

Credit Opinion: Auckland Council

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New Zealand

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aa2
Senior Secured	Aa2

Contacts

Analyst	Phone
Debra Roane/Sydney	612.9270.8145
Mary Anne Low/Sydney	612.9270.8137
David Rubinoff/London	44.20.7772.5454

Key Indicators

Auckland Council

As at June 30	2011	2012	2013	2014	2015B
Net Direct and Indirect Debt/Operating Revenue (%)	103.1	127.9	154.6	158.4	183.0
Net Direct and Indirect Debt/Total Revenue (%)	89.8	116.9	136.5	137.2	164.6
Gross Operating Balance/Operating Revenue (%)	4.1	5.0	15.1	17.3	13.5
Interest Payments/Operating Revenue (%)	11.5	10.0	11.4	12.2	13.5
Cash Financing Surplus (Requirement)/Total Revenue (%)	-27.2	-27.4	-23.5	-19.9	-27.4
Short-Term Direct Debt/Direct Debt (%)	23.6	13.2	21.9	18.5	14.3

Opinion

SUMMARY RATING RATIONALE

Moody's assigns long-term issuer and debt ratings of Aa2 to Auckland Council.

The Aa2 rating reflects New Zealand's well-established and stable institutional framework for local governments, which provides flexibility over both revenues and expenditures and ensures strong governance practices through reporting and planning requirements. In addition, Auckland's large and diversified economy amply supports its operations and debt obligations. The rating also incorporates the council's high and increasing debt levels, which result from borrowing needs related to major upgrades in transit and water infrastructure.

Credit Strengths

Auckland Council's credit strengths include:

- A well-developed institutional framework that supports good governance practices
- Stable property rates and the ability to adjust expenditure provides budget flexibility
- Fiscal policy to place greater emphasis on narrowing deficits
- Sizeable and diverse economic base

Credit Challenges

Auckland Council's credit challenges include:

- Sizeable cash financing deficits reflecting large infrastructure investments
- Projected rapid increase in debt levels that are already above average
- Relatively low levels of internal liquidity

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

The generation of sizeable cash surpluses and a reversal in the significant projected rise in debt ratios would place upward pressure on the ratings.

What Could Change the Rating - Down

A reduction in the rate-setting powers of the council, without access to alternative revenue sources, would place downward pressure on the rating. Additionally, a significant increase in the council's debt burden above the projected levels would exert negative pressure on the ratings.

DETAILED RATING CONSIDERATIONS

Auckland's rating combines (1) a baseline credit assessment (BCA) of a1, and (2) a high likelihood of extraordinary support coming from national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

Auckland Council's BCA of a1 reflects the following factors:

SUPPORTIVE INSTITUTIONAL FRAMEWORK AND EASING PRESSURES RELATED TO AMALGAMATION

Councils in New Zealand are governed under a supportive institutional framework that includes access to sufficient revenues to support their operations, and discretion over expenditure decisions that provide the tools to respond to adverse budgetary developments.

Councils are subject to a high degree of oversight and extensive reporting requirements and transparency is enhanced by detailed and comprehensive financial statements on an accrual basis, published regularly and audited. They are required to produce a 10-year financial plan every three years and to establish clear borrowing and investment policies. The national government can carry out audits on any aspect of council operations and place local governments under administration if there are financial concerns, all of which supports prudent financial planning practices.

The framework also provides Auckland with ample access to own-source revenues which are dominated by property rates while national government grants are typically reserved for capital and other special purposes. For example, subsidies are provided to the council-owned transport company that runs the public transit system.

The creation of Auckland Council through the amalgamation of seven smaller councils and the Auckland Regional Council on November 1, 2010 initially led to some additional pressures on expenditures, related to the complex process of reorganizing activities necessary to create the new entity. However, the council has achieved savings in recent years that contribute to better results.

STABLE INCOME FROM PROPERTY RATES AND FLEXIBILITY IN EXPENDITURES SUPPORT BUDGET OUTCOMES

The council's financial operations are supported by stable and predictable own source revenues, primarily property taxation or rates, which account for 49% of operating revenues. An additional 35% of income is derived from fees and charges, primarily water and wastewater tariffs.

Auckland enjoys a significant degree of budget flexibility due to its ability to adjust rates without constraints,

although political pressures to maintain lower rates and the impact of the unification of rates across former council boundaries -- that occurred as a result of the amalgamation -- have contributed to a policy focused on minimizing rate adjustments.

The council also benefits from a broad discretion to cut expenditures, if necessary. Its ability to adjust personnel costs is due to the sizeable proportion of its services that are contracted out as well as the absence of legal barriers to downsizing the public sector workforce. The minimum level of responsibilities that the council has for social services, such as health, education and welfare, reduces its exposure to demand for these services, which can be quite volatile. Other costly services, such as police and fire, are also under the purview of the national government.

GROSS OPERATING BALANCES INDICATE PROGRESS IN CONTROLLING CURRENT EXPENDITURES

In FY2013/14, the council generated a healthy gross operating balance equal to 17.3% of revenues, which was above the budgeted expectation of 14.6% and larger than the 15.1% registered in FY2012/13. The improved result -- when compared to budget -- was supported by rates coming in close to budget and fees rising 1.2% over budget, while operating expenditures were 3.0% below budget. The lower spending stemmed from a 9.2% reduction in operating expenses due in turn to savings achieved in spending on parks and maintenance activities, as well as the implementation of efficiencies as part of the amalgamation process. These savings offset a sharp rise in employee costs - which were 7.4% over budget - because of the need to hire temporary workers to support various events and the decision to increase hiring of direct employees and correspondingly reduce contracted-out positions.

Compared to 2012/13, the better outcome reflected a 4.6% rise in operating revenues, while operating expenditures rose by a lower 1.9%, similarly pointing to progress in controlling expenditures. The decision to strike lower rate increases - 2.9% compared to the 4.9% specified in the long-term plan - was offset by new properties coming on the property tax rolls and a rise in property consent fees. While personnel costs rose by 5.3%, this result was partly due to reclassifications as well as increased hiring of permanent employees as indicated above. Interest costs also increased, in line with the rise in debt. These cost increases were partly offset by a 1.4% reduction in other expenses.

NEW FISCAL POLICY PLACES GREATER EMPHASIS ON NARROWING DEFICITS

While the council continues to generate large cash deficits, largely owing to an ambitious capital improvement plan, a new proposal by the Mayor that places greater focus on narrowing deficits -- with the expressed goal of moderating its rising debt burden -- is being considered.

The new fiscal approach emerged in response to pressures for lower increases in property rates, which had been programmed in the original 10 year plan to rise annually by 4.9%, but in recent years, have actually been lower -- 3.6% in 2012/13 and 2.9% in 2013/14 - and, if the Mayor's proposal is adopted, they would rise by a lower 2.5% over the next two years and then 3.5% over the remaining years.

The new proposal would reduce capital expenditures correspondingly, with the main goal being to maintain fiscal outcomes and to reduce the Council's debt burden, which we see as a credit positive.

LARGE AND DIVERSE ECONOMY

With a population of 1.5 million, Auckland Council is home to one-third of New Zealand's population. It is also the country's economic engine, contributing to about 35% of national GDP. Key economic sectors are professional, scientific, and technical services, retail trade, healthcare and social assistance, education and training, wholesale trade and manufacturing. GDP per capita was NZD57,117 in 2013, or 115% of the national average.

Dwelling investment is a key driver of the economy although it represents only 5.7% of GDP, because of the large multiplier effects it has on other sectors, including the manufacturing of housing materials, as well as engineering and property-financing activities. Economic growth strengthened in 2013, rising by 2.7%, following several years of subdued growth, in part reflecting a recovery in housing construction. This construction was bolstered by rapid rise in prices and pent up demand following a period of low levels of investment.

In January-June 2014, GDP rose by 2.4%, driven by increased migration, growth in business services, and some recovery in retail spending. However non-residential construction remained weak and housing sales are stagnating after a period of very strong growth.

Employment trends have improved - employment rose by 2.9% during January - June 2014, helping reduce the

unemployment rate to 6.2% from 7.5% in 2013. However, it is still above the national rate of 5.0%. In part a greater decline in the unemployment rate was dampened by an increase in the participation rate, which in turn reflected rising net migration.

Over the medium term, risks to growth include the impact of Reserve Bank of New Zealand's macro-prudential rules on the housing sector. These include restrictions on loan-to-value home lending by the banks implemented with the aim of an easing housing prices. In addition, lower housing affordability in the wake of rapid price increases and reduction in undersupply could lead to easing in investments.

SIZEABLE CASH FINANCING DEFICITS TO PERSIST REFLECTING INFRASTRUCTURE DEVELOPMENT

The council's high cash financing deficits reflect its large program of capital investment, which includes spending on roads, public transit and utilities. In FY2013/14, the cash deficit was NZD653 million, or 19.9% of revenues, but still well below the 30.3% of revenues budgeted, and slightly below the 23.5% registered in the prior year. This outcome reflected the improved gross operating balance, as described earlier along with a rise in developer contributions -- up by 27.5% -- as the value of building approvals exceeded expectations, a one-time dividend payment NZD102 million from Auckland Airport and lower capital spending.

The FY2014/15 budget projects that the cash deficit will rise to 27.4% of revenues as total revenues are forecast to fall by 1.1%, while total expenditures rise by 5.6%. This trend is largely driven by less robust operating revenues which are expected to rise by only 2.7% - due to lower adjustments to both property tax and water & wastewater rates and reduced transit fare collections - while operating expenses are set to rise by a higher 7.4%. These expenses are driven by higher compensation costs as out-sourced employees for Ports of Auckland and Watercare are replaced by permanent employees - only partially offset by savings in other areas. As a result the council's gross operating balance is forecast to narrow to 13.5% of revenues.

In addition, capital expenditures are set to contribute to the higher cash deficit. But to the extent that the council lowers capital spending, as reflected in the Mayor's proposal, by NZ300 million, the cash deficit would narrow to 18.2% of revenues.

Over the medium term, cash deficits had been projected to average 17.5% of revenues over the five years through to 2018/19, assuming continued strength in the gross operating balance, which is forecast to average 18.1% over the same time frame, along with NZD16.6 billion in capital expenditures. The council's fiscal performance could improve to the extent that it adopts new fiscal policies to re-prioritize capital expenditures and maintains its commitment to expenditure savings.

ABOVE-AVERAGE DEBT BURDEN PROJECTED TO RISE FURTHER

The high cash deficits registered in recent years pushed Auckland's debt to a high 158.4% of operating revenues in FY2013/14, up from 103.1% in FY2010/11. Total direct and indirect debt amounted to NZD6.3 billion, and excluding the debt of self-supporting public enterprises, such as Watercare and Port of Auckland, the net direct and indirect debt was NZD4.5 billion.

The positive operations and self-supporting nature of the council-owned and guaranteed water utility, Watercare, eases the debt burden as this debt is deducted from the council's total and indirect debt. In 2013/14, the council borrowed on behalf of Watercare for its longer term requirements, as compared to earlier years when the company issued debt directly. Moody's does not net out financial assets to compute its internationally comparable debt ratios.

The debt burden is projected to rise sharply in the existing long term plan for 2012-2022, peaking at 198% of revenues in 2019/20 and to be 183% in 2021/22 due to the NZD22 billion capital improvement plan. These debt levels and the associated increase in annual debt service costs to 15.8% of revenues in 2020/21, are high when compared to similarly rated peers and will constrain budget flexibility.

However, the council is considering reducing investment in capital projects in line with lower property rate increases, and if implemented, Moody's estimates that the debt burden could peak at a lower 179% of revenues in 2019/2021 and fall to 156% of revenues in 2021/22. The council will make a final decision on the 2015 - 2025 long term plan in June 2015.

Included in the program is the city rail project, which has been reduced from NZD2.8 billion to NZD2.4 billion, and related central government subsidies of NZD1.2 billion as well as NZD344 million in addition council revenues that have yet to be enacted.

The council has a well-developed liability management and investment policy as required by the Local Government Act of 2002. The "Treasury Management Policy" clearly sets out debt limits, guidelines for debt structure and addresses interest rate, credit and liquidity risks. However, in our view, the debt limit, set at 275% of revenues (debt net of liquid assets), is high.

In recent years, the council has made progress in extending its relatively short term maturity profile from 4.5 years in FY2011/12 to 7.9 years in FY2013/14 thereby reducing refinancing risks. This has been supported by the USD2.5 billion Euro Medium term note programme which has tapped into off-shore investors' appetite for longer maturities - foreign currency debt now represents about a quarter of the total debt. In addition, debt undertaken through the Local Government Funding Agency (LGFA), an agency set up in December 2011 to borrow on behalf of local governments provides longer tenors. The council participates as a shareholder, borrower and guarantor in the LGFA. Concerns relating to Auckland's exposure to the fund are mitigated by prudential controls and mechanisms that the LGFA has in place to collect amounts owed to the agency.

Short-term and floating-rate debt comprises 59% of total debt, but the council uses derivatives to swap its floating-rate debt into fixed rate, reducing its exposure to interest-rate volatility. The council's policy requires that foreign currency debt is hedged through swap agreements which would mitigate against any potential exchange rate risk.

RELATIVELY LOW LEVELS OF INTERNAL LIQUIDITY

The council's liquidity policy requires it to hold cash and committed funding facilities equal to 6 months of forecast net cash outflow and in practice, it maintains an amount equal to 12 months, however its reliance for liquidity on committed facilities is high. Its own holdings of cash and liquid financial assets amounted to a relatively small NZD390 million at year end FY2013/14, or equal to 9% of net direct and indirect debt, and less than 20% of its cash requirements for the next 12 months.

Extraordinary Support Considerations

Moody's assigns a high likelihood of extraordinary support from the national government, reflecting Moody's assessment (at the jurisdictional level) of the national government's close relationship to, and frequent monitoring of, local governments, and the strategic role that Auckland plays in New Zealand's economy.

Output of the Baseline Credit Assessment Scorecard

In the case of Auckland Council, the BCA matrix generates an estimated BCA of aa3, close to the BCA of a1 assigned by the rating committee.

The matrix-generated BCA of aa3 reflects (1) an idiosyncratic risk score of 4 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aaa, as reflected in the sovereign bond rating (Aaa, stable).

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Auckland Council

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	3	115.71	70%	2.4	20%	0.48
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1	20%	0.20
Financial flexibility	1		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	1	13.37	12.5%	4.5	30%	1.35
Interest payments / operating revenues (%)	9	11.77	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	7	170.20	25%			
Short-term direct debt / total direct debt (%)	1	9.50	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						3.53(4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3

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