	$m	$m	$m
Auckland (Group)	2,088	3,074	4,176	6,148	6,264	9,223
Hamilton City	122	180	244	361	366	541
Tauranga City	126	242	253	484	379	725
Wellington City	259	378	517	755	776	1,133
Queenstown-Lakes District	84	111	167	221	251	332

96 Relaxing the covenants to 300% could therefore free up immediately at least $2 billion in additional debt capacity for Auckland Council and between $84-269 million for the other local authorities.

Options for expanding local authority borrowing capacity

97 Any possible options for expanding local authority borrowing capacity will need to deal with both the technical factors and behavioural issues. Accordingly the proposed course of action set out below should be viewed as a package rather than being able to choose some elements and not others (with the exception of capital recycling). This is because central government currently has no direct levers to force change – the Government will need to influence and incentivise local authorities to make these changes.

The Technical Constraints

The LGFA

98 The LGFA covenants represent the main technical barrier to local authorities increasing debt levels. We think there is merit in addressing these constraints. The preferred solution is through relaxing the covenants, due to the value provided by and sector reliance on the LGFA.

99 We propose working with LGFA to achieve this. [33] [38]
[33] [38]

100 [33] [38]

[33] [38]

[33] [38]

Financial Prudence Regulations

103 The Local Government (Financial Reporting and Prudence) Regulations 2014 (the Benchmarking Regulations) are the next main technical barrier to increasing debt levels. These contain seven specific benchmarks reflecting three dimensions, affordability, sustainability and predictability. For the purposes of this report, we have focused only on the debt sustainability benchmark.

104 The debt sustainability benchmark requires high-growth local authorities to maintain debt at levels such that debt-servicing expenses do not exceed 15% of revenues. If this threshold is exceeded, additional monitoring and review by central government may apply. This approach is designed to ensure financial prudence from the sector, and acts to constrain debt levels.

105 However, all high growth Councils apart from Auckland could double their borrowing and still not breach this benchmark (assuming no change in interest rates). Therefore, we would question whether this is actually an appropriate benchmark.

106 Yet even the existence of the benchmark (regardless of when it bites) conveys a view that Central Government considers debt restraint is a matter which it needs to maintain oversight of, rather than let a council work this out for itself. The issue was originally raised by the 2015 Productivity Commission in its report "Using Land for Housing" when the Productivity Commission recommended DIA review whether 15% is the most appropriate debt-servicing ratio for high growth councils. DIA's view is the benchmark is already split between high and other councils and that by already having two levels undermines the credibility as a benchmark. Our preference is therefore to consider the case for removing the benchmark entirely. Removing the benchmark also removes the ability of local authorities to blame the benchmark for their decisions. Some of that behaviour is illustrated in submissions from councils quoted in the Using Land for Housing Report.

The Behavioural Constraints

107 Even if we deal with the technical constraints, there are behavioural issues that might mean local authorities are not willing to borrow more.

Credit Ratings

108 Local authorities appear to be focussed on maintaining their current credit rating and minimising borrowing costs[10]. [34]
[34]

[10] The Mayor of Auckland is reported to have committed to keeping Auckland Council's AA credit rating (NBR, 7 October 2016; NZ Herald, 14 December 2016). [34]

Financial Strategies

109 The Financial Strategy is theoretically a technical constraint once agreed, yet it is self-selected, so really a reflection of the behaviour of the local authority.

110 Local Authorities have a legislative requirement to produce a financial strategy as part of their Long Term Plans (LTPs). The financial strategy sets out the overall financial goals of the local authority and where the local authority wants to be positioned during, and at the end of, the LTP period.

111 As part of the Financial Strategy, local authorities must include specific statements on their quantified limits on rates, rate increases and borrowing. Therefore the debt levels within the Financial Strategy are self-selected, but binding once signed-off.

112 Should we manage to relieve the technical constraints, Local Authorities would need to amend their financial strategies so they can use the new limits.

Ratepayer Reaction

113 Community attitudes and perceptions can also constrain local authorities borrowing. Local authorities have reported that they are faced with strong opposition to borrowing more, due to a perception that it will result in rates increases. This was also highlighted within the 2015 Productivity Commission Report: Using Land for Housing.

114 Influencing the behaviour of local authorities is likely to be most successful if technical change is combined with incentives to partner. The overall approach could take the form of an arrangement between central and local government to partner. We cover how this may work in the conclusion of this report.

Other Solutions

Capital Recycling

115 We also want to test Ministers' appetite to consider capital recycling by local authorities as part of a package for expanding local authority borrowing. Capital recycling, or the generation of funds from the sale of assets that are either underutilised by local authorities or are not core to local authorities role, has the potential to free up funds for the provision of infrastructure.

116 A full exposition of capital recycling opportunities across the sector is beyond the scope of this note. [33]
[33]
[33] [34] [37]
[34] [37]
[34] [37]
[34] [37] Auckland Council also owns 22.4% of Auckland airport, with a market valuation of $1.86 billion in June 2018.

117 We understand that capital recycling can be a politically sensitive issue. However, at this stage, we are simply recommending that we undertake the research to assess the size of the opportunity so that Ministers have access to this information when approaching any deal with local government.

Recommendations for action for IFF Objective 2

[33]

Officials recommend that Ministers direct DIA to review the debt servicing benchmark of the Benchmarking Regulations, with the intention of removing it entirely

Officials recommend that Treasury conduct an assessment of opportunities for capital recycling across local government.

Objective 3: Ensuring financing is available for viable projects through alternative financing models

118 Alternative financing models should increase the provision of infrastructure. They would essentially be new entities that could be owned by local authorities, the Crown or third parties (including developers) with an ability to borrow/issue bonds and set user charges or taxes.

119 For the purposes of this report, "alternative financing models" means the principles behind new methods to access finance and "delivery vehicles" means the different structures and entities established to deliver the infrastructure that will utilise the alternative financing models.

120 We consider that alternative financing models should be explored because:

- They will allow for a much greater quantity of debt to be leveraged from revenue streams than would be possible through a local authority;
- It makes the viability of the project the determinate of whether to proceed, removing the trade-offs which local authorities often have to make when allocating capital;
- It provides greater rigour in the allocation of risk and costs to the appropriate parties; and
- It allows viable projects to proceed outside of the local government framework.

121 These alternative financing models would complement – rather than replace – local government infrastructure provision.

Overview of the Alternative Financing Models

122 We have investigated what is required to establish alternative financing models taking into account international experience, central government's experience with public private partnerships and models presented by private sector parties and local authorities.

123 All feature the same key characteristics: long-term secure revenues that are ring-fenced from the balance sheet, debt capacity or credit rating of the local authority.

***Long-term secure revenues**:*

124 There are two main types of revenues available for funding housing and urban related infrastructure:

- Taxing powers: The Local Government (Rating) Act 2002 (the LGRA) provides councils with flexible powers to set, assess and collect rates from landowners.
- User charges: This is the use of prices/contractual arrangements rather than taxes as a means of funding – so a user pays system. This matches willingness to pay directly with the provision and use of goods or services.

125 The former is currently only available to local authorities. The latter is theoretically available to both public/private parties yet many sectors that allow user charging are subject to heavy regulation that in practice significantly limits their use. Therefore, the first challenge is to ensure that the new financing models can access these revenues streams.

126 Financiers will require certainty that the revenues are secured for the agreed financing term (this could be for a 25 to 30 year period). The second challenge is therefore ensuring these funding streams can be committed for long periods of time. Currently rates can only be set for one year at a time.

***Ring-Fencing Debt**:*

127 To limit the risk to the local authority if a specific infrastructure project fails, the recourse of the financiers needs to be limited to the project assets or to the cash flows. This is known as "ring-fencing".

128 Ring-fencing is a critical component of any alternative financing model. Without ring fencing, any new borrowings would sit on the local authority balance sheet and be included in its debt to revenue ratios. Ring-fencing also reinforces the discipline in ensuring that projects have adequate funding streams.

129 Ring-fencing has two main components:

- **Financial Recourse**: Any delivery vehicle needs to be structured in a way that means, from an accounting perspective, it is not treated as a financial liability of the local authority and thus forms part of the local authority's debt/revenue calculation.
- **Moral Recourse**: Removing the understanding, that credit rating agencies take, that the institutional settings in New Zealand mean that a local authority would not allow a project vehicle to fail – even where the local authority has no legal obligation to act in the event of financial distress.

130 The preconditions to achieve ring fencing of debt is not clear-cut. We expect that accountants and credit rating agencies will take into account factors relating to the ownership of the asset, the ownership of the revenue stream, and the allocation of risk across the parties to the project in assessing whether issues around financial and moral recourse are satisfactorily dealt with.

What are the preconditions for alternative financing models?

Legislative Change

131 In the course of work to date, officials have identified legislative change as a key precondition to the successful introduction of alternative financing models.

132 Legislative change will be necessary to:

- Update the Targeted Rates regime so that local authorities can strike multi-year rates or commit future revenue streams. Under existing legislation, rates may only be set by a local authority, and for one financial year only (in accordance with their annual or long-term plan for that year). The current inability of local authorities to pre-emptively set rates over an extended period is a barrier to the financing of infrastructure projects.

- Allow new entities the ability to set, target and charge fees/taxes. This hurdle exists because local authorities cannot transfer their powers to rate or levy ratepayers to other organisations or entities. This may require an amendment to the Local Government (Rating) Act 2002 and the Local Government Act 2002.

133 Legislative change will mark a significant change to the *status quo*. Making user charges or local funding tools available to third parties (including the Crown) is a significant but necessary shift to enable alternative financing models. Appendix 5 outlines the key policy issues to be considered as part of any legislative change. In particular, we will need policy discussions about who has the power to set levies or charges and to whom they are accountable.

Risk Allocation

134 In any project, there are risks that will not be able to be passed to the financier or the contractor building the infrastructure. In the first instance, we would expect that these residual risks[11] would remain with the local authority. However, Auckland Council believe that leaving any residual risk with Auckland Council would mean full recourse back to the Council, or reinforcing moral recourse – thus not ring-fencing the project effectively.

135 We think this position needs testing as we are sceptical that the impact of certain residual risks means the full financial liability of the project is recognised on the local authority balance sheet. We will need to establish what level of recourse could/should sit with the local authority and what the impact would be. That said, Crown support in the form of appropriate residual risk taking could be an effective and relatively low cost manner to facilitate the alternative models.

Ownership

136 The impact of ownership will need to be factored into any delivery vehicle, since ownership will often result in the infrastructure asset and corresponding liability being "on-balance sheet" of the owner. There is merit in testing this assumption and investigating how local authorities can still be the owner of the delivery vehicle, yet either ring-fencing revenue and/or this debt or limiting the amount that is treated as an existing debt to the local authority through crown support.

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[11] Typical residual risks include geotech risks, insurance, refinancing protection, step-in rights and termination protections

137 Third party ownership of the delivery vehicles may enable it to be off-balance sheet of both Council and Crown, but Ministers need to weigh up that trade-off with private ownership of assets or revenues. This is especially relevant to water assets, since Cabinet has already agreed that public ownership of existing assets is a bottom line for future water service provision. We need to explore what forms third-party options can take including the options for vesting assets.

Crown support for alternative financing models

138 Some form of Crown support is likely to be necessary to facilitate alternative financing models and in particular to achieve ring fencing. The level and form of Crown support will vary for the initial pathfinder projects. However, over time and as the concept alternative financing models mature, we would be looking to standardise the form of Crown support and minimise/remove the requirement for it.

139 The likely forms of Crown support could include an underwrite of residual risks and/or an ownership interest. Initially the level and form of Crown support will need to be tested on a project-by-project basis.

Delivery vehicles (or special purpose vehicles (SPVs))

140 There are a range of potential delivery vehicles to achieve alternative financing models. We have set out below an overview of the potential delivery vehicles through which alternative financing models could be undertaken, and these are set out in more detail within Appendix 4.

141 The delivery vehicles set out below each have their own features and varying likelihood of achieving long term secure revenues and ring-fencing. The key differences between these models relate to the ownership of the assets and the extent of Crown involvement. The most important design challenge will be **allocating risk** across project parties.

142 The treatment by rating agencies will also be important in determining whether the potential delivery vehicles achieve their purpose. We have indicated below the likely treatment by rating agencies initially, however, this treatment might change as these new delivery vehicles become more common within New Zealand[12].

143 Officials have yet to fully assess the merits of the options, but we can draw upon lessons from the experience of the Housing Infrastructure Fund (HIF) and Crown Infrastructure Partners (CIP), hence our inclusion of these in the table below.

Overview of the delivery vehicles

	Local authority as Borrower	**Local authority owned SPV**	**Crown Owned SPV**	**Third Party SPV**	**Crown Infrastructure Partners (CIP)**	**Housing Infrastructure Fund (HIF)**
Owner of the SPV	n/a	Local authority	Crown	Third Party	CIP	n/a
Owner of the infrastructure	Local authority	Local authority SPV	Local authority	Third Party SPV/Local authority	Local authority	Local authority
Owner of the revenue streams	Local authority	Local authority SPV	Local authority	Third Party SPV/Local authority	CIP	Local authority
Accounting Treatment for Local authority	On balance sheet	On balance sheet	Off balance sheet	Off balance sheet	Off balance sheet	On balance sheet
Accounting Treatment for Crown	Off balance sheet	Off balance sheet	On balance sheet	Off balance sheet	On balance sheet	On balance sheet
Crown Support Required	No	Maybe	Yes	Potentially	Yes (Crown subsidy through CIP)	Yes (through Crown funding)
Likely Rating Agency Assessment of Debt	Obligation of Council	Obligation of Council	Obligation of Crown	Obligation of Third Party	Obligation of Crown	Obligation of Council and Crown
Legislative Change Required	Maybe	Maybe	Yes	Yes	No	No
Scalability	Yes	Yes	No	Yes	No	Yes; limited

[12] For example vehicle 1 in Appendix 4 is where the debt and revenues associated with a specific infrastructure investment are ring fenced but not delivered through a separate delivery vehicle. These are known as revenue bonds in the United States and are viewed by rating agencies as separate from general local authority debt. However, the United States is the only country with such a system and it is untested in New Zealand. Credit rating agencies may still view these as part of the overall debt of local authority, thus not addressing their debt constraint issue.

Lessons from HIF

144 The HIF was established to facilitate infrastructure provision through the provision of infrastructure loans to high growth councils. Even though the HIF loans were provided interest free, they still counted as debt on the local authority balance sheet. Therefore, local authorities with limited debt headroom were constrained in their ability to take on these loans. HIF also requires Central Government to temporarily borrow the amount of the loans, which increases crown net debt until repaid.

Lessons from CIP

145 The purpose of CIP was to accelerate infrastructure development while minimising further debt on council's balance sheets. The work undertaken by CIP in trying to achieve this aim has shown that:

- CIP cannot access targeted rates via a contract with local authorities to pay off its debt without it impacting the Council's balance sheet[13];
- CIP is able to access other revenues from developers and infrastructure users, yet these are limited as depend on negotiating directly with each party. This means CIP works best where they are only dealing with one developer or infrastructure user;
- CIP's ability to secure financing for the infrastructure investment is less certain and more expensive because:
  - The lack of available long-term project revenue streams from councils to enable 'bankability' by financiers makes CIP's borrowing more expensive; and
  - Financiers will form a view on the counterparty risk associated with the developer/infrastructure user. i.e. what is the ability of CIP to enforce payment from the developer/infrastructure user compared to a targeted rate that has a charge against the property.
- As CIP is a crown owned company, it means that any borrowings of CIP ultimately shows on the Crown's balance sheet.

146 CIP is still looking to close its first project, which will deliver 4100 housing units in north Auckland by the end of the year, however, we will be reporting to Ministers in the next few months on the progress of this project and ongoing scalability of CIP's current models.

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[13] Only Local Authorities have the ability to levy rates. Therefore, if a rate is required to pay off a debt, the full debt is instantly treated as a financial obligation on the balance sheet of the local authority.

Proposed Strategy: Piloting New Delivery Vehicles and Developing Legislative Change in Parallel

147 There would be value in trialling a variety of delivery vehicles to identify the most promising approaches. Officials therefore recommend a short process of engagement with high-growth local authorities to explore how different delivery vehicles could support specific projects in each jurisdiction. The aim would be to develop a better understanding of which projects could be piloted through which delivery vehicle and the extent of legislative change needed to achieve ring-fencing.

148 Following this interim engagement, we would then provide advice to Ministers on the specific pilot projects to progress and how we will work with the individual local authorities and the local authority sector to deliver these, including respective resourcing and financial contributions. Legislative change and Crown support are likely pre-conditions to enabling access to new alternative financing models.

149 Infrastructure projects are often lengthy and therefore we think that work on pilot projects should continue concurrently alongside the legislative process. It will be important to have a clear framework so that the projects can be structured to support this, as well as to ensure investor appetite is maintained by a clear understanding of what is being proposed.

150 The clear benefit of having pilot projects in place is twofold: it enables the legislation to consider and be shaped by 'live' issues as they are worked through, which reduces risk of future amendment to the legislation in order to ensure it can be appropriately utilised; it also ensures there are projects ready to use the reform once available. Otherwise it would be reasonable to expect the reform will not enable meaningful change for at least a further 12-18 months post legislation as projects are scoped and shaped to fit the parameters of the reform.

151 We have already identified two specific opportunities we see the benefit in exploring further. The first is in relation to the Central Interceptor and the second is [25] [33]
[25] [33]

The Central Interceptor

152 Auckland Council has already proposed to use the Central Interceptor as a pilot project for a new alternative model. The Council estimates this may release up to $1.2 billion of capital. Given the Council's extensive work on this alternative model, officials see value in exploring this [33]
[33]
[33]
[33]

153 [33]
[33] it is recommended that work also begin on assessing how the model might be applied to Auckland Light Rail. This can happen in parallel with the Central Interceptor pilot and in discussion with the NZ Transport Agency and other government partners. More details of the applicability to Auckland Light Rail is within Appendix 7.

[25] [33]

Recommendations for action for IFF Objective 3

Recommended action: Investigate legislative change to enable alternative financing models.

Legislative change is necessary to enable alternative financing models – for example to allow local authorities to secure long term revenues and to enable new entities the ability to set and charge user charges or broad based taxes. Officials can provide further advice on what a programme of legislative change would entail.

Recommended action: Develop pilot projects to test new methods of accessing finance.

Officials recommend that Treasury partner with local authorities to investigate and pilot alternative access to finance. A pilot process will allow officials to identify promising pathfinder projects and modes of delivery that could be rolled out further.

Recommended action: Work with Auckland Council on the Central Interceptor Project to assess its suitability as a pilot project.

Officials recommend that Treasury work with Auckland Council on the Central Interceptor project and report back with an updated proposal by September 2018, to include any amendments to the structure, confirm the amount of headroom created by the proposal and any impact on the Crown or Council's balance sheet.

Recommended action: Auckland Light Rail.

We recommend that work also begin on assessing how the alternative models for accessing finance might be applied to the Auckland Light Rail project.

Recommended action: Agree that the [25] [33] **is worth investigating further.**

[25] [33]

Conclusion

156 Ministers have three main options in addressing the funding and financing constraints:

- Immediate change (next 6 months): Can only be achieved through central government funding and financing infrastructure directly. Will not address system issues, has a range of other issues and major fiscal implications for the Crown;
- Medium term change (next 12-18 months): Expanding local government borrowing and encouraging local authorities to borrow more to fund their infrastructure. Will put local government financing on a more sustainable footing yet will still always be subject to an limit; and
- Longer term change (next 1-5 years): Developing and implementing alternative financing delivery vehicles to provide an enduring solution to infrastructure provision.

157 We recommend the IFF work programme should focus on the latter two options.

158 Beyond technical barriers to the funding and financing of infrastructure, influencing the behaviour of local authorities is likely to be most effective through incentives to partner.

159 [38]

160

[38]

161 Ultimately, there is no enduring quick fix to the constraints in infrastructure financing and funding. Yet we think that by unblocking the financial constraints, and then central government working closely with local authorities, we will go a long way to achieving the objectives of the IFF programme.

APPENDIX 1: FUNDING TOOLS

FUNDING TOOLS – KEY TAKE OUTS:

- Existing tools should be used better to ensure full cost recovery and to vary charges based on actual cost. Means infrastructure charges may rise.
- Work is already underway on new tools that address key gaps: value uplift, congestion charging and areas facing high demand from tourism.
- Multiple related work programmes: Three Waters Review, UGA pillars, UDA, Local Government Funding Review, Value Capture.
- The rows highlighted in blue below are the areas that will be looked at specifically by the IFF work programme

Mechanism Name	Overview	Initial Assessment	Next Steps
General Rates	*Predominant source of revenue for local authorities*	General rates will continue to have a role in funding infrastructure. Future rate increases may be required to support volume of future capital investment.	Review as part of the **Local Funding Review** (by DIA) to assess the long term role and affordability of rates in funding infrastructure and local government functions.
Targeted Rates	*Councils can levy a targeted rate to fund activities that benefit identifiable ratepayers*	Use is variable, and there considerable scope to increase use of targeted rates for funding infrastructure. Should also be used to recover costs from landowners who are zoned and serviced to manage uptake risk and discourage land-banking.	Review as part of the **Local Funding Review** to assess ongoing role. **IFF** considering the ability to rate for multiple years to fund infrastructure.
Targeted Income	*A contractual equivalent to a targeted rate that is created by placing an encumbrance on the land title and guaranteeing a payment for say 25 years.*	Enables development to be brought forward outside of the Long Term Plan. To be successful, it will need an incentivised developer who is willing to place encumbrances on their titles.	Test as part of the **Crown Infrastructure Partners** project.
Development Contributions	*A charge levied against a new development to recover the costs of infrastructure – generally payable upon subdivision*	The use of Development Contributions could be improved and better recover the full cost of growth-related infrastructure (including a potential risk premium to reflect uptake risk). Some forms of community infrastructure excluded, and system seems biased to under collection	Review as part of the **IFF** to identify changes (both legislative and behavioural) that could increase use, scope and recoverability.
Development Agreements	*A contractual agreement between council and developers around provision and funding of infrastructure*	This allows a council and developer to bring forward a development outside of the Long Term Plan. To be successful, it will need an incentivised developer who is willing to pay the cost of acceleration. In use by number of councils.	Test as part of the **Crown Infrastructure Partners** project and through Future Development Strategies required under the NPS-UDC.
Volumetric Charging	*A charge used to recover the cost of water services*	Some high growth councils don't use water meters and volumetric charging. Assists in recovering the cost of growth along side upfront charges.	Review as part of the **Local Government Funding Review** to assess behavioural uptake of this charge.
Central Government Transfers	*A transfer of funds from central government to local government*	Central government contributions currently ad hoc. Local Government sector has argued for new revenues or transfers to supplement rates and other LG funding tools. Relevant also to city shaping infrastructure projects.	Review as part of the **Local Government Funding Review and Three Waters Review.**
Capital Recycling	*Accessing value held in existing assets through some level of sale (partial or full)*	Given the need for infrastructure investment, asset recycling could be a viable strategy for those Councils with appropriate assets and be a means for reducing the infrastructure investment gap.	Review as part of the **IFF** programme

POTENTIAL NEW FUNDING TOOLS

Mechanism Name	Overview	Initial Assessment	Next steps
Congestion charging	*A fee is charged on vehicles operating within, entering or exiting a defined geographic area (the congestion charge zone)*	Can improve the efficiency of road network use and lift productivity by making the actual costs and benefits of transport systems more apparent and enabling better informed decisions by households, businesses and government.	Being progressed through Auckland Smarter Transport Pricing Project as part of the Transport Pricing Pillar of the **Urban Growth Agenda**
Regional fuel tax	*A hypothecated tax is added to the per litre of price of fuel in a specified region and the revenue applied to local infrastructure.*	Can take pressure off general rates to fund the local government share of transport projects. [34] [34]	Application outside of Auckland should be reviewed as part of the **Local Government Funding Review**
Bed tax	*A uniform tax per person night or a percentage of a room charge.*	Potential funding source for those councils facing high levels of tourism demand.	Proposal being considered by Government (led by MBIE)
Sale or auction of development rights	*The right to develop beyond what the zoning or planning rules previously allowed could be sold or auctioned off*	*This would reveal the value to developers of up-zoning, it would allow more targeted 'up-zoning', it would compensate the community for any negative impacts of intensification and it would help recover the cost of additional infrastructure. However, it could encourage councils to adopt constrained zoning rules.*	Review as part of the **Value Capture** work programme

ADDITIONAL "LAND VALUE CAPTURE" MECHANISMS

Mechanism Name	Overview	Initial Assessment	Next steps
Value capture tax	*A tax on the value uplift of properties that benefit from a project.* *Like a targeted rate but on value uplift only.* *Being essentially a capital gains tax, there are different variants. For example, it could be levied on realised gains only (i.e. after a property is sold), or on accrued gains (which would need to be estimated).* *This would be in addition to the increase in ordinary rates that results from the value uplift.*	*Theoretically by applying to value uplift only, has some inherent equity between property owners built into it – the tax is directly proportional to the benefits received.* *Need not be limited to cost recovery, although political economy considerations may require it to be limited to cost recovery.* *Difficult in practice to target only that part of the capital gain that is attributable to a project.* *Taxes on unrealised capital gains can cause liquidity issues for property owners. Taxes on realised capital gains encourage land owners to hold on to their land for longer than is efficient, but do not require estimation of unrealised capital gains*	Review following report of **Tax Working Group**
Leveraging government land	The Crown uses existing Crown land (or purchases additional unimproved land), builds the infrastructure, and then either sells the land or leases at the improved price.	Requires upfront capital yet the easiest way to capture value. Potentially limited utility outside of existing Crown land development since once the government indicates interest in land purchases, the price increases and the value capture is lost.	Review as part of the **Value Capture** work programme

Appendix 2: Review of the Constraints on Local Government Financing

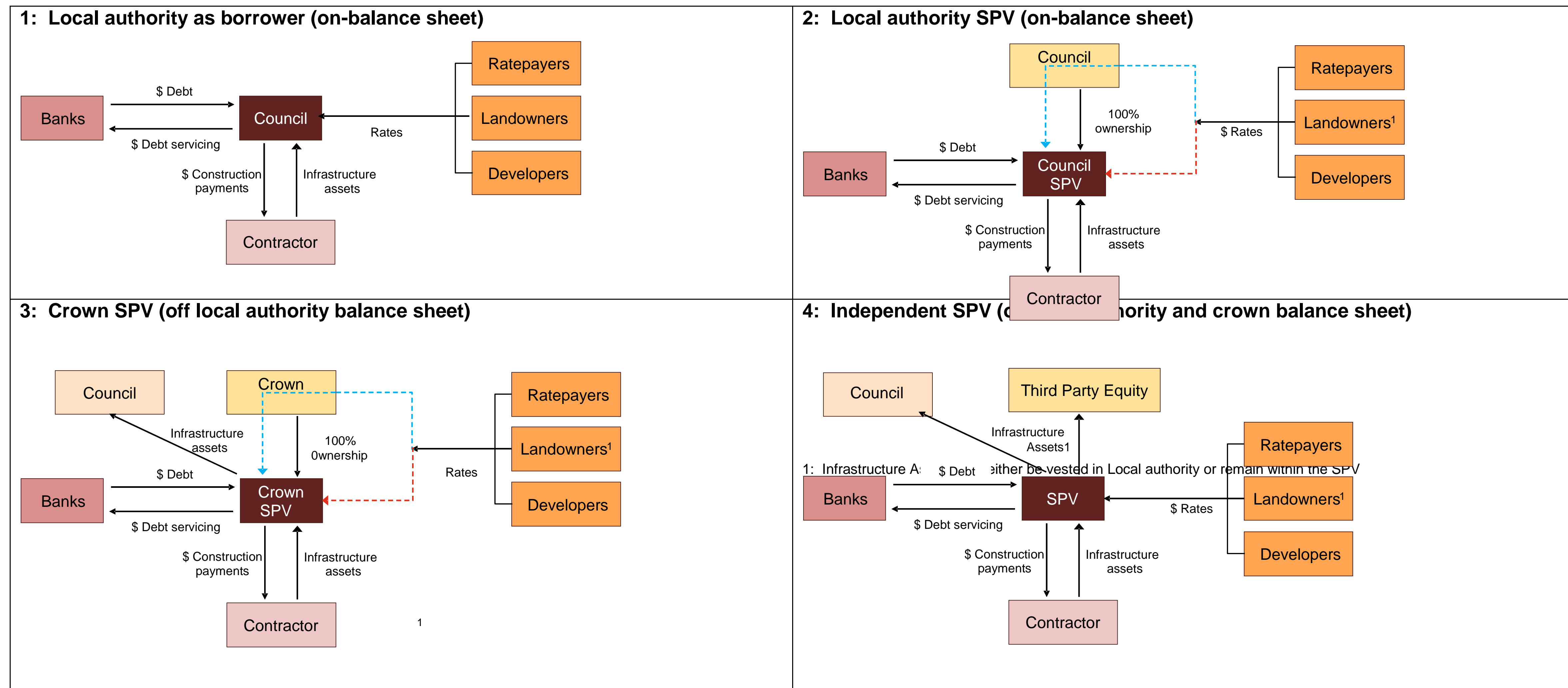
Factors	Constraint	Rationale for current position	Consequences of local authority non-compliance	Technical ability to change	Implications of change
The Local Government Funding Authority (LGFA) borrowing covenants The LGFA is a Council-Controlled Organisation (CCO) operating under the Local Government Act 2002. LGFA was established to raise debt on behalf of local authorities on terms that are more favourable (pricing and security of access to capital markets) to them than if they raised the debt directly.	• LGFA to maintain AA+ credit rating. This is the same credit rating as the New Zealand Government. • Local authorities must retain debt to revenue ratios of less than 250%[14]	The LGFA's credit rating is driven by the underlying credit worthiness of the local authorities it lends to; the capitalisation of its balance sheet; and institutional arrangements, including any central government support available to it. A weakening in the credit worthiness of the local authorities supported by the LGFA (through for example, an increase in their debt levels) would increase LGFA borrowing cost in the absence of additional capital or central government support.	A breach of the LGFA's covenants could preclude a local authority from borrowing from the LGFA or, in the case of existing local authority borrowers, trigger an event of review[15].	Amendments to the covenants of the LGFA would require the passing of an ordinary shareholders resolution (50% of shareholders in LGFA to vote in favour of the resolution). Central Government is a 20% shareholder and the remaining 30 shareholding councils hold 80%.	[33]
Credit Ratings	Local authorities wish to maintain their current credit ratings	Local authorities aim to retain a strong rating to minimise debt servicing costs. To maintain their existing ratings, they need to remain at a borrowing level of up to 270% debt/revenue. This is a "soft" limit as it is a local authority decision to adhere to these levels.	[33]	Behavioural change from the local authority	[38]
Local Government (Financial Reporting and Prudence) Regulations 2014	Borrowing costs as a percentage of revenue should be less than 15%	Ensure financial prudence from Local Authorities	If this threshold is exceeded, additional monitoring and review by central government may apply. The Minister of Local Government may intervene in the affairs of an authority if non-compliance constitutes a significant problem. The Minister can choose a range of responses from the relatively light touch such as requesting information about the problem to stronger interventions such as appointing a Commission to perform and exercise a local authorities responsibilities, duties and powers. Breach of a benchmark alone would be insufficient to justify intervention.	Legislative change. Order-in-Council.	The debt-servicing ratio is not currently an issue for the high-growth local authorities however LGNZ has suggested that the benchmarks are conservative. By way of comparison, the LGFA accept a debt servicing ratio of 25% of revenue as prudent. To ensure that these regulations do not act as a barrier to the provision of infrastructure in rapidly growing areas, we would recommend that DIA assess Whether this benchmak is helpful as a central government tool.
Financial Strategy	Self-imposed binding limit set out in the Long Term Plan	Desire to show ratepayers fiscal prudence and minimising debt	Breach of LTP	Yes through consultation outside of LTP	Requires behavioural change and signals change to strategy of limiting debt.

[14] LGFA specifies a range of debt covenants and has its own internal credit monitoring function to ensure that its own credit rating remains equivalent to the New Zealand government. The covenants were set in consultation with rating agencies at the outset of the LGFA in 2011.

[15] An event of review is not dissimilar to an event of default, and could result in LGFA exercising the right to accelerated repayment of the debt of that local authority. This would be a significant event, with material negative implications for the local authority and for the perception of LGFA's financial strength in financial markets.

[38]

Appendix 4: New Delivery Vehicles



Vehicle 1: Local authority as Borrower (on-balance sheet)
This is the status quo, with the key exception being that the debt is "ring-fenced" from the existing debt of local authorities. If this could be achieved, then the ring-fenced debt would not be included in the local authority's debt/revenue ratio.

The ring-fenced debt is known as revenue bonds in the United States and is viewed by rating agencies as separate from general local authority debt. However, the United States is the only country with such a system and it is untested in New Zealand. Credit Rating Agencies may still view these in New Zealand as part of the overall debt of local authorities, thus not addressing their debt constraint issue.

However, we believe there is merit in testing whether such a system could be implemented in New Zealand. We would look to work with a local authority to issue a marketable project finance revenue bond that is self-supporting. We would need to take steps to minimise the prospect of recourse by debt providers to the local authority by helping the local authority address decision making structures, incentives, and technical feasibility of bailouts.

Vehicle 2: Local authority SPV (on-balance sheet)
Another version is a local authority owned SPV**.** The main difference to Vehicle 1 would be that the bond would be issued by the SPV. The main driver for this model is it might provide a stronger separation for credit rating agencies.

Vehicle 3: Crown SPV (off balance sheet of Local authority)
Under this version the SPV is owned by the Crown. This avoids the issue of how rating agencies might view an SPV that is still owned by the local authority. However ownership by the Crown will mean that the liabilities and assets of the SPV will sit on the Crown balance sheet.

Vehicle 4: Independent SPV (off-balance sheet of local authority and Crown)

A SPV that was owned by independent third party equity would most likely enable the debt of the project to be off-balance sheet from both local authority and Crown. Whilst third party equity would own the cashflows, the actual asset would be vested in the local authority to avoid any views of privatisation (although that may involve the local authority recognising some financial liability on their balance sheet). This is similar to the PPP model, yet the funding of the project would come from project cashflows, as opposed to funds from the Crown.

In all of these models, there may be a need for local authority or central government financial support. This is because there will be residual risks that the financiers are unwilling to accept. It is likely that local authorities would argue that if they accept these residual risks, then the rating agencies will not consider that the SPV is sufficiently separated from the local authority to enable the debt to be ring-fenced. We think this position needs testing before we accept that central government should take on responsibility for residual risks.

Appendix 5: Policy considerations associated with changes to access to funding tools

Key policy issues to be considered as part of any legislative change to allow local authorities to strike multi-year rates, and to enable new entities the ability to set and charge user charges or broad based taxes (the Policy)

The change in approach to funding localised infrastructure - The Policy will consider the parameters for how a third party or Crown could provide local infrastructure. Policy will need to consider the democratic accountability connected with granting local taxing or user pay powers to third parties or the Crown. The Policy is also likely to need to consider how to manage the interests of Local Authorities (ie the Local Authority will likely want to have comfort over affordability, the impact on the proposed charges on rate levels, as well as the interaction of the project with their infrastructure and long-term plans).
Aligning national objectives with local authority led delivery - The Policy may consider how key different types of infrastructure could utilise the new models to deliver broader centralised objectives. For instance, identify the key sectors with the need, articulate a National Policy Statement relating to this sector and enable local authority projects meeting these criteria to submit for consideration. Policy Statements can be updated annually in line with infrastructure planning and demand. The UK has a similar system, initially based on a consenting regime relating to water, power, waste and energy. This was later expanded to include housing, commercial and retail developments to help address the housing problem faced in the UK.
How charges are set - A key consideration for the Policy is likely to be whether and how to regulate charges, and monitor the type and level of charges being set and the interrelationship between these charges and the setting of rates. For example, in the case of the Central Interceptor, this is a new (additional) water charge, with an new (additional) developer contribution. This may be appropriate in this case as it aims to create an intergenerational payment profile to fund new infrastructure and ensure new housing developments are paying an equitable contribution. However it will need to be understood and considered at what point this is a trade-off against existing/proposed rate rises or charges, as opposed to a new charge (and therefore the impact on Local Authority debt capacity, ratings, balance sheet, etc.).
Long-term asset ownership – The Policy may consider whether long-term third party (private sector) ownership of key infrastructure is an option or if this is limited to long-term concessions/lease arrangements. The Policy may consider who is responsible for the long-term duties relating to the asset. We will also consider vesting issues and wider issue related to asset ownership such as whole of life cost.
Local government ownership and responsibility issues - Consideration will need to be given as to whether divorcing the Council from the project takes away the Council's responsibility in specific legislation. [33] [33]
SPV ownership – The Policy may want to consider in what circumstances the Crown may consider SPV ownership (including by Crown Entities such as ACC or GNZSF). Such a scenario may be where an asset has Iwi considerations or is considered undesirable to be privately owned (ie water).
SPV autonomy/right to fail: The Policy may wish to consider its process and policy for addressing scenarios where there is a serious default/issue with the SPV.

Appendix 6: Central Interceptor

Auckland Council has proposed the Central Interceptor as a pilot project for testing an alternative financing model.

The Central Interceptor project involves construction of a new wastewater tunnel proposed to run between Western Springs and the Mangere wastewater treatment plant in Auckland and link sewers conveying wastewater to the tunnel. The main tunnel will be approximately 13 kilometres long and will provide additional capacity to the network to accommodate population growth in Auckland and to reduce overflows to the Waitemata and Manukau Harbours during wet weather.

On current numbers, utilising an alternative financing model for the Central Interceptor will release up to $1.2 billion of additional investment capital for Auckland Council [33]
[33]

Whilst we think there is still some work to do with Auckland Council regarding the level and form of Crown support, we have done as much theoretical work as we can regarding the legal, accounting and rating agency treatment of alternative financing models. Having Central Interceptor as a pilot project will enable the views of credit rating agencies to be explored in a 'live' environment and encourage the ongoing development and evolution of these delivery vehicles. Auckland Council have invested budget, resources and time to this project so we are also confident that they have the capability and capacity to work in partnership with the Crown on a pilot.

Should Ministers agree to Treasury officials working with Auckland Council on assessing the suitability of Central Interceptor Project as a pilot project, we anticipate the next steps will be and we anticipate the next steps to be:

- Treasury officials would join the working group (made up of Auckland Council, Watercare and advisors)
- Auckland Council and Treasury would work together to revert with an updated proposal by September 2018, including any amendments to the structure, confirmation of the amount of headroom created by the proposal and any impact on the Crown's balance sheet.
- [23]

Appendix 7: [25] [33]

[25] [33]