AUDIT OPINION ON PROPOSED AMENDMENT TO 2009 NELSON COMMUNITY PLAN

AUDIT NEW ZEALAND
Mana Arotake Aotearoa

Report to the readers of Nelson City Council's proposed amendment to the Long-Term Council Community Plan for the ten years commencing 1 July 2009 Statement of Proposal for public consultation

The Auditor-General is the auditor of Nelson City Council (the City Council). The Auditor-General has appointed me, Scott Tobin, using the staff and resources of Audit New Zealand, to audit the proposed amendment to the Long Term Council Community Plan (the Statement of Proposal), on her behalf.

The Nelson City Council (the City Council) adopted its Long Term Council Community Plan (LTCCP) for the ten years commencing 1 July 2009 on 25 June 2009.

We expressed an unqualified opinion on the City Council's LTCCP in our audit report dated 25 June 2009.

We considered that the LTCCP provided a reasonable basis for long term integrated decision-making by the City Council and for participation in decision-making by the public and subsequent accountability to the community about the activities of the City Council.

The City Council is now proposing to amend its LTCCP to change its liability management policy and investment policy. The Statement of Proposal provides information about the proposed amendment and any consequential amendments to the LTCCP that will be required if it is amended in the manner proposed.

We are required by section 84(4) of the Local Government Act 2002 (the Act) to report on:

- the extent to which the Statement of Proposal complies with the requirements of the Act; and
- the quality of information and assumptions underlying the forecast information provided in the Statement of Proposal.

Those reporting requirements differ from the reporting requirements we had for the LTCCP for the ten years commencing 1 July 2009, due to recent changes to the Act.

Opinion

Overall Opinion

In our opinion, the information within the Statement of Proposal on pages 152 to 162, dated 24 March 2011 about the proposed amendment and any consequential amendments to the LTCCP that will be required if it is amended in the manner proposed, is fairly presented and the City Council has complied with the applicable requirements of the Act in preparing the Statement of Proposal.

In forming our overall opinion, we considered the specific matters in section 84(4) of the Act which we report on as follows.

Opinion on Specific Matters Required by the Act

In our view:

- **the City Council has complied with the requirements of the Act in all material respects demonstrating good practice for a council of its size and scale within the context of its environment; and**
- **the underlying information and assumptions used to prepare the Statement of Proposal provide a reasonable and supportable basis for the preparation of the forecast information.**

Actual results are likely to be different from the forecast information since anticipated events frequently do not occur as expected and the variation may be material. Accordingly, we express no opinion as to whether the forecasts will be achieved.

Our report was completed on 11 March 2011. This is the date at which our opinion is expressed.

The basis of the opinion is explained below. In addition, we outline the responsibilities of the City Council and the Auditor, and explain our independence.

Basis of Opinion

We carried out the audit in accordance with the International Standard on Assurance Engagements 3000: Assurance Engagements Other Than Audits or Reviews of Historical Financial Information and the Auditor-General's Auditing Standards, which incorporate the New Zealand Auditing Standards. We have examined the forecast financial information in accordance with the International Standard on Assurance Engagements 3400: The Examination of Prospective Financial Information.

We planned and performed our audit to obtain all the information and explanations we considered necessary to obtain reasonable assurance that the information within the Statement of Proposal, about the proposed amendment to the LTCCP and any consequential amendments does not contain material misstatements. If we had found material misstatements that were not corrected, we would have referred to them in our opinion.

Our audit procedures included assessing whether:

- the Statement of Proposal provides the community with sufficient and balanced information about the strategic and other key issues, choices and implications it faces to provide an opportunity for participation by the public in decision making processes;
- the presentation of the Statement of Proposal complies with the legislative requirements of the Act;
- the decision-making and consultation processes underlying the development of the Statement of Proposal comply with the decision-making and consultation requirements of the Act;

We do not guarantee complete accuracy of the information in the Statement of Proposal. Our procedures included examining on a test basis, evidence supporting assumptions, amounts and other disclosures in the Statement of Proposal and determining compliance with the requirements of the Act. We evaluated the overall adequacy of the presentation of information. We obtained all the information and explanations we required to support our opinion above.

Responsibilities of the Council

The City Council is responsible for preparing a Statement of Proposal to amend its LTCCP. The City Council's responsibilities include applying assumptions and presenting the financial information in accordance with generally accepted accounting practice in New Zealand. The City Council's responsibilities arise from sections 93 and 111 of the Act.

Responsibilities of the Auditor

We are responsible for expressing an independent opinion on the Statement of Proposal and reporting that opinion to you. This responsibility arises from section 15 of the Public Audit Act 2001 and section 84(4) of the Act.

It is not our responsibility to express an opinion on the merits of any policy content within the Statement of Proposal.

Independence

When reporting on the Statement of Proposal we followed the independence requirements of the Auditor-General, which incorporate the independence requirements of the New Zealand Institute of Chartered Accountants.

Other than this report, and in conducting the audit of the LTCCP and the annual audit, we have no relationship with or interests in the City Council.

S M Tobin
Audit New Zealand
On behalf of the Auditor-General
Christchurch, New Zealand

STATEMENT OF PROPOSAL TO UPDATE LIABILITY MANAGEMENT POLICY AND INVESTMENT POLICY IN VOLUME TWO, 2009-19 NELSON COMMUNITY PLAN

Summary

Nelson City Council proposes to update the Liability Management Policy and Investment Policy to:

- Take a longer term view of funding and interest rate risk management
- Therefore minimise the impact of interest rate changes on ratepayers over time

Details of proposal

The Liability Management Policy has been updated to include best practice benchmarks for:

- Fixed/Floating Risk Control limits
- Fixed Rate Maturity Profile Limit
- Maturity profile of the total committed funding
- Specific borrowing limits
- Interest rate risk management instruments
- Cash management and borrowing instruments

The Investment Policy has been updated to include best practice benchmarks for:

- Cash management investment instruments
- Counterparty limits

Proposed amendment to 2009 Nelson Community Plan, Volume 2

Pages 119 to 121 of the 2009-19 Nelson Community Plan volume two, being the full Liability Management Policy and pages 136 to 138 covering the Treasury Investments and Investment Limits and Controls sections of the Investment Policy, are proposed to be replaced with the updated policies that follow this section on pages 155-162 inclusive.

The key features of the proposed changes are:

- Debt ratios and limits have been updated to be consistent with best practice benchmarks
- Council's external borrowings and interest-rate risk management instruments are now secured by way of a charge over rates and rates revenue offered through a Debenture Trust Deed rather than a Security Sharing Deed

Reason for the proposal

The proposal to amend the policy allows the Council to take a longer term (10 year) view of interest rates.

Consideration of alternative options

While the status quo was considered, Council determined that it was in the best interests of ratepayers to amend the policy. Council took independent advice to ensure the new policy was in line with best practice Treasury Management.

DISCUSSION

Financial considerations

There is a financial impact of changing the policy. It is not possible to quantify the financial effect as this will depend on future interest rates. In the 2009-19 Nelson Community Plan the interest rate assumed over the 10 year period was 5.5% to 6.75%. The intent of the change is to minimise the impact of interest rate changes on ratepayers over a 10 year time horizon, so it is intended and expected to be a net positive financial effect for ratepayers.

Social and cultural effects

Council is not aware of any significant social or cultural effects that could arise as a result of implementing this proposal.

Environmental effects

Council is not aware of any significant environmental effects that could arise as a result of this proposal.

Economic effects

Refer to the section on financial considerations. Ratepayers are expected to benefit from this proposed policy change.

Proposed amendment to the 2009-19 Nelson Community Plan

It is proposed that the policy from pages 119 to 121 and 136 to 138 of volume two of the 2009 Nelson Community Plan be replaced with the updated policies that follow this section.

Performance measures

Performance measures for the Liability Management Policy and Investment Policy are included in the policies.

Period of submissions

An amendment to the Nelson Community Plan would normally require a separate published summary of the proposal. However, given the short length of this amendment, the summary has been incorporated into this draft Annual Plan and referred to in the draft Annual Plan summary. Submissions in response to this Statement of Proposal can be made on the form included in this document, or online at www.nelsoncitycouncil.co.nz. Submissions must be received by Council no later than 4pm on Friday 29 April 2011. You may ask to appear before Council to speak to your submission if you would like to do so.

LIABILITY MANAGEMENT POLICY

Interest rate exposure

Interest rate exposure refers to the impact that changes in interest rates can have on the Council's cash flow. The Council's policy for interest rate risk management is to take a conservative, risk-averse approach by requiring a certain percentage of the Council's borrowing to be fixed rate or hedged borrowing. Both the long-term nature of the Council's assets and the need for intergenerational equity mean it is important that the Council should:

- Have predicable interest costs and
- Avoid increases in annual rates caused by interest rate rises

How interest rate risk is managed: the rules

The Council's core net debt should be within the following fixed/floating interest rate risk control limits:

Master Fixed / Floating Risk Control Limits	
Minimum Fixed Rate	**Maximum Fixed Rate**
55%	95%

"Fixed Rate" is defined as an interest rate re-pricing date beyond 12 months forward on a continuous rolling basis.

"Floating Rate" is defined as an interest rate re-pricing within 12 months.

The percentages are calculated on the rolling 12 month projected net debt level calculated by management and signed off by the Council's Chief Executive. Net debt is the amount of total debt net of cash or cash equivalents. This allows for pre-hedging in advance of projected physical drawdown of new debt. When approved forecasts are changed, the amount of fixed rate cover in place may have to be adjusted to ensure compliance with the Policy minimums and maximums.

The fixed rate amount should be within the following maturity bands:

Fixed Rate Maturity Profile Limit		
Period	**Minimum Cover**	**Maximum Cover**
1 to 3 years	20%	60%
3 to 5 years	20%	60%
5 years plus	10%	60%

- Floating rate debt may be spread over any maturity out to 12 months. Bank advances may be for a maximum term of 12 months

- Interest rate options must not be sold outright. However, one for one collar option structures are allowable, whereby the sold option is matched precisely by amount and maturity to the simultaneously purchased option. During the term of the option, only the sold side of the collar can be closed out (i.e. repurchased). Otherwise both sides must be closed simultaneously. The sold option leg of the collar structure must not have a strike rate 'in-the-money'
- Purchased borrower swaptions mature within 12 months
- Interest rate options with a maturity date beyond 12 months that have a strike rate (exercise rate) higher than 2.00% above the appropriate swap rate, cannot be counted as part of the fixed rate cover percentage calculation

The forward start period on swaps and collar strategies is to be no more than 24 months, and the underlying cap or swap starts within this period.

Risk management instruments

The following instruments may be used for interest rate risk management activity

Category	Instrument
Interest rate risk management	Forward rate agreements ("FRAs") on: • Bank bills • Government bonds Interest rate swaps including: • Forward start swaps (start date <24 months) • Swap extensions and shortenings Interest rate options on: • Bank bills (purchased caps and one for one collars) • Government bonds • Interest rate swaptions (purchased swaptions and one for one collars only)

- Interest rate options must not be sold outright. However, one for one collar option structures are allowable, whereby the sold option is matched precisely by amount and maturity to the simultaneously purchased option. During the term of the option, only the sold side of the collar can be closed out (i.e. repurchased) otherwise, both sides must be closed simultaneously. The sold option leg of the collar structure must not have a strike rate 'in-the-money'
- Purchased borrower swaptions and swaption collars mature within 12 months

- Interest rate options with a maturity date beyond 12 months that have a strike rate (exercise rate) higher than 2.00% above the appropriate swap rate, cannot be counted as part of the fixed rate cover percentage calculation
- Forward start period on swaps to be no more than 24 months from deal date

Any other financial instrument must be specifically approved by the Council on a case-by-case basis and only be applied to the one singular transaction being approved.

Liquidity and funding risk management

Liquidity risk management refers to the practice of making sure funds can be available when needed, without incurring penalties for breaking investments before time. The Council does not hold all its reserves in cash and must anticipate and plan for drawings against reserves.

The Council's objective for funding risk management is to minimise the risk of large concentrations of debt being reissued at a time when interest rates are high for reasons beyond the Council's control.

Policy

The Council's policy for liquidity and funding risk management is:

- Ensure that the Council's committed debt facilities and term loans mature over a wide time period
- Term loans and committed debt facilities must be maintained at an amount of 110% over projected peak net debt levels over the next 12 months
- Diversify borrowing over a range of bank and debt capital market lenders

Rules

The Council's rules for managing liquidity and funding risk are that the maturity profile of the total committed funding in respect to all loans and committed debt facilities is to be controlled by the following system:

Period	Minimum Cover	Maximum Cover
0 to 3 years	20%	60%
3 to 5 years	20%	60%
5 years plus	0%*	60%

*a minimum of at least 10% should core debt amounts increase above $50 million.

A maturity schedule outside these limits will require specific Council approval.

Credit exposure

The Council imposes a minimum long term credit rating on its bank lenders of A+ or better, as determined by Standard and Poor's or equivalent international credit rating agency. Hedging facilities are only with organisations that have a long term A+ or better credit rating.

Debt repayment

The Council repays borrowings from rates, debt raising, surplus funds, proceeds from the sale of investments and fixed assets.

Note that the proceeds from sales of fixed assets and investments may also be used for the acquisition of other fixed assets.

Borrowing mechanisms

The Council will borrow through a variety of market mechanisms including approved financial instruments as follows:

Category	Instrument
Cash management and borrowing	• Bank overdraft • Committed cash advance and bank accepted bill facilities (short term and long term loan facilities) • Uncommitted money market facilities • Retail and Wholesale Fixed Rate Bond and Floating Rate Note (FRN) issuance • Commercial paper (CP)

Any other financial instrument must be specifically approved by the Council on a case-by-case basis and only be applied to the one singular transaction being approved.

Specific borrowing limits

The Council's policy for borrowing limits is to adhere to the following:

Item	Borrowing Limit
Net interest expense on external debt as a percentage of total revenue to be less than:	15%
Net interest expense on external debt (secured by rates) as a percentage of rates revenue to be less than:	20%
Net external debt (secured by rates) as a percentage of total revenue to be less than:	150%
Net external debt (secured by rates) as a percentage of equity to be less than:	20%

Revenue is defined as earnings from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue. Revenue excludes non government capital contributions (e.g. developer contributions and vested assets).

Net debt is defined as total debt less liquid cash or cash equivalents.

Security policy

Council's external borrowings and interest-rate risk management instruments will generally be secured by way of a charge over rates and rates revenue offered through a Debenture Trust Deed. Under a Debenture Trust Deed Council's borrowing is secured by a floating charge over all Council rates levied under the Rating Act. The security offered by Council ranks equally or pari passu (on equal terms in all respects, at the same rate, or proportionately) with other lenders.

From time to time, with Council and Trustee approval, security may be offered by providing a charge over one or more of Council's assets.

Physical assets will be charged only where:

- There is a direct relationship between the debt and the purchase or construction of the asset, which it funds (e.g. an operating lease, or project finance)
- Council considers a charge over physical assets to be appropriate
- Any pledging of physical assets must comply with the terms and conditions contained within the Debenture Trust Deed

INVESTMENT POLICY – following sections only

Treasury investments

Background

The Council maintains treasury investments, including general reserves and restricted reserves, in order to invest:

- surplus cash, and working capital funds
- funds allocated for the purpose of accumulating surplus
- funds allocated for approved future expenditure, implementing strategic initiatives, supporting intergenerational allocations and proceeds from the sale of assets

Policy

The Council's policy for its treasury investments is to use only credit-worthy counterparties with a strong Standard and Poor's rating or equivalent international credit agency.

Rationale

The Council's primary objective is the protection of its investment.

Benefits

The main benefit of treasury investments is that they provide funds for capital expenditure as needed.

Risk

The fixed rate investment is vulnerable to changes in interest rates and this can impact on both the returns available, and the capital value of the investment, if sold before maturity.

The amount invested and return is at risk from a counterparty default, where the party is unable to repay principal and interest amounts as they fall due.

Investment limits and controls

Policy and rules

The Council ensures it receives amounts owed to it in full and on due dates by undertaking investments only with institutions that have a strong Standard and Poor's or equivalent international credit agency credit rating and by applying the following rules for investment counterparty controls:

- Limit total exposure to prescribed amounts, as set out below

Rules on investment risk

Approved financial instruments are as follows:

Category	Instrument
Cash management investments (up to six months)	• Call and short term bank deposits • Bank certificates of deposit (RCDs) • Treasury bills • Promissory notes/commercial paper (senior)

Any other financial instrument must be specifically approved by the Council on a case-by-case basis and only be applied to the one singular transaction being approved.

Counterparty credit risk

Counterparty credit risk is the risk of losses (realised or unrealised) arising from a counterparty defaulting on a financial instrument where the Council is a party. The credit risk to the Council in a default event will be weighted differently depending on the type of instrument entered into.

Credit risk will be regularly reviewed by the Council. Counterparties and limits can only be approved on the basis of long-term Standard and Poor's or equivalent international credit rating agency credit rating being A+ and above or short term rating of A-1 or above.

Limits should be spread among a number of counterparties to avoid concentrations of credit exposure.

The following matrix guide will determine limits:

Counterparty/ issuer	Minimum long term/short term credit rating	Investments maximum per counterparty ($million)	Interest rate risk management instrument maximum per counterparty ($million)	Total maximum per counterparty ($million)
NZ Government	N/A	Unlimited	None	Unlimited
NZ Registered Bank	A+/ A-1	10.0	10.0	20.0
Corporate CP	A+/ A-1	2.0	None	2.0

In determining the use of the above gross limits, the following product weightings will be used:

- Investments (e.g. Bank Deposits) – Transaction Principal × Weighting 100% unless a legal right of set-off exists
- Interest Rate Risk Management (e.g. swaps, FRAs) – Transaction Notional × Maturity (years) × 3%
- Foreign Exchange – Transactional face value amount x the square root of the Maturity (years) x 15%