Statement of Proposal to amend the Treasury Risk Management Policy contained in the Regional Council's 2009-2019 Long Term Council Community Plan and to invest in New Zealand Local Government Funding Agency Limited

Introduction

The Council is considering participating as a "Principal Shareholding Local Authority" in the New Zealand Local Government Funding Agency Limited (**LGFA**), which will be a council–controlled trading organisation (**CCTO**).

The LGFA is being established by a group of local authorities and the Crown to enable local authorities to borrow at lower interest margins than would otherwise be available.

All local authorities will be able to borrow from the LGFA, but different benefits apply depending on the level of participation. Generally all local authorities borrowing from LGFA will be required to have some shareholding and enter into guarantees in favour of LGFA and other local authorities. This is certainly the case for Principal Shareholding Local Authorities. The exceptions will apply to some local authorities with much lower levels of borrowing, but those local authorities will only be able to borrow a limited amount, and will be required to pay higher funding costs.

Principal Shareholding Local Authorities will be required to invest capital in the LGFA, but are expected to receive a return on that capital. The Principal Shareholding Local Authorities will be required to meet a certain proportion of their borrowing needs through the LGFA Scheme for an initial period.

An Information Memorandum, describing the arrangements in detail, is attached as Appendix 2, and forms part of this proposal. A number of terms used in this proposal are defined in that Information Memorandum.

Change to Council's security structure

As set out in the Information Memorandum (see paragraphs 26 to 28, 45 and 53), each participating local authority will be required to provide security for the performance of some of its obligations under the LGFA Scheme by granting a charge over its rates and rates revenue. This is a type of security which is widely granted by New Zealand local authorities to secure their general borrowing obligations (and related incidental arrangements).

In contrast to most local authorities, the Council currently borrows without granting such security, and instead has an arrangement under a "Negative Pledge Deed" under which it undertakes to each borrower not to grant security to any other borrower. This arrangement will need to be replaced by one under which the Council grants security in the form of a charge over its rates and rates revenue to its lenders (including the LGFA) if the Council is to participate in the LGFA Scheme.

Statutory Considerations

Section 56 of the Local Government Act 2002 (**LGA 2002**) provides that a proposal to establish a council-controlled organisation (**CCO**) (which includes a CCTO) must be adopted by special consultative procedure before a local authority may establish or become a shareholder in the CCO.

Section 102(6) of the LGA 2002 requires any amendment to a liability management policy or investment policy to be by way of an amendment to the 2009-2019 Long Term Council Community Plan (LTCCP).

Both of these provisions are relevant in the present case. The Council's involvement in the LGFA as a Principal Shareholding Local Authority is not provided for in the Investment Policy, and specifics of the debt raising arrangements with the LGFA go beyond what is currently provided in the Liability Management Policy particularly the guarantee commitments and the required charge over the Council's rates and rate revenue. It is therefore appropriate to amend these policies (by amending the LTCCP) using the same special consultation procedure required to comply with section 56. (Section 83A of the LGA 2002 expressly authorises combined special consultative procedures.)

Reasons for Proposal

The Council is proposing participating in the LGFA Scheme because it believes that it will enable it to borrow at lower interest margins, and that this benefit outweighs the costs and risks associated with the LGFA Scheme. A discussion of these costs and benefits is included as Part C of the Information Memorandum.

The Council is proposing that its participation be as a Principal Shareholding Local Authority for two reasons:

(a) As discussed in the Information Memorandum (in Part C), a return will be paid on the capital investment made by Principal Shareholding Local Authorities.

(b) A certain amount of capital (expected to be around $20,000,000) will need to be invested by local authorities for the LGFA Scheme to be viable. As a Principal Shareholding Local Authority, the Council will be contributing some of this amount, which increases the chance that the LGFA Scheme will be viable, and the Council will be able to gain the benefits of participating in it. The Council understands that eight other local authorities are currently considering participating in the LGFA Scheme as Principal Shareholding Local Authorities.

The Council is consulting on this proposal for the reasons set out above under "Statutory Considerations" above.

Analysis of Reasonably Practicable Options

The reasonably practicable options are as follows:

(a) Participate in the LGFA Scheme as a Principal Shareholding Local Authority.

(b) Participate in the LGFA Scheme as a Guaranteeing Local Authority, but not a Principal Shareholding Local Authority.

(c) Participate in the LGFA Scheme, but not as a Principal Shareholding Local Authority or as a Guaranteeing Local Authority.

(d) Not participate in the LGFA Scheme.

Part C of the Information Memorandum sets out an analysis of the costs and benefits of participating in the LGFA Scheme. That analysis is supplemented by some consideration of the Council's specific circumstances below.

Should the Council participate in the LGFA Scheme as a borrower?

The projected level of the Council's borrowings (that could be financed by LGFA) at 30 June 2011 is $38 million based on the 2009-2019 LTCCP. Borrowings (that could be financed by LGFA) are projected to grow to $190 million by 2018/19. Consequently, the benefits of lower interest margins are significant. The borrowings for WRC Holdings Limited which may be refinanced have been included when existing borrowings mature in 2013/14 as savings will be realised for the Council through increased dividends.

The Council anticipates that savings will be $40,000 per $10 million (0.4%) of borrowings financed with the LGFA instead of through the existing debt market.

Based on this assumption the savings for the Council on the projected levels of debt are:

	2010/11 ($000s)	2011/12 ($000s)	2012/13 ($000s)	2013/14 ($000s)	2014/15 ($000s)	2015/16 ($000s)	2016/17 ($000s)	2017/18 ($000s)	2018/19 ($000s)
Total projected borrowings in the 2009-2019 Long Term Council Community Plan (LTCCP)	**162,527**	**181,973**	**200,684**	**218,554**	**223,959**	**226,303**	**229,617**	**230,200**	**225,473**
Total new and re-financed debt (that could be financed by LGFA. This includes WRC Holdings Limited's refinanced debt, but excludes working capital requirements which will be financed through private sector banks.	**38,314**	**106,173**	**123,190**	**193,001**	**196,222**	**196,747**	**194,617**	**195,200**	**190,473**
Expected savings from Council's involvement in the LGFA	**-**	**425**	**493**	**772**	**785**	**787**	**778**	**781**	**762**
Impact of current interest margins compared to interest margins in the LTCCP	**-**	**(266)**	**(310)**	**(482)**	**(491)**	**(492)**	**(486)**	**(488)**	**(476)**
Expected savings from Council's involvement in the LGFA compared to interest margins in the LTCCP	**-**	**159**	**185**	**290**	**294**	**295**	**292**	**293**	**286**

The projected savings are based on modelling by Cameron Partners and Asia Pacific Risk Management. Although the modelling is based on a number of assumptions, this number gives an indication of the scale of potential savings. The Council believes that the benefit of these savings outweigh the costs referred to in the cost/benefit analysis in Part C of the Information Memorandum.

Consequently, the Council proposes that option (d) is **not** adopted.

Should the Council participate in the LGFA Scheme without being a Guaranteeing Local Authority?

If the Council was to join the LGFA Scheme without being a Guaranteeing Local Authority, the cost of participating would be less. However, it would face higher funding costs, reducing the benefit of participating, and it is likely that it would only be able to borrow up to $20 million, meaning the benefits would be limited to a small portion of its borrowing.

Consequently, the Council is proposing to participate as a Guaranteeing Local Authority, and therefore proposes that option (c) is **not** adopted.

Should the Council participate in the LGFA Scheme as a Principal Shareholding Local Authority?

The Council believes that investing in the LGFA Scheme as a Principal Shareholding Local Authority is justified here for the two reasons set out above. That is:

(a) As discussed in the Information Memorandum (in Part C), a return will be paid on the capital investment made by Principal Shareholding Local Authorities.

(b) If the Council participates as a Principal Shareholding Local Authority, that increases the chance that the LGFA Scheme will be viable, and that the Council will be able to gain the benefits of participating in it.

What is the risk of the Council participating in the LGFA Scheme as a Principal Shareholding Local Authority as a result of the guarantee?

The Council is intending to provide a guarantee in support of the LGFA and to all participating Local Authorities. Council has considered the risks associated with the guarantee and consider it to be low because:

- The only borrowers from LGFA will be Local Authorities and there has been no default by a Local Authority in New Zealand. In the event of a default, the LGFA will immediately be able to appoint a receiver and assess a special rate against all ratepayers in the defaulting Local Authority's district.

- The LGFA will have considerable sources of capital and liquidity available to meet any shortfall in timing of payments before any call is made under the guarantee.

- Operational risk is minimal due to the conservative borrowing and lending policies proposed as part of the LGFA scheme. Furthermore, it is proposed that all borrowing, investing, back office and hedging functions will be undertaken on behalf of LGFA by the Debt Management Office of the New Zealand Treasury.

Why can we not quantify the guarantee exposure?

Council cannot quantify the guarantee exposure at this time because it depends upon the size of the LGFA, the lending profile and the operating structure. This information is not available until such time that the LGFA is established and these factors are more certain. At inception of the LGFA, Council will assess its exposure to the guarantee and review the exposure on an annual basis. This exposure may have to be included in the annual financial statements. .

Consequently, the Council is proposing that **option (a)** be adopted. That is, Council is proposing that it participates in the LGFA Scheme as a Principal Shareholding Local Authority (and Guaranteeing Local Authority) and amends the Treasury Risk Management Policy accordingly.

Parts of Policies Documents from the 2009-19 Long Term Council Community Plan to be Amended

The Council proposes that sections be added to Treasury Risk Management Policy (**TRMP)** which incorporates the Council's Investment Policy and Liability Management Policy. The suggested additions are attached as Appendix 1, and form part of this proposal.

Investment activity

The investment activity component of the TRMP will be amended to make it clear that the Council's investment activity includes participating as a Principal Shareholder in LGFA.

There will be a direct return on this investment, but it is acknowledged that this may be less than might be achieved by alternative investments. There is an additional benefit to the Council in that the Council's investment of capital makes it more likely that the LGFA Scheme, which will deliver benefits to the Council, will become viable.

The primary objective for Council's interest in LGFA is to lower the Council's cost of borrowing.

There are no consequential changes the investment activity component of the LTCCP, though there is a related change to the liability management policy component which is discussed below.

Liability management

The liability management component of the TRMP will be amended to make it clear that the Council may participate in the LGFA Scheme, including borrowing from the LGFA and entering into the transactions relating to that borrowing described in paragraph 63 of the Information Memorandum.

The primary objective of these changes is to allow borrowing by the Council at lower interest margins than it currently faces.

The Council will also need to change the security arrangements it has in relation to its borrowing (and related incidental arrangements) from the exiting negative pledge deed arrangements to one under which its lenders are granted a charge over the rates and rates revenue of the Council.

Opportunity to make Submissions

This proposal and the summary of proposal will be distributed, and available for inspection and copying, as required by section 83 of the Local Government Act 2002.

This statement of proposal and the Information Memorandum is available for inspection at the Council offices at 142 Wakefield Street, Wellington – ground floor and on the Council's web site www.gw.govt.nz .

Submissions on this proposal must be in writing (using the form attached or any other form) and addressed to the Council. Submissions may be sent either:

- by post to:

  Proposed Annual plan Summary
  FreePost 3156
  Greater Wellington Regional Council
  PO Box 11646
  Manners Street
  Wellington 6142

- or by email to: info@gw.govt.nz

Submissions must be received no later than 4.00 pm on 28 April 2011.

Any person or organisation who makes a submission has a right to be heard by the Council. Submitters who wish to be heard must request this in their submission.

Every submission will be:

- acknowledged by the Council in accordance with the LGA 2002,
- copied and made available to the public.

The LGA 2002 requires the Council to make all written submissions on this consultation available to the public. This requirement is subject to the provisions of the Local Government Official Information and Meetings Act 1987. If you consider there to be compelling reasons why your contact details and/or submission should be kept confidential, you should advise within your submission.

The consultation process dates are as follows:

3 March 2011 – adopts statement of proposal and summary of proposal
28 March 2011 – submissions open
28 April 2011 – submissions close at 4.00 pm
19 and 20 May 2011 – submissions heard.
8 June 2011– Council considers outcome of consultation process
29 June 2011 – final Council decision
1 July 2011 – decision comes into effect.

Appendix 1 – Proposed Treasury Risk Management Policy wording

The following wording would be added into section 5 of current Policy:

"**New Zealand Local Government Funding Agency Limited investment**

Despite anything earlier in this Policy, the Council may invest in shares and other financial instruments of the New Zealand Local Government Funding Agency Limited (**LGFA**), and may borrow to fund that investment.

The Council's objective in making any such investment will be to:

(a) obtain a return on the investment; and

(b) ensure that the LGFA has sufficient capital to become and remain viable, meaning that it continues as a source of debt funding for the Council.

Because of this dual objective, the Council may invest in LGFA shares in circumstances in which the return on that investment is potentially lower than the return it could achieve with alternative investments.

If required in connection with the investment, the Council may also subscribe for uncalled capital in the LGFA."

The following wording would be added into section 4 of the current Policy:

"**New Zealand Local Government Funding Agency Limited Investment**

Despite anything earlier in this Policy, the Council may borrow from the LGFA and, in connection with that borrowing, may enter into the following related transactions to the extent it considers necessary or desirable:

(a) contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;

(b) provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself;

(c) commit to contributing additional equity (or subordinated debt) to the LGFA if required;

(d) subscribe for shares and uncalled capital in the LGFA; and

(e) secure its borrowing from the LGFA, and the performance of other obligations to the LGFA or its creditors with a charge over the Council's rates and rates revenue."

The following wording would replace section 4.2 of the current Policy:

Security and charges

The Council operates under a “negative pledge” arrangement, which is an arrangement under which (with some limited exceptions) it provides no security to any creditor. Although lenders are unsecured, they have the benefit of an undertaking that other lenders will also be unsecured. This arrangement is created by the Council’s “Negative Pledge Deed”.

The Council may join a scheme (LGFA Scheme) under which it borrows from the New Zealand Local Government Funding Agency Limited (LGFA). One of the requirements of the LGFA Scheme is that the Council grants a change over its rates and rates revenue to secure obligations related to its borrowing from the LGFA. It cannot do this under the current negative pledge arrangement, so will need to replace the arrangement if it joins and LGFA Scheme.

From time to time, with prior Council approval, security maybe offered by providing a security interest in one or more of the Council’s assets other than its rates and rates revenue. Security interest in physical assets will only be granted when:

- there is a direct relationship between a debt and the purchase or construction of the secured assets which it funds(eg through a finance lease, or some form of project finance)
- the Council considers a security interest in the physical assets to be appropriate
- the security interest is permitted by the Negative Pledge Deed (unless the Negative Pledge Deed has been terminated)

In addition, the Council may grant security interests in physical assets where those security interests are leases or retention of the arrangements which arise under the terms of any lease or sale and purchase agreement,

Appendix 2– Information Memorandum

Proposed Local Government Funding Agency Scheme Information Memorandum

PROPOSED LOCAL GOVERNMENT FUNDING AGENCY SCHEME

INFORMATION MEMORANDUM

PART A – INTRODUCTION AND PURPOSE

Purpose of Information Memorandum

1. This Information Memorandum provides a description of a proposed funding structure for local authorities (**LGFA Scheme**), which is designed to enable participating local authorities (**Participating Local Authorities**) to borrow at lower interest margins than they would otherwise pay.

2. The purpose of this Information Memorandum is to provide information to supplement consultation materials prepared by local authorities consulting on whether to participate in the LGFA Scheme.

3. This Information Memorandum is divided into three parts:

(a) This Part A (Introduction and Purpose), which sets out the purpose of the Information Memorandum and provides some background on the purpose of, and rationale for, the LGFA Scheme.

(b) Part B (How the LGFA Scheme Works), which sets out the characteristics of the LGFA Scheme, and the transactions that Participating Local Authorities will be entering into as part of their participation in the LGFA Scheme.

(c) Part C (Local Authority Costs and Benefits), which sets out the costs and benefits to individual local authorities of participating in the LGFA Scheme.

Origin of the LGFA Scheme

4. The LGFA Scheme has been developed by a group of New Zealand local authorities and central government over the last 18 months. That development has involved:

(a) undertaking a detailed review and analysis of:

(i) the current borrowing environment in which New Zealand local authorities borrow; and

(ii) centralised local authority debt vehicle structures that have been developed offshore to successfully lower the cost of local authority borrowing;

(b) using this review and analysis to develop a funding structure (the LGFA Scheme), which is anticipated to deliver significant benefits to New Zealand local authorities;

(c) confirming with rating agencies that the proposed LGFA Scheme can achieve a high enough credit rating to deliver the anticipated benefits;

(d) obtaining formal central government support to facilitate establishment of the LGFA Scheme.

Rationale for LGFA Scheme

New Zealand Local Authority debt market

5. New Zealand local authorities face a number of debt related issues.

6. First, local authorities have significant existing and forecast debt requirements. Current long-term council community plans indicate that local authority debt will double over the next five years to over $9 billion.

7. Secondly, pricing, length of funding term and other terms and conditions vary considerably across the sector and are less than optimal. This is due to:

(a) Limited debt sources – Local authorities' debt funding options are limited to the banks, private placements and wholesale bonds (issuance to wholesale investors), and, to a lesser extent, retail bonds. Increasing local authority sector funding requirements and domestic funding capacity constraints are likely to further negatively impact pricing, terms and conditions and flexibility of local authority sector debt.

(b) Fragmented sector – There are 78 local authorities. Individually, a significant proportion of these local authorities lack scale - the 10 largest account for ~68% of total sector borrowings with average borrowings of ~$470 million and the remaining 68 have average debt of ~$33million.

(c) Regulatory restrictions - Offshore (foreign currency) capital markets are closed to local authorities and the compliance process for local authority retail bond issuance is burdensome and generally restricts issuance to a six month window.

Addressing the local authority debt issues

8. Each of these issues needs to be addressed to rectify this situation. This is not likely to happen without an intervention like the LGFA Scheme for the following reasons:

(a) The New Zealand debt markets (at least in the foreseeable future) are likely to maintain the status quo.

(b) Individually, local authorities will not be able to attain significant scale (except organically in the long-term).

(c) At a sector level it may be possible to address the issue regarding regulation, but regulators are likely to remain reluctant to significantly ease restrictions on financial management across the sector without gaining significant comfort as to the sophistication of the financial management of all local authorities. Even if this issue was addressed by regulators, this change alone would be insufficient to provide a major step change.

9. The LGFA Scheme has been developed because the homogenous nature of local authorities; the large sector borrowing requirements and the high credit quality / strong security position (ie charge over rates) of local authorities, creates the opportunity for a centralised local authority debt vehicle to generate significant benefits.

10. There are numerous precedents globally of successful vehicles which pool local authority debt and fund themselves through issuing their own financial instruments to investors. Such vehicles achieve success through:

(a) "Credit rating arbitrage" – Attaining a credit rating higher than that of the individual underlying assets (local authority borrowers) and therefore being able to borrow at lower margins.

(b) "Economies of scale" – By pooling debt the vehicles can access a wider range of debt sources and spread fixed operating costs, thereby reducing the $ cost per $ of debt raised.

(c) "Regulatory arbitrage" – The vehicles can receive different regulatory treatment than the underlying local authorities, improving their ability to efficiently raise debt eg through access to offshore foreign currency debt markets.

11. The offshore precedents are typically owned by the local authorities in the relevant jurisdiction (often with central government involvement), and that is what is proposed here through the LGFA Scheme.

PART B – HOW THE LGFA SCHEME WORKS

Basic structure of the LGFA Scheme

12. The basic structure of the LGFA Scheme is that a company is established which will borrow funds and lend them on to local authorities at lower interest margins than those local authorities would pay to other lenders. For a number of reasons discussed below, it is expected that the company will be able to borrow at low enough interest margins to be able to do this.

New Zealand Local Government Funding Agency Limited

13. The company which will be lending to local authorities under the LGFA Scheme has not yet been established, but it is expected to be called the New Zealand Local Government Funding Agency Limited (**LGFA**). It will be a limited liability company, and its shares will be held entirely by central government and by local authorities.

14. At this stage the exact percentage of shares that will be held by central government has not been finalised, but it will be less than or equal to 20%, meaning more than 80% or more of the shares will be held by local authorities. Consequently, the LGFA will be a council-controlled organisation. Further, it is intended that the LGFA turn a small profit, at least in the medium to long term, so it will be a council-controlled trading organisation.

15. The LGFA will be established solely for the purposes of the LGFA Scheme, and its activities will be limited to performing its function under the LGFA Scheme.

16. It is anticipated that a small number of local authorities (**Principal Shareholding Local Authorities**) will hold most, if not all, of those shares that are not held by central government. The Principal Shareholding Local Authorities will contribute capital and, as compensation for their capital contribution, will receive a pre-determined return on this capital. However, the over-arching objective is that the benefits of the LGFA Scheme are passed to local authorities as lower borrowing margins, rather than being passed to shareholders as maximised profits.

17. As discussed below, it is possible that the local authorities outside the Principal Shareholding Local Authority group will hold some shares in the LGFA as well, but this aspect of the LGFA Scheme has not yet been finalised.

Design to minimise default risk

18. One of the things which is critical to the LGFA Scheme delivering its anticipated benefits is the achievement of a high credit rating for the LGFA (to achieve the credit rating arbitrage referred to in paragraph 10(a). Consequently there are a number of features of the LGFA Scheme which are included to provide the protections for creditors which rating agencies require before agreeing to a high credit rating. These features are described in paragraphs 19 to 54 below.

19. Before agreeing to a high credit rating, rating agencies will consider the risks of both short term and long term default. Short term default is where a payment obligation is not met on time. Long term default is where a payment obligation is never met. In many cases short term default will inevitably translate into long term default, but this is not always the case – a short term default may be caused by a temporary liquidity problem (ie a temporary shortage of readily available cash).

Features of the LGFA Scheme designed to reduce short term default risk

20. When a local authority borrows, the risk of short term default, although low, is probably significantly higher than its risk of long term default. In the long term it can assess and collect sufficient rates revenue to cover almost any shortfall, but such revenue cannot be collected quickly. Consequently, there is a risk that inadequate liability and revenue management could lead to temporary liquidity problems and short term default.

21. The principal asset of the LGFA will be local authority debt, so such temporary liquidity risks are effectively passed on to the LGFA. Consequently, the rating agencies will look for safeguards to ensure that liquidity problems of a Participating Local Authority will not lead to a default by the LGFA.

22. There are two principal safeguards that the LGFA will put in place to manage short term default (liquidity) risk:

(a) It will hold a certain amount of cash and other liquid investments (investments which can be quickly turned into cash).

(b) It will have a borrowing facility with central government which allows it to borrow funds from central government if required.

23. It is expected that these safeguards will sufficiently reduce any short term default risk.

Features of the LGFA Scheme designed to reduce long term default risk

24. There are a number of safeguards that the LGFA will put in place to manage long term default risk, the most important of which are set out below:

(a) The LGFA will require all local authorities that borrow from it to secure that borrowing with a charge over that local authority's rates and rates revenue (**Rates Charge**).

(b) The LGFA will maintain a minimum capital adequacy ratio (or have some equivalent capital adequacy safeguard).

(c) The Principal Shareholding Local Authorities will be required to subscribe for uncalled capital in an equal amount to their paid up equity contribution.

(d) The LGFA will require most, or possibly all, Participating Local Authorities (**Guaranteeing Local Authorities**) to guarantee the obligations of all other Guaranteeing Local Authorities and the obligations of the LGFA.

(e) The Guaranteeing Local Authorities will commit to contributing additional equity to the LGFA if there an imminent risk that the LGFA will default.

(f) The LGFA will hedge any exposure to interest rate and foreign currency fluctuations to ensure that such fluctuations do not significantly affect its ability to meet its payment obligations.

(g) The LGFA will put in place risk management policies in relation to its borrowing and lending designed to minimise its risk. For example, it will impose limits on the percentage of lending which is made to any one local authority to ensure that its credit risk is suitably diversified.

(h) The LGFA will ensure that its operations are run in a way which minimises operational risk. It will do this from commencement of operations by outsourcing its operations to the New Zealand Debt Management Office (**NZDMO**), which is part of The Treasury. NZDMO manages the capital raising for central government, and has robust processes in place to manage operational risk. It is possible that at some point the operations function will be moved from NZDMO, but this will not be done unless the LGFA is satisfied that it has alternative robust processes in place.

25. Additional detail in relation to the features referred to in paragraphs 24(a) to 24(e) is set out below.

Rates Charge

26. All local authorities borrowing from the LGFA will be required to secure that borrowing with a Rates Charge. Many but not all, local authorities have a Rates Charge in place already.

27. This is a powerful form of security for the LGFA, because it means that, if the relevant local authority defaults, a receiver appointed by the LGFA can assess and collect sufficient rates in the relevant district or region to recover the defaulted payments. Consequently, it significantly reduces the risk of long term default by a local authority borrower.

28. From a local authority's point of view it is also advantageous, because, so long as the local authority does not default, it is entitled to conduct its affairs without any interference or restriction. This contrasts with most security arrangements, which involve restrictions being imposed on a borrower's use of its own assets by the relevant lender.

Minimum capital

29. One important safeguard against long-term default for the LGFA will be having a minimum capital adequacy ratio (a ratio which measures the relative amounts of equity and debt-based assets which an entity has). This ratio is important, because it provides an indication of the ability of the LGFA to ultimately repay all of its debts despite local authorities that have borrowed from it defaulting or some other loss occurring.

30. The minimum capital adequacy ratio requirement is likely to be that the equity of the LGFA is an amount equal to at least 1.6% of its total assets.

Sources of equity for capital adequacy purposes

31. The equity held by the LGFA to ensure that it meets its minimum capital adequacy ratio requirement will come from two sources. First, central government and the Principal Shareholding Local Authorities will contribute initial equity as the issue price of their initial shareholdings. Secondly, it is anticipated that each Participating Local Authority will, at the time that it borrows from the LGFA, contribute some of that borrowing back as equity.

32. The way the second source of equity will work is that, whenever a Participating Local Authority borrows, it will not receive the full amount of the borrowing in cash. Instead, a small percentage of the borrowed amount will remain with the LGFA as equity. That percentage is expected to be 1.6% of the amount borrowed.

33. The equity contributed in this way will be repaid when the borrowing is repaid, so, in effect, the amount which must be repaid will equal the cash amount actually advanced.

34. The equity will be contributed by subscribing for “Borrower Notes”. It is likely, though not yet finally decided, that these Borrower Notes will be redeemable preference shares in the LGFA.

35. To illustrate with an example, if a local authority borrowed $1,000,000 for five years from the LGFA, it would receive $984,000 in cash and $16,000 of Borrower Notes (likely to be redeemable preference shares in the LGFA). At the end of the five years, it would repay $1,000,000, but would simultaneously redeem its Borrower Notes for $16,000, meaning its net repayment was equal to the $984,000 it initially received in cash.

36. A return will be paid on the Borrower Notes, which will be in the form of a dividend if they are redeemable preference shares. The exact amount of that return is not yet finally decided, but is likely to be equal to the cost of funds of the LGFA. While it is anticipated that this return will be paid, it will be paid at the discretion of the LGFA. It is likely that this return will be capitalised and paid at maturity.

37. There is some additional risk to Participating Local Authorities from this arrangement, because redemption of the Borrower Notes will only occur if the LGFA is able to pay its other debts. For example, if at the end of five years, the LGFA was insolvent, the local authority would have to repay $1,000,000, but would not receive its $16,000 back for redeeming its Borrower Notes.

Uncalled capital

38. Each Principal Shareholding Local Authority will be required to subscribe for uncalled capital which is equal in amount to its paid up equity contribution (**Uncalled Capital**).

39. It is anticipated that the Uncalled Capital will only be able to be called by the LGFA if it determines that there is a risk of imminent default if the call is not made. However, such a call is likely to be made before the Guarantee or additional equity commitment described below are utilised.

Guarantee

40. Most, if not all, Participating Local Authorities will be required to enter into a guarantee when they join the LGFA Scheme (**Guarantee**). Under the Guarantee the Guaranteeing Local Authorities guarantee the payment obligations of other Guaranteeing Local Authorities to the LGFA (**Cross Guarantee**), and guarantee the payment obligations of the LGFA itself (**LGFA Guarantee**).

41. The purpose of the Guarantee is to provide additional comfort to lenders (and therefore credit rating agencies) that there will be no long term default, though it may also be used to cover a short term default if there is a default which cannot be covered using the protections described in paragraphs 20 to 23 above, but which will ultimately be fully covered using the rates charge described in paragraphs 26 to 28. The Guarantee allows the LGFA to draw upon the resource of all Guaranteeing Local Authorities to avoid defaults.

Risk from Cross Guarantee

42. There are five factors which mitigate the risk to Guaranteeing Local Authorities under the Cross Guarantee:

(a) The risk only materialises if another Participating Local Authority defaults on its debt obligations. It is believed that no such default has ever occurred, which suggests that the risk of a local authority default is very low.

(b) If a Participating Local Authority defaults, but it is because of temporary liquidity problems only, the safeguards in place to cover temporary liquidity shortages may be sufficient for the LGFA never to have to call upon the Cross Guarantee. The detail of when the LGFA will be able to call upon the Cross Guarantee is not yet finalised, but it is likely that it will be restricted to situations in which there is a risk of an imminent default by the LGFA.

(c) It is anticipated that the Guarantee will only be called if a call on the Uncalled Capital does not generate sufficient funds to eliminate the risk of an imminent default by the LGFA.

(d) If a Participating Local Authority defaults, the burden will be shared by all Guaranteeing Local Authorities.

(e) If a Participating Local Authority defaults, the LGFA will exercise its rights under the Rates Charge to recover the payments defaulted on. The funds recovered through that exercise of rights will be passed on to the local authorities who have made payment under the Cross Guarantee, so those local authorities should, in the long term, be reimbursed for a significant portion, if not all, of the amount they have paid under the Cross Guarantee. The statutory processes involved in exercising these rights suggest that funds will be able to be recovered within 18 months of default.

LGFA Guarantee

43. The LGFA Guarantee will only ever be called if the LGFA defaults. Consequently, a call on the LGFA Guarantee will only occur if the numerous safeguards put in place to prevent an LGFA default fail. This is highly unlikely to happen.

44. If any such default did occur, and the Guaranteeing Local Authorities were called on under the LGFA Guarantee they could potentially be called on to cover any payment obligation of the LGFA. Such payment obligations may (without limitation) include obligations under the following transactions:

(a) A failure by the LGFA to pay its principal lenders.

(b) A failure by the LGFA to repay drawings under the liquidity facility with central government.

(c) A failure by the LGFA to make payments under the hedging transactions referred to in paragraph 24(f).

Guarantee risk shared

45. Although the detail is not yet finalised, there will be a mechanism to ensure that payments made under the Guarantee are shared between all Guaranteeing Local Authorities. The proportion of any payments borne by a single Guaranteeing Local Authority is likely to be based on the number of ratepayers in its district or region, or on some other statistic which is a proxy for its relative ability to make payments.

Rates Charge

46. It is possible that Guaranteeing Local Authorities will be required to provide a Rates Charge to secure their obligations under the Guarantee.

Benefits of being a Guaranteeing Local Authority

47. If some Participating Local Authorities are permitted not to be Guaranteeing Local Authorities it will be on the basis that their borrowings are only allowed to reach a limited level. The exact limitation is not yet finalised, but is likely to be less than $20,000,000. Such local authorities will also be required to pay higher funding costs, either by paying higher interest margins or through some other mechanism.

48. Guaranteeing Local Authorities will, therefore, have the benefit of not having this low limit on borrowing, and paying lower funding costs.

Additional equity commitment

49. In addition to the equity contributions made in conjunction with borrowing, all Guaranteeing Local Authorities are likely to be required to commit to contributing equity if required under certain circumstances. It is expected that calls on any such commitments will be limited to situations in which there is a risk of imminent default by the LGFA.

50. A call for additional equity contributions will only be made if calls on the uncalled Capital and on the Cross Guarantee will not be sufficient to eliminate the risk of imminent default by the LGFA. Consequently, the factors which limit the risk in relation to the Cross Guarantee also apply here.

51. It is not yet finalised what form the additional equity contributions will take.

52. If an additional equity contribution is required, the LGFA will lend the money required to make that contribution to the relevant local authority. For example, if $100,000 was required, the LGFA might issue $100,000 of shares to the local authority and, in return, the local authority would owe it a debt of $100,000. Consequently, there would be no requirement on the local authority to immediately make a cash payment. However, such a debt would ultimately have to be paid if the LGFA never regained a position in which it could buy back the shares.

53. It is possible that Guaranteeing Local Authorities will be required to provide a Rates Charge to secure their obligations to contribute additional equity.

Initial purchase of a single share

54. It is possible that Guaranteeing Local Authorities may be required to initially subscribe for 1 share in the LGFA. This is so that, if they have an ongoing commitment to subscribe for shares when required, they will already be a shareholder in the LGFA. The significance of this is that they will not be required, when subscribing for further shares, to go through the special consultative process associated with becoming a shareholder in a council-controlled organisation.

Characteristics designed to make the LGFA Scheme fair for all Participating Local Authorities

55. The principal risk involved with the LGFA Scheme is that Participating Local Authorities will default on their payment obligations. The greater this risk is, the less attractive participation in the LGFA Scheme is for all Participating Local Authorities.

56. The Participating Local Authorities do not create this risk in equal amounts. There are some that carry a greater default risk than others, and therefore contribute disproportionately to the overall risk in the LGFA Scheme. Those local authorities are also the local authorities that would be likely to pay the highest interest margins if they borrowed outside the LGFA Scheme, and so potentially benefit the most from the LGFA Scheme.

57. To avoid, or at least minimise, what is effectively cross subsidisation of the higher risk local authorities by the lower risk local authorities, it is anticipated that different interest margins will be paid by different local authorities when they borrow from the LGFA, with those carrying the higher default risk paying the higher interest margins.

Viability of the LGFA Scheme dependent on participation levels

58. The modelling and other analysis done by Cameron Partners and Asia Pacific Risk Management (**APRM**) suggests that the LGFA Scheme will be viable (in that it will deliver sufficient benefits to justify its establishment and continued existence) if:

(a) the LGFA attains a high enough credit rating; and

(b) sufficient funds are borrowed through it to obtain the economies of scale benefits referred to in paragraph 10(b).

59. Discussions with rating agencies to date about the credit rating have been promising, and considerable work has gone into a design which will achieve this credit rating. However, a high credit rating will only be attainable if, among other things, sufficient capital is initially contributed.

60. Consequently, the participation of sufficient local authorities, both initially as Principal Shareholding Local Authorities (to contribute initial capital) and in meeting their ongoing borrowing requirements through the LGFA Scheme is critical.

61. It is anticipated that Principal Shareholding Local Authorities will need to collectively contribute $20 million by way of initial capital contribution. What this amounts to on a per-local authority basis will depend on the number of Principal Shareholding Local Authorities.

62. It is likely that Principal Shareholding Local Authorities will be required to meet a certain proportion of their borrowing needs through the LGFA Scheme for an initial period, to ensure that the critical amount of utilisation is achieved.

Summary of transactions a Council will enter into if it joins the LGFA Scheme

63. If a Council joins the LGFA Scheme as a Principal Shareholding Local Authority, it will:

(a) subscribe for shares in the LGFA to provide it with capital (see paragraphs 16 and 31);

(b) possibly commit to meeting a certain proportion of its borrowing needs from the LGFA (see paragraph 62);

(c) borrow from the LGFA;

(d) subscribe for Uncalled Capital in the LGFA (see discussion in paragraphs 38 to 39 above);

(e) subscribe for Borrower Notes (see discussion in paragraphs 32 to 37;

(f) enter into the Guarantee (see discussion in paragraphs 40 to 45 above);

(g) commit to providing additional equity to the LGFA under certain circumstances (see discussion in paragraphs 49 to 53 above);

(h) possibly purchase one share in the LGFA at the time of joining the LGFA Scheme (see discussion in paragraph 54 above); and

(i) provide a Rates Charge to secure some or all of its obligations under the LGFA Scheme (see discussion in paragraphs 26 to 28, 46 and 53 above).

64. If a Council joins the LGFA Scheme as a Guaranteeing Local Authority, but not as a Principal Shareholding Local Authority, it will enter into the transactions described in paragraph 63, other than those described in paragraphs 63(a), 63(b) and 63(d).

65. If a Council joins the LGFA Scheme, but not as a Guaranteeing Local Authority (and therefore also not as a Principal Shareholding Local Authority) it will only enter into the transactions described in paragraph 63(a) and 63(i).

PART C - LOCAL AUTHORITY COSTS AND BENEFITS

66. The costs and benefits to a Participating Local Authority will depend on whether it participates as a Principal Shareholding Local Authority, a Guaranteeing Local Authority, or as neither.

Benefits to local authorities that borrow through the LGFA Scheme

67. It is anticipated that the LGFA will be able to borrow at a low enough rate for the LGFA Scheme to be attractive because of the three key advantages the LGFA will have over a local authority borrower described in paragraph 10. That is – exploiting a credit rating arbitrage, economies of scale and a regulatory arbitrage.

68. In addition, the LGFA will provide local authorities with increased certainty of access to funding and terms and conditions (including the potential access to longer funding terms eg ~ 10 yrs+).

69. The potential savings for a local authority in terms of funding costs will depend on the difference between the funding cost to that local authority when it borrows from the LGFA and the funding cost to the local authority when it borrows from alternative sources. This difference will vary between local authorities.

70. The funding costs each local authority pays when it borrows from the LGFA will be affected by the following factors, some of which are specific to the local authority:

(a) the borrowing margin of the LGFA;

(b) the operating costs of the LGFA;

(c) any price adjustment made by the LGFA for that specific local authority as a result of:

(i) the credit quality of the local authority;

(ii) the size of the borrowings of that local authority from the LGFA and

(iii) the local authority being a Guaranteeing Local Authority or not.

71. A diagram which shows what will affect the amount of any funding cost savings is set out as Annex 1.

72. Cameron Partners and APRM have developed a detailed financial model of the LGFA Scheme and analysed the current debt markets. The table set out in Annex 2 summarises the potential savings for local authorities depending on their credit status. (The modelling is based on conditions prevailing at December 2010 and on a number of assumptions regarding the LGFA, including its credit rating and the amount of loans it makes to local authorities.)

Costs to local authorities that borrow through the LGFA Scheme

73. The costs to Participating Local Authorities as a result of their borrowing through the LGFA Scheme take two forms:

(a) First, there are some risks that they will have to assume to participate in the scheme, which create contingent liabilities (ie costs which will only materialise in certain circumstances).

(b) Secondly, there is some cost associated with the Borrower Notes.

Risks

74. The features of the LGFA Scheme described above which are included to obtain a high credit rating are essentially steps which remove risk from lenders to make their residual risk low enough to justify the high credit rating. These features remove risk, in part, by transferring it to Participating Local Authorities.

75. These risks are that:

(a) in the case of Guaranteeing Local Authorities, a call is made under the Guarantee (see discussion in paragraphs 40 to 45 above);

(b) in the case of Guaranteeing Local Authorities, a call is made for a contribution of additional equity to the LGFA (see discussion in paragraphs 49 to 53 above); and

(c) in the case of all Participating Local Authorities, the LGFA is not able to redeem their Borrower Notes (see discussion in paragraphs 32 to 37).

76. Each of these risks is discussed in some detail in the paragraphs indicated next to the relevant risk. For the reasons set out in those discussions, it is anticipated that each of the risks is low.

Cost of Borrower Notes

77. As discussed in paragraphs 32 to 37, all Participating Local Authorities will be required to invest in Borrower Notes when they borrow from the LGFA. This carries a cost in addition to the risk referred to in paragraph 75(c), because the investment in Borrower Notes will be funded by borrowing from the LGFA, and the cost of this funding will be higher than the return paid on the Borrower Notes.

78. It is anticipated that the Borrower Notes will pay a discretionary payment equal to the LGFA's own cost of funds. Any discretionary payment is likely to be capitalised until maturity.

79. As noted in paragraph 36, while it is the intention for the LGFA to always pay the proposed annual payment on the Borrower Notes, such payments are at the LGFA's discretion so, in some situations, those payments may not be made.

Cost/benefit analysis for the investment by Principal Shareholding Local Authorities

80. In addition to those costs and benefits that all Participating Local Authorities are expected to receive in relation to their borrowing from the LGFA, Principal Shareholding Local Authorities will also hold shares in the LGFA (**Establishment Shares**).

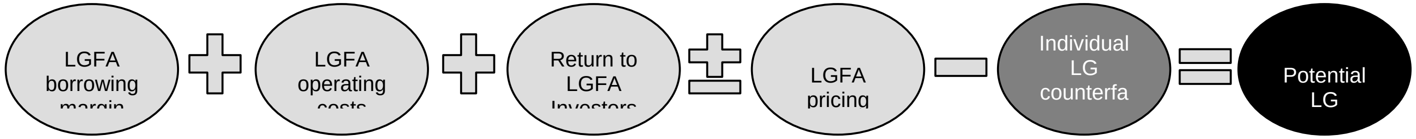
81. Establishment shares will pay a discretionary annual payment which is an amount up to the LGFA's own cost of funds plus 200 bps[1].

82. While it is the intention for the LGFA to always pay the proposed annual payment on the Establishment Shares, this payment will not be made, or will be reduced, if the performance of the LGFA means that the LGFA does not consider it appropriate to make the payment.

83. Any local authority investor in Establishment Shares will also be required to subscribe for the same amount of Uncalled Capital in the LGFA. This Uncalled Capital can be called at the discretion of the LGFA under certain circumstances to ensure the ongoing viability of the LGFA. Once called the Uncalled Capital is called, it will have the same characteristics as Establishment Shares. This is an additional risk (and therefore contingent cost) for Principal Shareholding Local Authorities. Uncalled Capital is discussed in more detail in paragraphs 38 to 39 above.

[1] A "bp" is a "basis point", which is a term that means "0.01%". 200 bps therefore refers to 2% of the amount invested.

ANNEX 1
DIAGRAM SHOWING FACTORS AFFECTING POTENTIAL SAVINGS



ANNEX 2
TABLE SHOWING ANTICIPATED PRICING BENEFITS

Cameron Partners and APRM have developed a detailed financial model of the LGFA Scheme and analysed the current debt markets. The following table summarises the potential savings for local authorities depending on their credit status and based on conditions prevailing at December 2010 and a number of assumptions regarding the LGFA (including its credit rating and the amount of loans it makes to local authorities).

Potential LGFA 5 Year Pricing Benefits (all bps*)						
LA Borrowers	LGFA Borrowing Margin	LGFA Operating Costs & Investor Returns	LGFA Pricing Adjustment	LGFA Pricing	Standalone LA Borrowing Rate	Potential LA Savings
AA+ rated	65	25	-10	80	120	40
AA rated	65	25	-5	85	125	40
AA- rated	65	25	0	90	130	40
A+ rated	65	25	5	95	135	40
A rated	65	25	10	100	140	40
Un-rated	65	25	15	105	155	50
As at December 2010						

* A "bp" is a "basis point", which is a term that means "0.01%".