Financial Strategy 2021-31

HAWKES BAY
REGIONAL COUNCIL

TE KAUNIHERA Ā-ROHE O TE MATAU-A-MĀUI

Financial Strategy | Rautaki Pūtea

1. Introduction

1.1 Purpose

As required under section 101A of the Local Government Act, the purpose of this financial strategy is to facilitate prudent financial management by providing a guide for the council to consider proposals for funding and expenditure against. Furthermore, this strategy will endeavour to make transparent the overall effects of these strategies on HBRC's services, rates, debt and investments.

1.2 Context

The Financial Strategy informs and guides the assessment of funding and expenditure proposals outlined in the LTP. It brings together key aspects of other sections in the LTP to from a coherent strategy as illustrated below.

Key Changes to the 2021-31 Financial Strategy

- An increase in debt limit from Net Debt / Total Revenue 150% to 175% - in-line with LGFA policy covenants
- Increase in Rates as a % of Revenue from 50% to 60% to reduce reliance on investment income
- Build an investment equalization reserve of $10m by the end of the plan
- Borrowing to fund operational costs in years 1 to 4 to balance the rating impact in order to fund an accelerated work programme
- Hawkes Bay Regional Investment Company mandated to grow its investment portfolio

2. Key Goals and Outcomes

The 2021-31 LTP consolidates the growth initiated in 2018 and continues

to push on multiple fronts, particularly implementation of freshwater reform, increasing biodiversity restoration and increasing the climate resilience of our flood control infrastructure, all to achieve faster results on-the-ground at scale.

The Financial Strategy pulls all levers available to council to accelerate and scale-up activity to achieve these goals. Key levers include the council's funding mix (i.e. fees and charges, investment income, debt, external grant funding and rates).

It supports the 'Act Now' philosophy of this LTP being an acceleration of delivery in the early years to both capitalise on third party funding and achieve more, sooner.

The impact of which sees significant pressure on rates and a need to borrow to fund intergenerational and capital projects, and to bridge operating expenses until income from rates and investments increases sufficiently in year 5. By 2025-26 rates revenue is at a level where borrowing to offset rates is not required. By 2030-31 this borrowing from the previous four years is repaid.

This plan includes new borrowing of $120 million over ten years with a total outstanding loan balance of $110 million by the end of 2031 after repayments. External debt peaks in 2026 at $123 million at 140% of revenue.

The strategy over 10 years aims to reduce reliance on investment income by lifting the percentage of income from rates from 50% to 60% and to build an investment income equalisation fund. Council would like to build up investment reserves to increase its resilience to market fluctuations which impact its ability to fund operating expenditure. This does not discount the need and role of investment income as an important revenue stream to subsidise rates, rather aims to protect the organisation against financial/economic shocks/market volatility.

The Investment Strategy aims to optimise returns and portfolio growth by maintaining real capital value and protecting capital for future generations.

It introduces an overall yield split target for Council's investment portfolio and a process for recognising capital gains.

Councils primary objective for its investment company, HBRIC, is to deliver a commercial return to Council over the long term. HBRIC has a mandate to grow its investment portfolio, particularly where the investment drives regional growth and environmental outcomes.

3. Key Considerations

3.1 Significant Forecasting Assumptions

The section in this plan on significant forecasting assumptions sets out the key factors and assumptions used in preparing the 2021-31 LTP. Key assumptions influencing the financial projections and financial strategy include interest rates and projected returns on investments, projected inflation rates, Environment, Climate change, population and land use.

3.1 Changes in population

Providing for population change in Hawke's Bay is not expected to have a significant impact on HBRC's operating and capital costs over the 10-year life of the plan.

HBRC's assumptions on changes in population are set out in the Significant Forecasting Assumptions section of this LTP. The HB population is expected to grow by between 0.61% and 0.76% per annum over the 10-year period. The Hawke's Bay population is expected to grow from 176,694 in 2021 to 189,672 in 2032.

3.2 Change in land use

HBRC is a regional council and as such the demand for council services and capital expenditure is not impacted by changes in population and land use to the degree that these factors impact on a City or District Council.

HBRC's assumptions on changes in land use are set out in the Significant Forecasting Assumptions section of this LTP.

Changes in land use are not expected to have a major impact on the cost of Council services over the 10 years of this plan.

3.3 Change in community values and expectations

There is increasing pressure on government (local and central) to deliver better environmental outcomes, faster. As a result, central government has created new legal and rule-based instruments (such as the National Policy Statement for Freshwater, amongst others) that require HBRC to do more in certain areas. This plan proposes a range of land and water related initiatives to effect change at scale and pace to address increased community expectations. This package of initiatives is

focussed on getting things done on-farm through a mix of incentives and regulatory backstops as needed. The package is designed to provide landowners with the knowledge, tools and resources to meet the required changes, ideally before nationally driven deadlines come into effect.

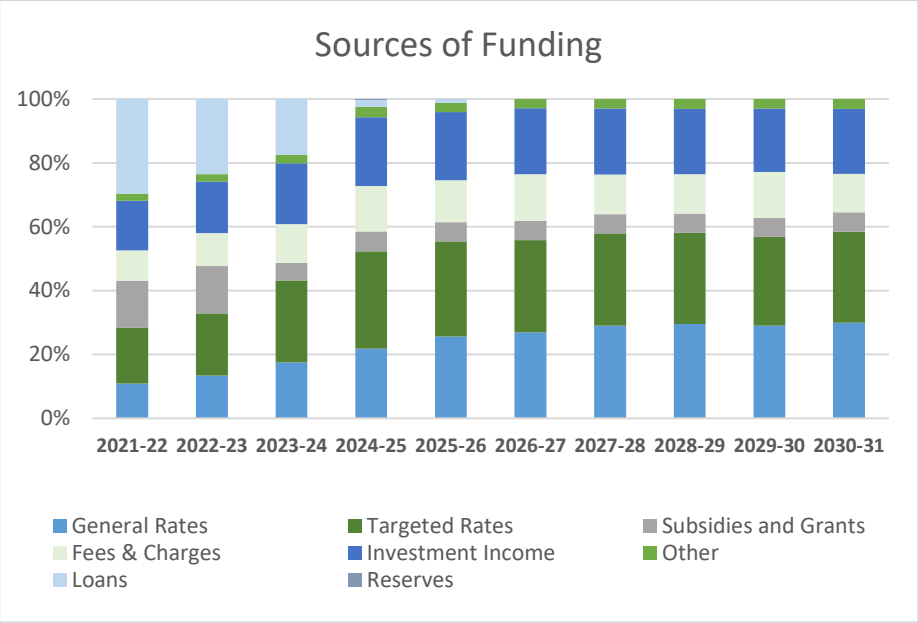
4. Funding

4.1 Funding Sources

HBRC activities are funded by a diverse mix of funding sources, including:

- General Rates
- Targeted Rates
- Investment Income
- Fees and Charges
- Loans
- Reserves
- Grants
- NZU's

The funding mix over the period of the LTP is shown below.



The challenge for HBRC is to fund its accelerated strategic agenda and reduce it's reliance on investment income and build an investment equalisation fund to provide a more resilient long-term strategy. This funding strategy uses external borrowing particularly in the early years to balance rate increases. It strives to maintain real value and grow returns from the investment portfolio to ensure future both current and future generations of rate-payers benefit.

4.1 Fees and charges

Fees and charges provide around 15% of the annual funding requirement of HBRC, reflecting the user pays principle of charging directly to those using our services, where it is practical to do so. Eighty percent of recoverable costs related to consent and compliance activities are charged to consent holders, and it is proposed to introduce a new charge to Napier Port Ltd to cover 60% of the costs of the management of navigational safety in the Napier Pilotage area.

Section 36 of the RMA allows regional councils to charge consent holders to recover costs related to research, investigation and monitoring of the environment. HBRC has continued with the policy of recovering 35% of the cost of water science activities from relevant consent holders but are proposing a change to the methodology used to allocate the annual charges, to simplify the fee schedule to region wide charges, and to introduce more proportionality of the charge to consented activity and the effects of the consented activity.

4.2 Investments

HBRC has historically been able to keep general rates at a minimum as they are subsidised by investment income effectively providing these returns back to the regional community.

A significant portion of investment income is derived from HBRC's investment in HBRIC Ltd which owns Napier Port. This ownership was reduced from 100% to 55% in August 2019 by way of an IPO listing 45% of shares on the NZX. The capital released from the IPO was ring-fenced and placed into managed funds. This achieved an objective of greater diversification of the investment portfolio. Other investment income includes leasehold income, forestry income, cash on term deposit.

Because of its reliance on investment income, HBRC was significantly impacted by the volatility of financial markets in the wake of the Covid-19 pandemic. The 2021-31 investment strategy aims to reduce reliance on investment income to fund Councils day to day operations and to build an investment income equalisation fund to provide resilience and reliability in the future.

4.3 Debt

The 2021-31 LTP continues the strategy to leverage the balance sheet set out in the previous plan. Low external debt and historically low interest rates support the financial strategy set out in this plan.

We will continue to borrow for capital works and for projects and programmes that provide intergenerational benefits, specifically where additional funding can be leveraged from other parties (government). This plan includes borrowing in years one through five to balance the rating impact and fund the accelerated work programme until income from rates and investment income is sufficient to fund the Councils operations.

Planned new borrowing includes riparian planting and afforestation, sustainable homes, asset management (flood control schemes), system integration software and other capital expenditure.

HBRC has considered the timing of the programmes and the associated borrowing required to ensure that this best meets the needs of current and future generations. The debt levels stated below are set as such to enable HBRC to maintain the present levels of service and to meet the increased levels of service proposed in this Plan.

A key aspect of this LTP financial strategy is an increase in the debt limit of Net Debt as a percentage to Total Revenue from 150% to 175% in line with LGFA policy covenants. This provides more headroom and ability to borrow in the plan

Debt Security

When HBRC undertakes external borrowing it does so under the Debenture Trust Deed which was established in October 2009.

Under the Debenture Trust Deed HBRC's borrowing is secured by a floating charge over all HBRC rates levied under the Rating Act, excluding any rates collected by HBRC on behalf of any other local authority. In such circumstances, the security offered by HBRC ranks 'Pari Passu' for all stock issues by HBRC including any security stock issued.

Under the Debenture Trust Deed HBRC offers deemed rates as security for general borrowing programmes. From time to time, with prior HBRC and Debenture Trustee approval, security may be offered by providing a charge over one or more of HBRC's assets.

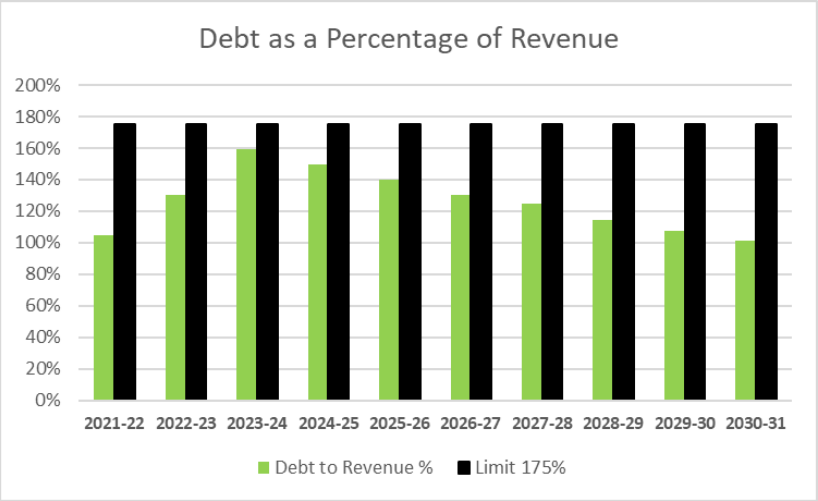
- Physical assets will be charged only where:
- There is a direct relationship between the debt and the purchase or construction of the asset which it funds (such as an operating lease or project finance);
- HBRC considers a charge over physical assets to be appropriate;
- Any pledging of physical assets must comply with the terms and conditions contained within the Debenture Trust Deed.

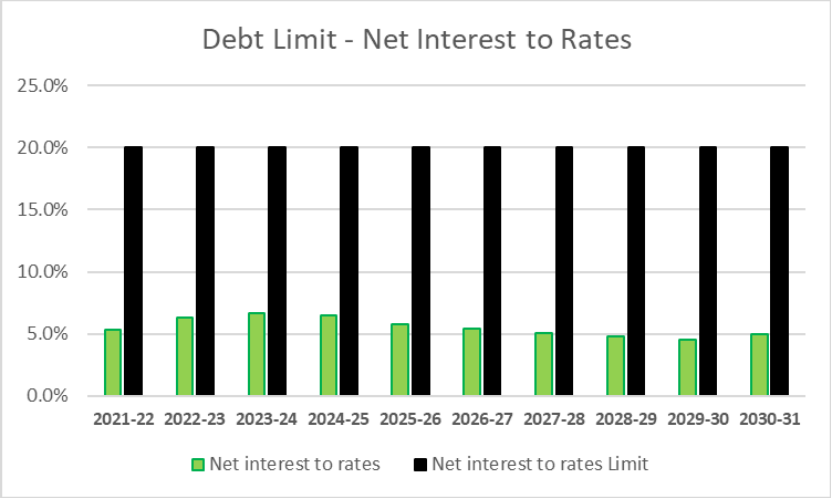
Limits on Debt

HBRC has two debt affordability limits which must be complied with:

- Net external debt as a percentage of total revenue must be under 175%
- Net Interest on external debt as a percentage of annual rates income must be less than 20%

The graphs below show the proposed limits on debt for the 2021-31 LTP





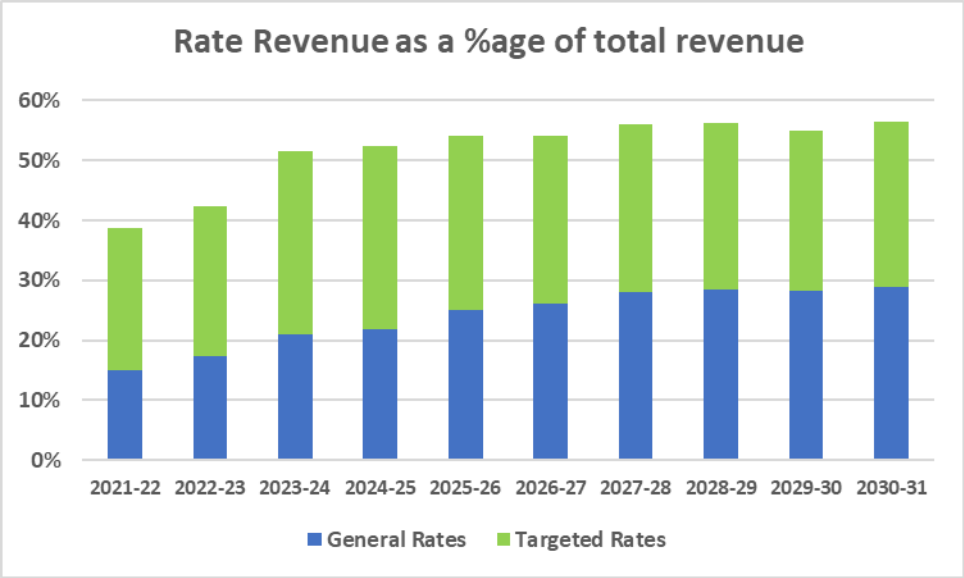
4.4 Rates

The balance of HBRCs funding requirements are provided by rates. Rates are always the last alternative for funding operations due to the direct impact on the community, however they are a Councils most reliable source of income, and a key aspect of this LTP financial strategy is to reduce the reliance on other revenues and move the proportion of rates revenue up to 60% of total income over time. The proportion increase up from 39% in 2021-22 to 56% in 2031.

Limits on Rates and Rate Increases

HBRC has set the following limits in relation to its rate revenue:

- Total rates revenue will not exceed 60% of HBRCs annual revenue requirements
- Increases in the annual rate revenue requirement will not exceed 8% of HBRCs annual operating expenditure requirements



4.5 Impact on Proposed HBRC Service Levels

HBRC is confident of its ability to provide and maintain existing levels of service and to meet additional demands for services included in the LTP within these limits.

4.6 Balanced Budget and Operating Surplus

HBRC have prepared an LTP balanced budget other than in year three with a balanced budget benchmark of 97% (-$1.04m). The increasing surplus in the later years is to repay borrowing used to smooth the rates impact in the initial 4 years.

Rate Increases/(Decreases)										
	2021-22	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**	2028-29	2029-30	2030-31
Total rates increase from previous year	↑ **19.5%**	↑ **15.0%**	↑ **14.5%**	↑ **10.0%**	↑ **11.4%**	↑ **7.2%**	↑ **6.9%**	↑ **4.9%**	↑ **3.9%**	↑ **3.4%**

Financial Measures: Rate Forecasts											
Rates ($000's)	2020-21	**2021-22**	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**	2028-29	2029-30	2030-31
General Rates	8,427	11,347	13,834	15,776	17,809	21,983	24,626	27,294	29,003	30,385	31,489
Total Targeted Rates	16,213	18,101	20,031	22,992	24,846	25,594	26,348	27,200	28,134	29,036	29,942
Total Rates	24,640	29,448	33,865	38,768	42,655	47,577	50,975	54,494	57,137	59,421	61,431

Projected Number of Rating Units										
	2021-22	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**2026-27**	**2027-28**	**2028-29**	**2029-30**	**2030-31**
Rating Units	71,957	72,525	73,105	73,653	74,213	74,792	75,360	75,918	76,465	77,000

5. Investment Strategy

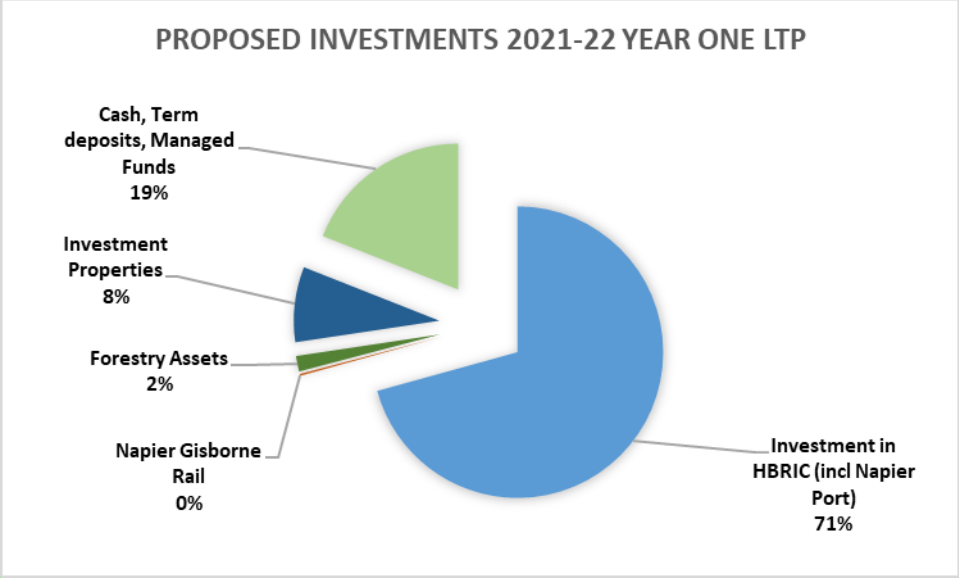
5.1 Financial Strategy for HBRC's Investment Portfolio

HBRC's strategic investment agenda for the 2021-31 LTP is to optimise returns and protect and grow the real value of its investments for the benefit of all ratepayers.

It aims to reduce Council's reliance on investment income to fund day to day operational expenditure and build an investment income equalisation fund to increase its resilience to market fluctuations impacting its ability to fund operating expenditure. This does not discount the need and role of investment income as a revenue stream to subsidise rates and to help fund an aggressive programme of environmental enhancement projects, rather aims to protect the organisation against financial/economic shocks/market volatility.

Following the Napier Port minority IPO which took place during the previous planning cycle, Councils primary objective for its investment company HBRIC, is to deliver a commercial return to Council over the long term. Council has given HBRIC a mandate to borrow against its assets to grow its investment portfolio. Particularly where the investment drives regional growth and environmental outcomes.

The allocation of the current investment portfolio in year one of the LTP is shown below.



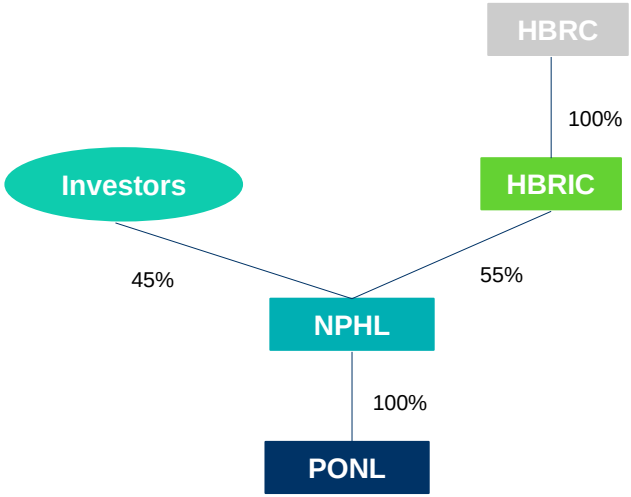
5.2 Investment Strategies/Economic Drivers/Value of Investment

HBRIC Ltd

HBRIC Ltd, the Council's investment company, commenced activities in February 2012. As signalled in the previous LTP, in August 2019, as part of a capital restructure, HBRIC reduced its ownership in the Port of Napier Limited (PONL) from 100% to 55%. HBRIC Ltd maintains majority ownership of PONL through its share (55%) of ownership of the PONL's holding company, Napier Port Holdings Ltd (NPHL). The capital restructure also saw the successful NZX listing of NPHL in August 2019.

Dividends payable to HBRC will be determined by the HBRIC Ltd Directors after taking into account its profitability, future investment and cash flow requirements and requirements to meet the solvency test under provisions of the Companies Act 1993.

During this LTP HBRIC Ltd intends to develop its own Investment Strategy and Statement of Investment Policy and Objectives (SIPO) which will reflect HBRIC Ltd.'s desire to actively grow its portfolio while meeting HBRC's dividend expectations.



The following table summarises the significant forecasting assumptions in respect of HBRIC Ltd dividends.

Year	$'000
2021-22	10,100
2022-23	10,500
2023-24	10,900
2024-25	11,250
2025-26	11,690

Year	$'000
2026-27	12,150
2027-28	12,620
2028-29	13,120
2029-30	13,630
2030-31	14,170

Leasehold Properties

Napier

HBRC owns leasehold endowment property within and around Napier City. Ground rents paid by lessors are predominantly set at 5% of current land value, or "fair annual ground rental" and reviewed every 21 years.

In 2013, HBRC sold the annual rentals due from its portfolio over the next 50 years (i.e. until July 2063) to ACC for a lump sum of $37.8 million. As the annual rents have been sold this LTP assumes that the income received will be paid out as an expense with a small margin to be kept by HBRC as an administration fee for the ACC contract and property values being greater than the assumed growth.

The underlying properties continue to be owned by HBRC and sales to lessors have continued, and may continue in the future, in the same way as they have done in the past. HBRC has invested these funds in investments specified in HBRC investment policy and will continue to do so in respect of net proceeds, (after disbursements to ACC), of sales of freehold interests to lessors.

Wellington

HBRC holds a portfolio of 12 leasehold properties in inner city Wellington which were purchased from the historic proceeds of the sale of Napier leasehold properties. These leases provide a return of $841,314 per annum with leases renewed every 14 years.

Forestry

HBRC has an existing forestry portfolio consisting of:

Site Name	Area (ha)	Assumptions
CHB	168	No material investment, maintenance only, no harvesting in LTP period
Mahia	36	No material investment, maintenance only, no harvesting in LTP period
Waihapua	213	No material investment, maintenance only, no harvesting in LTP period
Tutira	114	Harvesting proposed over the period from 2021 to 2027. Replanting after Harvest
Tutira Manuka Honey	90	Maintenance continues with yearly honey income of $7,000 assumed
Tangoio	330	Second tranche of harvesting proposed in 2023 (first tranche was in 2020-21) Replanting after Harvest

Returns on the forestry investments are determined by the harvest revenue received.

Tangoio forestry is treated differently from all the other forestry investment as HBRC does not own the land but does have responsibility for the management and control of the forest. Any income received from harvest is kept on reserve to fund the continuing maintenance programme and is not available for the funding of general HBRC operations.

Managed Funds

Long term Investment Fund (LTIF)

Invested since November 2018 with funds divested from the Ruataniwha Water Storage Scheme, this LTP assumes that the LTIF will return 5.16% per annum. Of the 5.16% assumed returned, 2% will be retained within the fund to protect its capital

amount from inflation. In LTP years 1 through to 3, 3.16% is allocated towards funding the Council's operating costs, reducing to 3.00% thereafter. From year 4, the 0.16% will be ring fenced in a Future Operating Reserve which will provide Council resilience and flexibility against any future market volatility.

Future Investment Fund (FIF)

Invested since September 2019, with the funds received from listing 45% of the Napier Port, this LTP assumes that the FIF will return 5.16% per annum. These returns will follow the same allocation as the LTIF mentioned above.

6. Infrastructure Capital Expenditure

HBRC proposes to embark on a significant Infrastructure capital programme across the 10 years of the Plan. This has significant co-funding from Central Government in the first two years as part of the Infrastructure Reference Group funding for Floodplain Risk Management and the increases in levels of service for the Heretaunga Plains stop banks. Full details regarding the Infrastructure Assets are included in the 30 Year Infrastructure Strategy.