# The Treasury

## Urban Growth Agenda: Infrastructure Levy Model - Development Contributions Information Release

## December 2019

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[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

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Office of the Minister for Urban Development

Chair
Cabinet Economic Development Committee

# Urban Growth Agenda: Infrastructure Levy Model – Development Contributions

## Proposal

1. This paper seeks Cabinet approval to alter its previously agreed position on the use of development contributions (DCs) in relation to the Infrastructure Levy Model (the Model). Officials propose more flexibility in the council funding system to enable the Model to be used in a broader range of projects.

2. The current design of the Model also requires the relevant portion of previously collected DCs to be transferred to a special purpose vehicle (SPV) where the SPV is responsible for the financing and/or development of infrastructure for which the DC was collected. This paper also seeks to provide an option to refund to the current landowner previously collected DCs for infrastructure that is subsequently funded by a Levy.

## Executive summary

3. Currently infrastructure is funded by three primary sources:

    3.1 Development contributions (DCs), paid to the local authority;

    3.2 Through a local authority's rating processes; or

    3.3 Through Crown contributions (for example NZTA co-funding or direct Crown funding).

4. In June this year we agreed to establish a new model for infrastructure – *the Infrastructure Levy Model* – to help address one of the key challenges to housing affordability; reforming the funding and financing system of local infrastructure [CAB-19-MIN-0263 refers].

5. To achieve this, the Model sets a multi-year infrastructure Levy (the Levy), which is paid by beneficiaries (or Levy payers) of infrastructure projects. The Levy is then used to service financing raised by SPV to cover the costs of the infrastructure. This levy provides a fourth mechanism to fund infrastructure.

6. Importantly, this Model separates the financing decision for the infrastructure from a council's usual financing processes and constraints by ensuring the associated debt does not count against a council's balance sheet.

7. The Model is not about relieving councils of their responsibility for delivering infrastructure or shifting costs that a council (or general ratepayers) would normally bear to new homeowners. It is about creating flexibility in the local infrastructure financing system to ensure that viable projects proceed, unencumbered by a council's financing constraints. This will improve the responsiveness of infrastructure supply to service land for housing and competitive urban land markets, reducing the overall cost of housing in the long term.

8. In June we agreed that, should a local authority utilise the Model, the authority:



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8.1 cease collecting compulsory DCs for infrastructure to be funded by the Levy, and from properties subject to the Levy; and

8.2 transfer the relevant proportion of any DCs already collected from Levy payers within the project area to the SPV delivering the infrastructure. [CAB-19-MIN-0263 refers].

9. Officials have been working with councils and commercial advisers to undertake high level assessments of projects that could proceed under the Model. This work has shown that there needs to be flexibility within the Model to combine available funding streams. Through this work, officials have suggested a more flexible position for DCs to enable as many projects as possible to proceed under the Model.

10. The proposed approach would enable projects to combine levies with DCs in a way that ensures a Levy is set at an appropriate amount and that a project, which Council funding constraints would otherwise prevent from occurring, is able to proceed.

11. The balance of DCs and a Levy is a choice between meeting costs upfront via a DC or recovering these costs via a Levy over time. Under either approach, the costs of the infrastructure will be borne by homeowners. In approving a Levy, we will need to ensure that it is appropriate for the circumstance and maintains the policy intentions behind the policy. There is also a specific prohibition on "double-dipping".

12. However, using a DC to keep a Levy artificially low in most cases will not be appropriate. This is because it involves trading away Infrastructure Funding and Financing (IFF) and Urban Growth Agenda (UGA) objectives. The use of DCs reintroduces the council's debt constraint to the decision to proceed, limits the transparency of the cost of infrastructure and diminishes the incentive to develop land. Consequently, it should only be used to supplement a project's financing where it would otherwise not proceed.

13. Officials have also examined practical treatment of previously collected DCs for infrastructure that is then delivered via the Model and whether the positions are equitable. The transferring of previously collected DCs to an SPV is problematic. To mitigate this, SPVs and councils should be provided with the option to refund the appropriate portion of a previously collected DC to the current landowner instead of always being required to transfer it to an SPV. This also avoids potential issues in accounting for a previously collected DC in the assessment of a property's liability for a Levy. It ensures an equitable approach as the previously paid DC will be reflected in the value of the land.

## Background

### *Infrastructure Funding and Financing and the Urban Growth Agenda*

14. The IFF work programme is an integral pillar of our ambitious UGA which is aimed at improving housing affordability by removing barriers to the supply of land and infrastructure.



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15. One key barrier to the supply of developable urban land is a council's ability to borrow to build the necessary supporting infrastructure – mainly roading, drinking water, wastewater and stormwater infrastructure. This is because most high growth councils are close to their maximum debt ceiling (with debt at around 250 per cent of revenue). Without appropriate financing and funding tools, infrastructure supply to support development will continue to be constrained, supporting dysfunctional land markets. Improving the responsiveness of infrastructure supply to meet demand will help drive well-functioning land markets in our urban centres and keep prices in check.

16. In September 2018, we tasked officials with investigating alternative financing models to fund local infrastructure and any associated legislation that would be required to underpin these models [CAB-18-MIN-0466 refers]. In June this year we agreed to the Infrastructure Levy Model [CAB-19-MIN-0263 refers] which is intended to create a system where:

    16.1 the provision of infrastructure is financially sustainable, without a need for substantial or ad-hoc Crown/council support, and that finance is readily available;

    16.2 the viability of projects becomes the key determinant on whether they proceed;

    16.3 a much greater quantity of debt can be leveraged from revenue streams than would be possible through a council;

    16.4 the costs of growth are properly allocated, so that they fall on the communities and homeowners who benefit from the new infrastructure;

    16.5 there is greater rigour and transparency in the allocation of risk and costs to the appropriate parties; and

    16.6 price signals are provided to help ensure investment occurs where the market demands are.

17. The core of the Model involves the setting of a multi-year infrastructure Levy, which is paid by beneficiaries (or Levy payers) of the infrastructure projects. The Levy will be enabled by legislation and can only be struck following an Order in Council, which will set out the terms of the Levy. An SPV will be responsible for financing all or part of the project and has the power to collect the Levy which is used to support the financing.

18. The Levy is used to service financing raised by the SPV to cover the costs of the infrastructure. In most cases the SPV will be responsible for construction of the infrastructure assets. Once constructed, the infrastructure will then vest with the relevant council (or public body) for nil consideration.

19. Importantly, the Model separates the financing decision for the infrastructure from councils' usual financing processes and constraints, including the debt being ring-fenced from a council's balance sheet. It is about providing the flexibility the local authority infrastructure funding and financing system to be able to respond to infrastructure demands. Councils are still required to meet their usual obligations under the Local Government Act 2002.

20. While we have separated the financing decision, it does not absolve councils of their responsibility to their current and future communities to provide the infrastructure they need. There will be spill over benefits to their existing communities associated with these projects, and councils will be expected to make a contribution to these projects that reflects that benefit.



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21. I have also communicated to officials that this model is to enable new housing supply that otherwise would not proceed. It will not be able to be utilised to remove costs from local authorities in order to artificially suppress rates for existing property owners.

***Development contributions, an overview***

22. Councils have several tools to recover the costs of infrastructure. To fund growth infrastructure, they commonly employ DCs. DCs *"enable territorial authorities to recover from those persons undertaking development a fair, equitable, and proportionate portion of the total cost of capital expenditure necessary to service growth"* (section 197AA of the Local Government Act 2002).

23. DCs may be levied by a council in accordance with a policy framework authorising and defining such contributions. A DC may be levied on a person developing, when a council is granting a resource consent, a building consent or an authority to connect to a network. A person developing will typically pay DCs to a council at the time of subdivision. This lump sum at the time of subdivision creates issues:

    23.1 **Councils**, under the DC regime, typically borrow the cost of the infrastructure and recover a portion of this from DCs, based on an assumed development profile. This carries several risks, mainly due to the council carrying development uptake and timing risks (which are then borne by ratepayers), cost escalation risk, and the debt appearing on their balance sheet. Consequently, a council may be unwilling or unable to borrow the capital to pay for the infrastructure in the period between infrastructure construction and timing of DC collection.

    23.2 **Developers** may undertake development slowly, as land value increases are typically higher than holding costs of land. This weakens the incentive to develop land. In fact, they can serve as an incentive to land-bank as they are only charged when development occurs.

    23.3 **Homeowners** face higher upfront costs when purchasing a new home as the lump sum nature of the DC means that it is added to the cost of a section. While the nominal incidence is on the person developing the section, the economic incidence is borne by the purchaser/owner of the new home.

***Previous Cabinet resolutions on the application of development contributions to the Levy Model***

24. One of the fundamental reasons the Model works is because it achieves separation of the debt associated with delivering the infrastructure from a council's balance sheet. DCs on the other hand do not achieve this. Under the Model the debt associated with a project sits with an SPV that collects the Levy to fund that debt.

25. However, it is possible that a council may have been collecting DCs for infrastructure that is subsequently funded by an SPV and delivered via the Model. This presents a risk of 'double charging'.

26. We agreed in June that a council be required to:

    1. **cease collecting compulsory DCs** for infrastructure that is to be funded by the Levy from properties subject to the Levy; and



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2. **transfer the relevant proportion of any DCs already collected** from Levy payers within the project area to the SPV delivering the infrastructure.

   [CAB-19-MIN-0263 refers].

## Providing flexibility to create tailored funding and financing packages for projects

### *Revising our previous position on development contributions*

27. Since our decisions in June, more detailed work by officials on projects that are candidates for the Model has revealed two issues with the previously agreed policy for how DCs work with the Model:

    1. **Supplementing a Levy with development contributions**: Fully funding a project via a Levy may result in a Levy above what may be perceived or deemed appropriate by Ministers or councils. However, under the policy approach we agreed in June, the project may be unable to proceed without a supplementary funding source being used. A council contribution (funded via DCs) to supplement a Levy would be a suitable source to assist a project's viability.

       I am proposing that we revoke our previous decision and enable the use of DCs to supplement a Levy to ensure it appropriate for the circumstances. This will help ensure that the Model is flexible and more projects proceed than the current policy would enable.

    2. **Applying previously collected DCs**: Where a council has previously collected DCs from properties for infrastructure that is subsequently delivered via the Model, these DCs need to be utilised and recognised against the relevant Levy payer's liability. This is problematic in many circumstances due to the complexities involved in transferring DCs and appropriately offsetting a Levy payer's liability.

       I propose that we provide councils and relevant SPVs with the option to refund the relevant portion of previously collected DCs to landowners who will be subject to a Levy.

## Issue one: Supplementing a Levy with development contributions

28. This issue has arisen as officials have been working with councils and advisers to examine how potential projects could be structured. This work has made it clear that some projects may not be considered viable if fully funded by a Levy.

29. The appropriateness of a Levy will be specific to the development and surrounding circumstances. Enabling DCs to supplement a Levy will provide us and councils with the flexibility we need to ensure that viable projects proceed.

30. Using DCs to supplement or bring down the cost of a Levy may involve trading off some of the IFF policy objectives and outcomes outlined in paragraph 16. This is because DCs have characteristics that do not align with the UGA or IFF objectives. This is illustrated in **Appendix A** and summarised below:

    30.1 The cost of **DCs are capitalised into the purchase price of land**. This increases the upfront cost of section prices.

    30.2 **A 'low' levy may not be priced into section prices** as efficiently as a larger one, thus producing a de facto developer subsidy. This is likely to result in a windfall gain to developers.



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30.3 **The use of DCs for IFF projects reintroduces the council debt constraint**, and the decision to proceed is tied to these constraints. If a project's funding is supplemented by DCs, a council will likely need to borrow to bridge this funding, this borrowing will appear on their balance sheet.

Requiring a council contribution keeps the project reliant on council financing decisions and trade-offs. This does not support creating competitive tension between land owners or the timely provision of infrastructure.

There is also timing uncertainty of revenues for the council. This is because a DC is only charged when development occurs and will likely mean that any debt raised will appear on a council's balance sheet for an unknown period. This transfers development risk to existing ratepayers.

30.4 **DCs do not incentivise growth and development**, and often result in the drip feeding of land due to the incidence of the charge often being at the point of development or subdivision.

31. The points raised in paragraph 30 send a signal that we need to consider more closely when the use a levy to fully recover the costs of infrastructure is appropriate. This will have a significant influence on how the Model is implemented and the extent to which IFF objectives are achieved. Critically, if a Levy is too low, prospective purchasers may not appropriately adjust their offer prices which would result in a de-facto developer subsidy. Alternatively, a Levy that us too high will limit the uptake of the Model.

32. There is a trade-off between the Levy amount (as a proxy for the level of finance that can be raised) and the need to rely on a council making a capital contribution to a project and recovering this via DCs. Equally, there are financial efficiencies associated with recovering greater amounts of capital due to the establishment and SPV administration costs being relatively fixed. The other potential downside of using DCs in conjunction with IFF projects is that it produces a more confusing funding situation for the land owner/Levy payer because they meet capital costs through two paths rather than one.

**Table one: Example interaction between a Levy, DCs and amount of capital raised**

[37] [38]

*Note, this table is indicative and should be used for illustrative purposes only. It is based on preliminary costings and estimates.*



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33. Table one, above, illustrates potential Levy scenarios for stage one of the proposed [37] [38] development in [37] [38] It includes the growth component of strategic growth infrastructure only (waters and road infrastructure) at an estimated cost of [37] [38] [37] [38] An additional investment from [37] [38] approximately [37] [38] [37] [38] over ten years will be required to 'upsize' existing infrastructure to meet their requirements.

34. The [37] [38] example highlights the trade-off between the amount of a Levy, and the level of capital that it can support over a given period. This is a decision about whether a Levy is deemed 'appropriate' and where costs should lie. Every project will be different and face unique circumstances that will influence this view.

35. However, there remains a choice about our preferences for structuring a Levy and striking the balance between keeping levies circumstance appropriate and the need to meet our IFF and UGA objectives:

   a) **Supplement a Levy with DCs to partly recover the cost of infrastructure via DCs**. The DCs will be capitalised into the section prices upfront and likely have a lesser influence on a purchaser's offer price when compared to full recovery via a Levy. This option will require the support and agreement of the council to make the contribution and recover it via a DC. This will impact its balance sheet. Given the council will be committing its capital, the council will need to publicly consult and make trade-offs within its capital works programme. This will likely limit the supply of land available.

   ***OR***

   b) Recover the cost of the infrastructure solely via the Levy. This will result in higher Levies than option 'a' above and have a higher likelihood of purchasers appropriately discounting this cost when purchasing a section or home. This also removes the need to rely on council financing decisions.

36. **Relying on a council capital contribution (funded by DCs) to supplement the revenue stream for a Levy should not be the default approach for the Levy Model.** This is because it is contrary to the primary IFF objective of enabling infrastructure to be delivered without being limited by council financial constraints. Further, a Levy that does not reflect the cost of the infrastructure will send weak or inappropriate price signals to the market and is unlikely to influence section prices, undermining a key IFF policy objective. This may mean the Levy serves as a subsidy to developers.

37. Nevertheless, I consider it is appropriate to enable the Model to allow DCs to supplement a Levy where that project's Levy would otherwise be considered inappropriate and prevent a project from proceeding. This will help ensure that viable projects can proceed. A strong communications and education programme by the Facilitator and Monitor will help to mitigate the risks that the supplementing a Levy with DCs presents.

## Issue two: Applying previously collected development contributions

38. In June we agreed that any DCs previously collected from properties that are subsequently subject to a Levy, must be transferred to the relevant SPV if it is delivering the same infrastructure for which the DC was collected [CAB-19-MIN-0263 refers]. The objective of this approach was to prevent double charging and ensure that a person who has paid DCs directly, or indirectly, is not unfairly disadvantaged.



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39. Subsequently, officials have been working through the practicalities of applying DCs in this manner, including testing the concept with councils.

40. I now consider that the practical application of this approach is significantly more complex than initially thought. There is likely to be varied situations between different properties within a project area about what DCs had been paid and for what services. It could lead to levy payments that are highly individualised for different levy payers and difficult to explain to property owners in a transparent manner. It could also make the process of setting and assessing the levy difficult to monitor.

41. In light of this, I consider that where a DC has been previously collected by a council for infrastructure now delivered by an SPV, there should be an option to refund it to the current land owner. The current landowner is the appropriate recipient of any refunded levy, as the previously paid DC will have been capitalised into the value of their property.

42. In practice, I expect this will become the predominant treatment of previously paid DCs.

## Consultation

43. The Department of the Prime Minister and Cabinet, the Department of Internal Affairs, Land Information New Zealand, the Ministry for the Environment, the Ministry for Housing and Urban Development, the Ministry of Transport, Te Puni Kōkiri, and the Treasury were consulted during the development of this paper.

## Financial implications

44. None.

## Human rights, disability and gender implications

45. None.

## Legislative implications

46. Parliamentary Counsel Office (PCO) is currently preparing the Infrastructure Funding and Financing Bill (the Bill). The Department of Internal Affairs is responsible for the development of drafting instructions and will work with PCO to make necessary adjustments to the Bill to reflect the new policy direction agreed in this paper.

## Impact analysis

47. A regulatory impact assessment was undertaken to inform Cabinet's decisions to proceed with the Levy model. The policy change sought in this paper is not inconsistent with the *Infrastructure Funding and Financing Regulatory Impact Assessment*.

## Publicity and proactive release

48. There is likely to be widespread stakeholder interest in the broader IFF work, including from councils. Accordingly, I intend to proactively release this Cabinet paper following introduction of the Bill into the House.



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## Recommendations

The Minister for Urban Development recommends that the Cabinet Economic Development Committee:

1. **note** that Cabinet previously agreed to the Infrastructure Levy Model [CAB-19-MIN-0263 refers];
2. **note** that in June 2019 Cabinet agreed:
   2.1 to prevent the collection of compulsory development contributions in respect of infrastructure to be funded by the Levy from properties subject to the Levy [CAB-19-MIN-0263 refers]; and
   2.2 that if a local authority has required development contributions in respect of the infrastructure funded from the Levy, the development contributions required must be transferred to the Special Purpose Vehicle to assist with the cost of constructing infrastructure;
3. **note** that, preventing compulsory development contributions for infrastructure to be funded by the Levy, from properties subject to the Levy, may mean that a Levy is considered 'unaffordable' and render a project nonviable;
4. **note** that preliminary assessments of projects that are candidates for the Infrastructure Levy Model has identified that in some instances financing will need to be supplemented with other sources of funding to cover the full costs of infrastructure;
5. **agree** that the Infrastructure Funding and Financing Bill should enable the collection of compulsory development contributions in respect of infrastructure to be funded by the Levy to **supplement a project's financing where it would otherwise not proceed**;
6. **agree** that relying on development contributions to supplement a revenue stream for a Levy should not be the default approach taken when developing a Levy proposal;
7. **note** that councils are unable to double charge for infrastructure where combining development contributions with the Infrastructure Levy Model;
8. **note** that using development contributions to supplement a project's financing requires the trading away of core Infrastructure Levy Model objectives;
9. **agree** that development contributions previously collected from properties that are subject to a Levy may be transferred to the relevant Special Purpose Vehicle, or refunded to the current land owner, and that the Special Purpose Vehicle shall have discretion as to which option is applied;
10. **note** that, if you agree to recommendations 5, 6 and 9, this is a substantial policy change from Cabinet's previous resolution noted in recommendation 2, and requires, respectively, revoking and altering Cabinet's previous resolution and amending drafting instructions for the Infrastructure Funding and Financing Bill; and
11. **agree** to revoke Cabinet's previous decision to prevent the collection of compulsory development contributions in respect of infrastructure to be funded by the Levy from properties subject to the Levy [CAB-19-MIN-0263, recommendation 17 refers]; and



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12. **invite** the Minister of Housing and Urban Development to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above proposals for the Infrastructure Funding and Financing Bill.

Authorised for lodgement

Hon Phil Twyford

Minister for Urban Development



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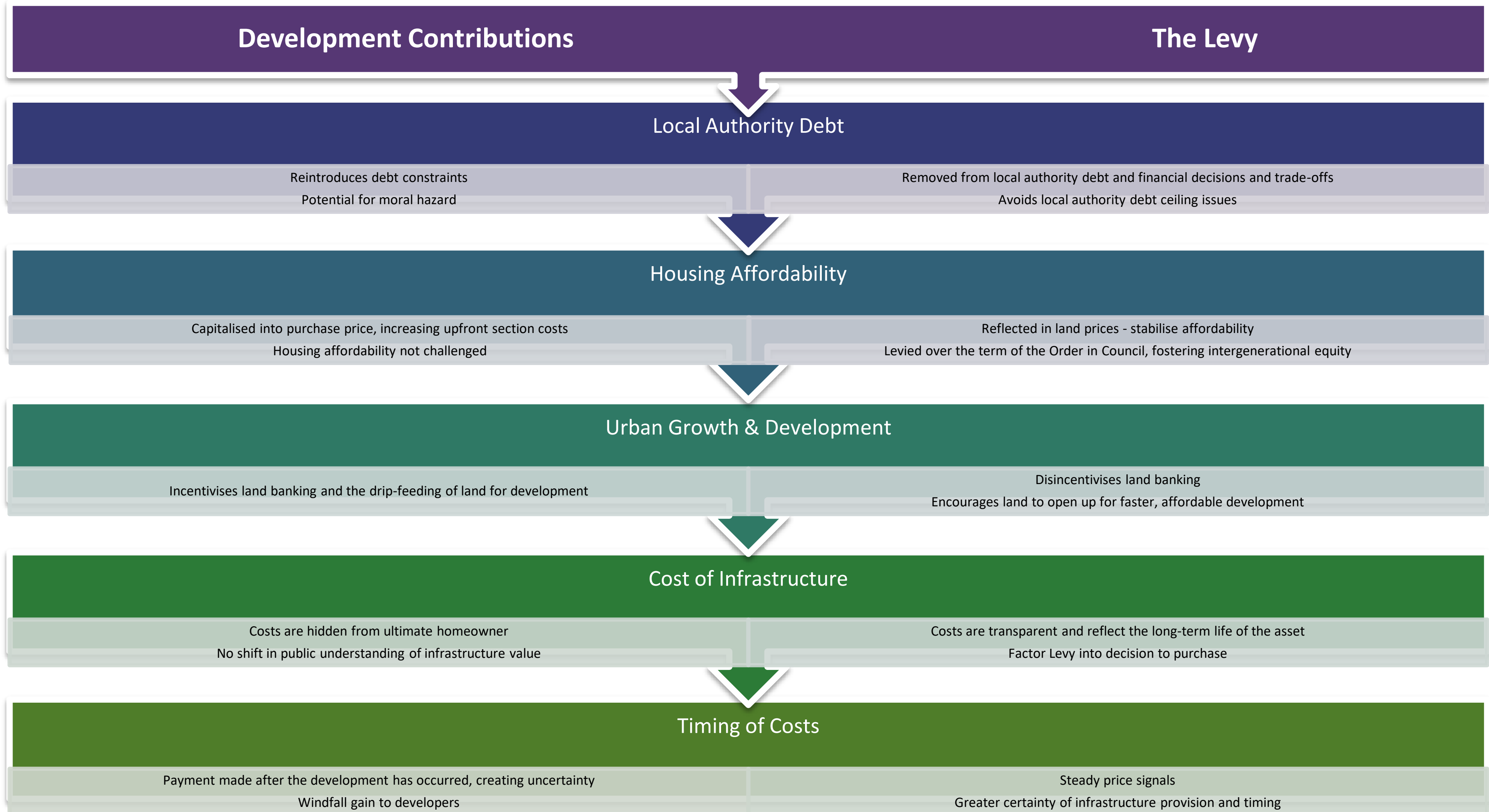
## APPENDIX A: Appendix A: Illustration of the potential trade-offs of IFF objectives if supplementing a Levy with Development Contributions



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