# The Treasury

## Urban Growth Agenda: Proposed Approach for Infrastructure Funding and Financing Information Release

## December 2019

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**Office of the Minister of Housing and Urban Development**

**Chair**
**Cabinet Economic Development Committee**

# Urban Growth Agenda: Proposed approach for Infrastructure Funding and Financing

## Proposal

1 This paper seeks Cabinet endorsement of the proposed approach to the Infrastructure Funding and Financing (IFF) pillar of the Urban Growth Agenda (UGA).

2 "Financing" refers to accessing the capital required to meet the upfront cost of the infrastructure, whilst "funding" refers to the revenue streams that repay the capital over time.

3 This paper proposes that officials be tasked with designing alternative financing models to be used primarily for investment in bulk infrastructure including three-waters and transport infrastructure to support housing and urban development.

4 This paper further proposes as a complementary work programme to that of alternative financing models, that officials:

4.1 investigate easing the existing local authority debt constraints with the Local Government Funding Authority (LGFA); and

4.2 assess whether the existing targeted rates/development contributions regime can be utilised more effectively to better recover the cost of infrastructure.

## Executive Summary

5 Improving housing affordability is my top priority. As well as direct home building initiatives such as Kiwibuild, working to address the underlying structure issues causing scarcity and high house prices is of paramount importance. One of the underlying issues to this is the lack of financing which is holding up housing developments.

6 The aim of the IFF work is therefore to improve housing affordability, by enabling responsive infrastructure provision and appropriate cost allocation, including the use of project financing and access to financial capital.

7 The focus of the IFF work is on the funding/financing of the large bulk infrastructure for transport and water, such as wastewater or drinking water treatment plants, major arterial roads and major reticulation pipelines. This is because bulk infrastructure (and the infrastructure provided by the developer within the development site) is a necessary enabler for development.

8 Most bulk infrastructure is provided by local authorities. Under the business as usual model, local authorities fund and deliver infrastructure using their balance sheets and revenue streams. Local authorities have unique access to the revenue streams related to these services (e.g. targeted and general rates) and there are currently no mechanisms in place for the private sector to access these revenue streams. At the same time, due to balance sheet constraints, local authorities in high-growth urban areas are unable to raise sufficient debt to finance infrastructure projects.

9 The outcome presents itself as a long list of "unfunded" but economically positive projects that cannot proceed unless self-funded by developers, degraded services, road congestion in high growth urban areas, and dysfunctional urban land markets due to an under-supply of serviced urban land.

10 As financing is the presenting constraint to meeting infrastructure demand, the focus of this paper is about addressing the financing constraints. A financing structure that overcomes the local authorities borrowing constraints will enable new housing developments to be completed sooner than might otherwise be the case if left to local authorities to finance. The objective is to remove infrastructure financing as a barrier to housing developments proceeding.

11 I have considered how we could make changes to the existing financing framework, and what alternative structures we might need to put in place.

12 I propose the most enduring solution to the financing constraints is to consider alternative financing models to increase the provision of infrastructure. They would involve the use of new special purpose vehicles (SPVs) with an ability to set charges (so access a revenue stream) and raise finance. Critically, the debt of these SPVs would be treated separately from the debt on the local authorities' balance sheets.

13 I consider that alternative financing models should be explored because:

13.1 They allow viable projects to proceed outside of the local authorities framework and allows the system to be responsive to urban demand;

13.2 They allow costs to fall on the communities and homeowners who benefit from the new infrastructure;

13.3 They provide greater rigour in the allocation of risk and costs to the appropriate parties;

13.4 They will allow for a greater quantity of debt to be leveraged from revenue streams than would be possible through a continued reliance on the balance sheet of the local authority;

13.5 They make 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;

13.6 They provide a pipeline designed to allow new capital to flow into the system; and

13.7 They provide price signals to ensure investment occurs where it is most needed.

14 I see numerous benefits in creating an alternative system that will enable growth to pay for growth. I believe that an alternative financing system creates an efficient and cost effective means to meet the high demand for expanded residential development without burdening existing ratepayers with added expenditures. Instead the risk and cost is borne by developers or beneficiaries in the development areas that benefit from the additional infrastructure.

15 This is not about new taxes. These are costs that are already being borne by the ratepayer through their rates. Alternative models simply make these charges more transparent, borne by the communities and homeowners who benefit from the new infrastructure and are able to be spread over a long timeframe, reflecting the life of the asset and creating intergenerational equity.

16 This is also not about replacing the existing system of local government infrastructure provision. It is about creating an "alternative" system that can be utilised by various parties such as local authorities, developers or the Urban Development Authority (UDA) when suitable.

17 Work undertaken to date shows that these alternative financing models should be feasible if we are able to:

17.1 secure a long-term secure revenue stream that will pay for the cost of the infrastructure. This could be a user-charge (most applicable for water), or a tax or broad-based charge (most applicable for transport) paid by an identified group of beneficiaries; and

17.2 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.

18 I am aiming to design a system that does not impact the balance sheets of either the local authority or the Crown. A key part of this work programme will be obtaining formal views from the credit rating agencies and the Office of the Auditor General to see whether this can be done.

19 Securing long-term revenues for alternative delivery models would require the creation of powers to allow those models to tax or charge for access to infrastructure services and ability to set long-term revenues. This would require legislative change and we need policy discussions on a number of key issues, including who has the power to set levies or charges and how they are accountable to taxpayers.

20 This paper is therefore seeking the support of Cabinet to commence this policy/legislative process, with a report back to Cabinet in late 2018/early 2019 as to what form this would take. My expectation is that that the legislation is introduced into the house in mid-2019.

21 In addition, I would like to commence two complementary workstreams as part of the overall IFF work programme:

21.1 Investigate whether to expand local authorities borrowing capacity; and

21.2 Investigate the targeted rates/development contributions regime to see if they can better recover costs.

22 These workstreams are expected to have less of an impact on the infrastructure investment settings than alternative financing models, but will still assist in the overall shift in the system to achieving our goal of housing affordability.

23 Completing this phase of the IFF work programme will mean that New Zealand reduces the technical financial constraints and creates a more enabling system for infrastructure provision. Yet that is only the first part of the transition. It will then be necessary to ensure the new system is used. Central government has few direct levers when it comes to the provision of bulk infrastructure, so partnership with local authorities will be vital. For example, local authorities and communities may not want to grow and/or incur further charges. Funding and financing also always 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 the costs of a project.

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

25 I suggest that we must look at how outcomes of the IFF could be aligned with decisions made in the Urban Planning and Spatial Planning pillars of the UGA on how to incentivise or require local authorities to adopt planning practices that are more enabling of growth. The IFF workstream will not in isolation lower house prices – it needs to be a part of an entire urban development system change.

## Background

26 Housing is a top priority for this government. The housing crisis touches almost everyone, from young middle class families who have given up hope of ever owning their own home, to people who find themselves homeless or living in boarding houses and campgrounds.

27 Only a quarter of adults under 40 own their own home, compared to half in 1991. Homeownership is at its lowest level in 65 years. Yale researchers have found New Zealand's homelessness rate of nearly one percent of the population is higher than any other OECD country, and several times worse than the UK or US.

28 The roots of the crisis lie in policy issues that go back decades. Unless we address the underlying structural issues causing housing unaffordability, we will never come up with an enduring solution that can provide the social equity this government desires. Unaffordability is causing multigenerational impacts on housing, health and productivity.

29 It will be necessary for all of our system settings and frameworks to work effectively together to appropriately enable urban growth and be responsive to change. However, there is no simple fix – it is about the right mix of legislation, institutions, planning, funding and financing mechanisms, people with the right skills and strong relationships. That is the driver for the Urban Growth Agenda (UGA). The UGA is

an ambitious and far-reaching programme designed to improve housing affordability for New Zealanders by addressing the fundamentals of land supply, development capacity and infrastructure provision.

30 The IFF is an integral component of the UGA. Without appropriate financing and funding tools, infrastructure supply cannot meet demand. Infrastructure is a necessary enabler for development and most bulk infrastructure is provided by local authorities. The IFF workstream has focused on assessing the options for new funding and financing tools to serve demand for investment and services. It has also considered efficiency, equity, affordability and effectiveness, and how the transition to any new funding and financing models could be managed.

31 Unfortunately, our current infrastructure funding and financing system is broken. Local authorities, which provide most bulk infrastructure, are hindered by their existing financial practices. The undersupply and the just in time sequencing of infrastructure for expansion encourages land banking. In recent years the marginal cost of growth has not been met, leaving a growing bow-wave of unfunded infrastructure costs facing central and local authorities. Declining service levels as a result of under investment in capacity in existing urban areas can also limit development opportunities

32 This lack of finance is highly restrictive and stops cities growing and responding to demand. When a city cannot grow in response to demand, a pressure cooker effect is created. The housing shortage worsens and causes house prices to rocket, rents to balloon and increased overcrowding.

33 This is particularly evident in New Zealand's urban centres. In a number of our high growth regions, local authorities are facing constraints in their ability to invest in infrastructure to enable growth. In particular, the demand for new housing is outstripping local authorities ability and willingness to take on further debt, meaning there are investments that can be funded over time, but not financed from local authority balance sheets.

34 High growth centres have attracted the most attention, but I acknowledge that other areas across New Zealand are struggling with housing undersupply, rising land prices and transport and water infrastructure needs. I expect that much of this work will be able to be applied nationally so that we can provide housing across New Zealand.

35 The presenting problem of debt constraints however is only one of the symptoms of the deeper issues within our current funding and financing regime. The challenge of providing infrastructure is magnified by underlying institutions and incentives. These include:

35.1 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;

35.2 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;

35.3 We have a financing structure that puts minimising the cost of borrowing as the key 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;

35.4 This financing structure puts pressure on developers to be the primary financing model for the in-development infrastructure that is needed to bring new land into supply;

35.5 This 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

35.6 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.

**Proposal**

36 I propose that the main focus of our IFF work be on **alternative financing models**. By introducing an alternative approach to financing infrastructure, we should be able to lift the burden off local authorities of having to be financing models for infrastructure that is needed, yet also not require central government to be writing out cheques every few months. If we get this right, it will turn on a tap of infrastructure finance for new development and will allow our cities to respond to demand and grow.

37 Under the proposed alternative financing system, a new entity (referred to here as a Special Purpose Vehicle or SPV) will be established to deliver an infrastructure project. The SPV becomes responsible for ensuring that the infrastructure asset is financed, developed and managed for the period over which the development cost of the infrastructure asset is paid

38 The SPV funds and finances new infrastructure directly, outside of local authorities. They do this by charging the beneficiaries of the infrastructure an amount over a long period of time (typically 25 years), and using this money to pay off the capital costs of the infrastructure. It removes financial responsibility from the local authority, yet ownership of the assets will still ultimately vest with the local authority. Risk is transferred away from general ratepayers, by virtue of the ring-fencing from the balance sheet liability of local authorities.

39 There are a range of alternative financing models that could increase the provision of infrastructure. The SPVs could either 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 which are paid by an identified group of beneficiaries. To achieve this, we would need legislative change as at present only local authorities have the power to set targeted rates for landowners.

40 I consider that alternative financing models should be explored because if successful they will:

40.1 allow for a much greater quantity of debt to be leveraged from revenue streams than would be possible through a local authority;

40.2 make 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;

40.3 provide greater rigour in the allocation of risk and costs to the appropriate parties;

40.4 allow viable projects to proceed outside of the local authorities framework and allows the system to be aligned to anticipated urban demand;

40.5 allow costs to fall on the communities and homeowners who benefit from the new infrastructure;

40.6 provide a pipeline designed to allow new capital to flow into the system; and

40.7 provide price signals to growth occurs where the provision of infrastructure is most cost efficient.

41 Introducing alternative methods of financing provides a real opportunity to bring forward investment and finally address the problems raised in paragraph 35 in an enduring way. If we want a lasting solution to the housing problem, we have to make reforms that will allow the market to deliver better outcomes on its own and ensure we can access private capital. This will take courage, yet courage is required to make the broad, significant and enduring changes required.

42 I 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. All feature the same key characteristics: long-term secure revenues paid by the beneficiaries of the new infrastructure that are ring-fenced from the balance sheet, debt capacity or credit rating of the local authority.

*Long-term secure revenues:*

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

43.1 Taxing powers: The Local Government (Rating) Act 2002 (the LGRA) provides local authorities with flexible powers to set, assess and collect rates from landowners.

43.2 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.

44 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.

45 The second challenge is ensuring these funding streams can be committed for long periods of time. Currently rates can only be set for one year at a time meaning there is a risk that each year they are re-litigated and/or not reset. Financiers will require certainty that the revenues are secured for the agreed financing term (this could be for a 25 to 30 year period).

*Ring-Fencing Debt:*

46 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 of the project. This is known as "ring-fencing".

47 Ring-fencing has two main components:

47.1 Financial Recourse: Any delivery model 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.

47.2 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.

48 Without ring-fencing, any new borrowings would be included in the local authorities debt to revenue ratios.

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

50 We may also need to find a credible alternative party to step-in if required if a project fails, particularly where there is either:

50.1 a moral obligation to keep some infrastructure functioning (e.g. water networks) and we would need certainty this infrastructure would continue to be delivered in the event of distress; or

50.2 a view by rating agencies that unless an alternative to local authorities is identified, we will not achieve ring-fencing.

51 This party could be the Crown or another entity that has sufficient capability to fulfil and manage any potential future obligation. We will consider all options during the policy/legislative phase of this work.

*Credit Rating Agency Treatment*

52 The treatment by rating agencies will be one of the most important factors in determining whether the potential delivery models achieve their purpose. If the rating agencies still view alternative financing models as being an obligation of local authorities, we will not have achieved our goals for alternative financing models. For that reason, a rating agency assessment is a critical milestone before we commence any formal legislative work programme, and we would look to achieve that by the end of 2018.

53 A rating agency assessment is a formal submission to Credit Rating Agencies (such as S&P, Moody's and Fitch) of an information memorandum (IM). The IM provides the rating agencies with a detailed overview of a project, together with a summary analysis of the risks inherent in the project. The rating agencies use this information to test the ability of a particular structure to achieve the desired outcomes and the impact to the Crown, local authority and SPV. Whilst these

assessments follow a prescribed methodology, they also involve subjectivity, so outcomes cannot be fully anticipated in advance. New Zealand in particular does not have relevant precedent of these type of transactions (although there are a number internationally). I would expect a formal assessment to be provided within 6 weeks of submitting the IM.

54 I will not be able to submit an IM without a project on which it is based. The Central Interceptor Project was identified by Auckland Council as a potential SPV pilot project, and they have committed significant time and resources to this project. Auckland Council are testing Councillors and Watercare's appetite to proceed with this as a SPV pilot, so we should know by December whether this is a viable project. This is a complex project and we would need to test its suitability as a pilot project. However, regardless of that outcome, I think we will be able to utilise the work done to date for a rating agency assessment, even if it doesn't ultimately proceed under an alternative financing system. The Central Interceptor project has had the most work done to date and would enable a comprehensive IM to be submitted within the next few months.

*Pilot Projects*

55 I do also see clear benefit of having pilot projects for alternative financing in place over the next year so that once the legislation is passed, we have projects that are good to go. Using pilots to measure impact is also a robust way of establishing what works, for whom, why and at what cost. 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.

56 I will work closely with Treasury and high growth local authorities to identify which are the most suitable projects to pilot. These options will be within the next report back to Cabinet.

**Policy Considerations**

57 We will need to ensure that we fully consider all the policy implications when developing the alternative financing system. Key policy issues to be considered as part of any legislative change are set out below. I will report back to Cabinet with the outcome of this work and options for consideration by Cabinet.

*How charges are set*

58 A key consideration is likely to be whether and how to regulate charges, and monitor the type and level of charges being set, who they should be set against and the interrelationship between these charges and the setting of rates by local authorities.

59 We will need to consider how the revenue streams are structured and whether they are collected as charges, levies or rates. Each has specific meanings and different accountability requirements.

60 The work being led by MBIE, on the wider costs and benefits of growth will identify direct and indirect costs of a new development and this will be a key input into

working out the total cost of any new project, and then how these costs could be allocated. We will need to consider what costs should be attributed to the SPV, and then assess the impact this has on the total charge being set.

61 The approach to charging may also vary when it is a greenfield site (i.e. new developments where ratepayers have a choice whether to "buy" into the charge), as opposed to brownfield sites (i.e. existing sites where charges could be applied to existing ratepayers with limited option to opt out).

*Taxation without representation*

62 We will need to consider the parameters for how a third party (i.e. developers) or Crown could provide bulk infrastructure and potentially be granted the power to set taxes and charges to pay for the costs of that infrastructure. We will especially need to consider the democratic accountability connected with granting local taxing or user pay powers to third parties or the Crown. We are also likely to need to consider how to manage the interests of local authorities (i.e. 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).

63 The taxation with representation issue may be easier to resolve for greenfield areas where future land owners are able to "opt-in" to any infrastructure charges than for brownfield areas where opting in would not be practicable.

*Social equity considerations*

64 We will need to consider whether there are any equity concerns with introducing an alternative approach to financing infrastructure. We will consider whether any groups will be disproportionately affected by any of the models we consider.

*How projects are approved*

65 We will need to consider who has ultimate responsibility for approving a project to proceed. We will also need to consider operational detail such as what must be included in any feasibility analysis to assess whether a project has merit to proceed within the SPV model and what is the local authority and Crown role in approving these. Whilst we would hope for a culture of partnership with SPV's providing infrastructure that support local authority plans, we do need to consider all options. Do local authorities, for example, have the right of veto for any project, or must they grant approval within certain parameters for developer led SPvs.

66 We will also need to consider whether this legislation covers a particular infrastructure class (i.e. bulk infrastructure) or could apply to any project.

*Asset ownership and standards*

67 We will consider whether long-term third party (private sector) ownership of key infrastructure is an option. We will consider who is responsible for the long-term obligations relating to the asset. We could also consider vesting issues and wider issue related to asset ownership such as whole of life cost and whether asset ownership can differ between construction phase, financing phase and after financing is repaid.

*SPV ownership/structure*

68 We will need to consider the differences between asset ownership and SPV ownership, and in what circumstances Crown ownership of the SPV may be considered (including by Crown Entities).

69 There may be different considerations depending on the nature of the asset, if it is of significance to iwi or if it is considered undesirable to be privately owned. This may also include the process for addressing scenarios where there is a serious default/issue with the SPV.

70 We will want to consider whether projects can be bundled within one SPV (as opposed to one SPV per project) to allow economies of scale.

71 We will need to consider contractual structures to ensure that the models do not become cost prohibitive.

*Balance Sheet Constraints*

72 I am aiming to design a system where the project debt has no material influence on the respective credit ratings of the Crown and local authority entities, so as to:

72.1 Minimise the impact of the project on the cost and quantum of existing public debt

72.2 Maximise the local authorities debt capacity for other opportunities

73 We will need to consider how this is achieved. The most explicit way of achieving this outcome is to achieve off-balance sheet treatment whereby the debt liability (and the associated asset) are not reflected within local authority and Crown financial statements.

74 Another way is for the debt to sit on-balance sheet for the local authority (and/or the Crown) but for rating agencies to make exclusionary adjustments for this during their assessment processes. 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, it took decades to achieve such a system and it is untested in New Zealand. It is unlikely to be achieved immediately in New Zealand.

*The Role of Central Government*

75 We will need to consider the role of central government in any alternative financing system. We may also wish to consider when the role of the Crown as owner may be palatable in the provision of bulk infrastructure, for example, Crown agency led infrastructure projects.

76 Crown support in the form of appropriate residual risk taking could be an effective and relatively low cost manner to facilitate the alternative models. [38]
[38]

*Economic Regulation*

77 Any inclusion of private investment in infrastructure assets places additional focus on the need for appropriate regulatory oversight. We will need to consider whether these models require regulatory oversight. The regulatory regime for the three

waters, including the need for economic regulation, is being considered by the Three Waters Review project. We will also need to consider similar issues for transport assets.

**Complementary Workstreams**

78 I see alternative financing models as the game changer in infrastructure funding and financing. However, I have also identified two complementary workstreams that I propose are pursued as part of the IFF workstream

**Expanding Local authority Borrowing**

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

80 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)[1]. 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.

81 I note the risk of increased debt levels for local authorities (local authorities 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. The current debt/revenue ratio is very conservative (with debt at only 250% of revenue) considering the long life of the assets and the security of the revenue stream to service debt. Utility companies can have net debt to revenue ratios of 700-1400 percent. Whilst Local authorities provide more than utility services (so we would not expect as high a ration), I do support relaxing the constraints in a controlled manner to less conservative levels.

82 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 local authorities. However, addressing these constraints will be complex and require shareholder[2] agreement to amend the LGFA covenants and supporting regulatory changes to amend the Benchmarking Regulations would be desirable.

**Providing a broader range of tools and mechanisms**

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

[1] 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.
[2] 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 local authorities hold 80%.

84 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, I have focussed on identifying any other gaps or assessing if there is any benefit in fast tracking existing work programmes.

85 In general, the assessment is that the existing funding tools are generally fit for purpose, but are not used optimally (including not pricing services or assets accurately), and work on new funding tools is already underway in the majority of the areas that require attention. The Local Government Funding Review will deep dive into these issues and provide a comprehensive assessment of how these tools could be optimised.

86 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[3]. This work would primarily 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.

**Other Issues**

87 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.

88 This paper has concentrated on the technical constraints, which are challenging to address, but certainly possible. However, even once we have dealt with the technical constraints (regulatory or legislative) that prevent local authorities being able to fund or finance infrastructure; there are a number of behavioural constraints that influence the behaviour and practice of local authorities. Shifting behaviours may prove to be harder than addressing the technical issues. Yet I do believe that by agreeing to the alternative financing reform, we will make significant steps to enabling an enduring, scalable and affordable housing market.

89 Influencing the behaviour of local authorities is likely to be most successful if technical change is combined with incentives to partner and education about the merits of the new system. The overall approach could take the form of an arrangement between central and local authority to partner. Developing a clear understanding of the forms of support central government is willing to consider will be important in the overall success of the IFF programme. We will also consider how this type of arrangement could be developed across the UGA pillars.

[3] 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.

## IFF work programme over the next six months

90 I intend to report back to Cabinet at the end of 2018/early 2019 on the results of this work and present options on the nature and degree of system reform, including potential legislative/policy changes that are required to give effect to the IFF. This may have implications for the roles of central and local authorities. This would be the main decision point before proceeding to formal legislation.

91 The IFF work will be delivered through a cross-agency programme led by the Treasury, and involving the Department of Internal Affairs, the Ministry of Housing and Urban Development, MfE, MBIE, MoT and NZTA.

92 Working closely with local authorities, as the primary implementers of the bulk infrastructure, will be critical to delivering the aims of the IFF work programme. I expect the high growth local authorities to be important stakeholders within this programme. We intend to work initially with Auckland, Hamilton, Tauranga, Queenstown and Wellington local authorities. Whilst Christchurch is also a high growth local authority, due to the number of existing central and local authority interventions and relationships connected to the Greater Christchurch Regeneration project, they will not be an initial partner for alternative financing.

## IFF implementation plan

93 It is important that any alternative financing system is scalable, implementable, accessible and replicable. I envisage that once legislation is passed, that we need a market facing entity that could:

93.1 identify eligible infrastructure projects, from both public and private sources, that comply with the overarching principles noted above; and

93.2 design a transaction or commercial structure for each eligible project, including approving the necessary revenue streams to fund the project.

94 I would like this market facing entity to be open for business by mid-2019, so that a pipeline of projects can be ready to go as soon as the legislation is passed. Further work on the form and functions of this entity will be included in the Cabinet report back. This could range from an existing agency to the LGFA to CIP to a new entity. I will instruct officials to fully consider the functions required before advising on preferred form.

95 Central Government will also need to ensure a partnership with local authorities during the implementation phase of the IFF. This will need to be developed throughout the IFF work programme.

96 To achieve a scalable, implementable, accessible and replicable system, I have also not proposed that central government considers, at this stage, directly funding/financing bulk infrastructure.

## Relationship with other areas of work

97 There are significant interdependencies between the IFF workstream and other areas of work across government. I will look to ensure that work on these interdependent work-streams are well-integrated including reporting through to Ministers where applicable. This includes the other pillars of the UGA.

98 Key areas of work that relate closely to the IFF include:

*Three Waters Review*

99 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 models.

*Infrastructure Institutional Settings Review (IISR)*

100 The Minister of Infrastructure has asked the National Infrastructure Unit (NIU) within Treasury to look at the adequacy of central and local authorities 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 authorities 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 and procurement of projects under the alternative financing system.

*Urban Development Authority*

101 I have proposed 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 benefit from funding and finance tools created by the IFF, which would complement the UDA's own funding and financing powers for large scale projects.

*Local Government Funding Review (LGFR)*

102 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. Any outcomes from the IFF work programme will be fed into this broader review.

*The UGA Pillars*

103 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.

## Governance arrangements

104 I propose that Ministerial oversight be led by myself and the Minister of Finance. I will work with Urban Growth Agenda Ministers[4], the Minister of Local Government and other Ministers where appropriate.

## Consultation

105 This paper has been prepared by Treasury. The following agencies have been consulted: DIA, MBIE, MfE, MoT and NZTA. We have informed DPMC of the paper.

## Financial implications

106 This work-programme is only in its infancy, so there is uncertainty as to the level of funding and resources required. However, we expect funding needs to be in the range of up to $8 million over the course of 2018/19 and 2019/20 for officials to deliver the IFF work programme. This includes funding required for staffing, the formal rating agency assessments [37] [37] commercial structuring, the legislative programme, setting up a market facing entity and the pilot projects.

*Transferring funding from Crown Infrastructure Partners*

107 $600 million was recently appropriated to provide Crown Infrastructure Partners with funding to invest in water and roading infrastructure to support the timely increase of housing supply. This has been funded with $300 million from each of the Budget 2018 and Budget 2019 capital allowances. CIP's latest forecasts indicate that it expects to spend $477 million between now and 2021/22, with the balance of $123 million to be spent from 2022/23 and beyond, although based on the findings from the current project, we think it is unlikely to realise these forecasts. The first project for CIP is likely to only require $4.1 million as an equity investment.

108 I recommend that funding be reallocated from this appropriation to deliver the IFF work programme. The Cabinet decision in connection with CIP, and subsequent public statements, was that <u>up to</u> $600 million will be provided to CIP for the purpose noted above, and therefore re-directing funding from this source is not inconsistent with those statements. The money appropriated for CIP has a similar purpose to that required under the IFF programme and will have no impact on the ability for CIP to deliver its work programme. However, transferring funding from this appropriation arguably constitutes a 'significant policy decision' set out in paragraph 5.12 of the Cabinet manual, and therefore requires the approval of Cabinet.

109 Given that further analysis is still required to determine exactly how much funding is needed for the programme, and on what specific activities it is to be used for, I recommend that Cabinet delegate authority to myself and the Minister of Finance to make the necessary changes to appropriations to transfer up to $8 million of funds from CIP to the IFF work programme (including establishing new appropriations for the latter, if necessary).

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[4] Minister Parker: The Minister for the Environment; Minister Jones: The Minister of Infrastructure; Minister Genter: The Associate Minister of Transport

*Further budget bids*

110 Further budget bids may be required depending on any Crown capital requirements to facilitate the outcomes of the IFF work programme.

## Human rights, gender implications, disability perspective

111 There are no human rights, gender, or disability issues or implications associated with this paper.

## Legislative implications

112 Options that are identified through one or more of the workstreams described in this paper may require legislation to implement, and result in bids for a reprioritisation of the 2018 legislative work programme, or inclusion in the 2019 legislative programme.

113 I would expect, at best, 3 months for drafting the bill and 6 months for the legislation to pass through the house.

114 Any legislative implications of the IFF work programme will be covered in the report back to Cabinet

## Regulatory impact analysis

115 A regulatory impact statement may be required for the proposals in this paper and will be covered in the report back to Cabinet.

## Publicity

116 There is likely to be widespread stakeholder interest in this work, including from local authorities. Accordingly we intend to proactively release this Cabinet paper. I will engage with local authorities and other interested stakeholders on the IFF over the course of 2018.

## Recommendations

The Minister of Housing and Urban Development/Transport recommends that the Committee:

a **note** that the high cost and shortage of housing is partly due to deep seated problems with the operation of our urban land markets and how infrastructure is planned, funded, and financed.

### Financing: Alternative Financing Models

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

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

d **direct** Treasury officials to undertake targeted engagement with Auckland, Hamilton, Tauranga, Queenstown and Wellington local authorities and report back to Ministers with options for alternative financing model pilot projects e **direct** Treasury officials to work immediately with Auckland Council on preparing a rating agency assessment, that may include use of work undertaken by Auckland Council on the Central Interceptor project

f **direct** Treasury officials to undertake work on establishing the market facing entity that can facilitate the alternative financing models

g **direct** Treasury officials to report back to Cabinet by early 2019 on the outcome of the work undertaken on alternative financing models; and

h **note** that the view of the Credit Rating Agencies and Office of the Auditor General will be a critical milestone in establishing the viability and structure of alternative financing options

**Financing: Expanding Local Authority Borrowing**

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

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

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

**Funding**

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

m **direct** the Treasury and DIA to undertake targeted engagement with high growth local authorities 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.

**Strategy**

n **note** that MBIE is leading work on measuring and options for recovering the wider local and central government infrastructure costs which result from greenfield and brownfield developments as part of the Urban Growth Agenda.

o **note** that these wider costs should be properly taken into account so that the true costs of growth are transparent and shared by the appropriate beneficiaries.

p **note** that this work should form part of the assessment when determining the allocation of costs to pilot projects in alternative financing models, but care be taken in the transitional pilots not to load a burdensome share in comparison to existing funding and financing methods

q **note** that a package deal may need to be struck between central and local authorities to encourage behavioural changes in the sector, which may include central government financial support r **note** that the only approach likely to effect immediate change to infrastructure provision will be full central government funding and financing bulk infrastructure

s **note** that Officials will not consider central government funding and financing bulk infrastructure unless it receives specific instructions from Ministers to do so

**Budget**

t **note** that the cost of the Infrastructure Funding and Financing work programme is expected to be up to $8 million over 2018/19 and 2019/20

u **note** that there is currently $600 million appropriated for Crown Infrastructure Partners and that up to $8 million can realistically be reprioritised in a fiscally neutral manner to the Infrastructure Funding and Financing work programme

v **agree** that up to $8 million of funding currently allocated to Crown Infrastructure Partners be reallocated to enable the IFF work programme to proceed

w **authorise** the Minister of Housing and Urban Development and the Minister of Finance to jointly make the necessary changes to appropriations (including establishing any new appropriations as necessary) to give effect to the decision in recommendation c above

Authorised for lodgement

Hon Phil Twyford

**Minister of Housing and Urban Development**