CONFIDENTIAL

DEBT MANAGEMENT STOCKTAKE

FOR

FEBRUARY 2019

AUCKLAND • CHRISTCHURCH

CONTENTS

1. INTRODUCTION 1
2. EXECUTIVE SUMMARY 2
3. CURRENT FUNDING ARRANGEMENTS VERSUS LGFA 4
   3.1 Current Funding Arrangements 4
   3.2 LGFA Pricing 4
   3.3 Savings to KDC Utilising LGFA Borrowing 6
4. FINANCIAL COVENANTS AND REQUIRED REPORTING 8
   4.1 Financial Covenants 8
   4.2 Reporting Requirements 9
5. THE PROCESS AND COST OF JOINING THE LGFA 10
   5.1 The Process of Joining the LGFA 10
   5.2 Costs Associated with Joining the LGFA 12
6. ADVANTAGES AND DISADVANTAGES OF LGFA DEBT 13
   6.1 Potential Advantages 13
   6.2 Potential Disadvantages 14
7. THE JOINT AND SEVERAL GUARANTEE 15
   7.1 Details of the Joint and Several Guarantee 15
   7.2 KDC's participation as a Guarantor or Non Guarantor 18
8. INTEREST RATE RISK MANAGEMENT 19
9. OPERATIONAL PROCEDURES AND REPORTING 20
   9.1 Operational Procedures 20
   9.2 Reporting 21

APPENDIX ONE - THE LGFA 22
   Background to the LGFA 22
   Funding Offered by the LGFA 22
   The Processes Required to be Undertaken each time the LGFA is Used as a Funding Source 23
   The Legal and Administrative Requirements Associated with Joining the LGFA 24
APPENDIX TWO - DEFINITIONS 26
APPENDIX THREE – SAMPLE DEBT AND COVER GRAPH 27

This document has been prepared by Bancorp Treasury Services Limited ("BTSL"). Whilst all reasonable care has been taken to ensure the facts stated are accurate and the opinions given are fair and reasonable, neither BTSL nor any of its directors, officers or employees shall in any way be responsible for the contents. No liability is assumed by BTSL, its directors, officers or employees for action taken or not taken on the basis of this document.

1. INTRODUCTION

This confidential Debt Management Stocktake ("Debt Stocktake, Review") for Kaikoura District Council ("KDC") in relation to potential Local Government Funding Agency ("LGFA") borrowing and other associated treasury activities has been prepared by Bancorp Treasury Services Limited ("Bancorp Treasury"). The review has been carried out according to the parameters detailed in a proposal sent to KDC in December 2018, the terms of which were accepted in a Contract for Services signed on 30 December 2018.

The Debt Stocktake consists of the following:

- Review of current KDC bank funding arrangements, current pricing of LGFA debt and the potential savings available from using the LGFA. *(Section 3)*
- The financial covenants associated with LGFA borrowing, KDC's projected compliance with them and the reporting requirements associated with LGFA debt (*Section 4)*
- The processes associated with joining the LGFA and the cost of joining. *(Section 5)*
- The advantages and disadvantages of KDC accessing LGFA debt *(Section 6).*
- The LGFA's joint and several guarantee *(Section 7).*
- KDC's current interest rate risk management parameters and recommended amendments to these *(Section 8).*
- KDC's current treasury operational procedures focussing on the duties and responsibilities of the treasury function, potential areas of focus in a treasury policy and the recommended content for a robust quarterly treasury report. *(Section 9).*
- Background to the LGFA, details of the types of funding offered by the LGFA and the processes to be followed each time the LGFA is accessed for funding *(Appendix 1).*

2. EXECUTIVE SUMMARY

The LGFA has been continually evolving since its inception in 2011 and is generally able to offer pricing to participating borrowers that is lower than that provided by the banking sector and the capital markets, i.e. standalone bond issuance. In most cases the savings are material and this review identifies that KDC would derive a financial benefit in joining the LGFA and using it as a debt source.

In this Review Bancorp Treasury has identified that there are a number of potential advantages for KDC if it utilised the LGFA as a funding source, the key ones are as follows:

- Significantly lower borrowing costs for all funding terms.
- Longer borrowing terms are accessible at appropriate borrowing costs.
- Increased flexibility of maturity dates whereby KDC can nominate any maturity date out to a maximum term offered by the LGFA (which is currently April 2033).
- A more reliable form of debt in that KDC would not be subject to arbitrary decisions by the banking sector around perceived credit quality and related pricing. Borrowing can be accessed with as little as two days' notice.

It should also be noted that KDC is compliant with the all the financial covenants associated with LGFA borrowing over its current Long Term Plan ("LTP") cycle.

There are however a number of issues to consider:-

- There is administrative time and legal costs involved with joining the LGFA, although these are one-off demands that would be offset by cost and time savings in the future.
- There are contingent risks associated with involvement in the LGFA via the joint and several guarantee requirements. However, it is our view that these risks are substantially mitigated by the structure and operating framework of the LGFA. Analysis around the joint and several guarantee and the mitigating factors, are detailed in Section 7.
- There are a number of aspects relating to KDC's current treasury operation which would need to be improved. These include establishing a formal Treasury Policy and expanded Treasury reporting (typically quarterly).

Based on our analysis, we make the following recommendations:-

- KDC becomes a member of the LGFA with its level of participation as either a guarantor or non-guarantor being decided by the full Council.
- KDC maintains a notional bank facility for short-term liquidity purposes.
- KDC establishes a formal Treasury Policy and expands reporting requirements with details defined within this document.

3. CURRENT FUNDING ARRANGEMENTS VERSUS LGFA

3.1 CURRENT FUNDING ARRANGEMENTS

Currently KDC obtains its funding from a Customised Average Rate Loan ("CARL") facility from the Bank of New Zealand ("BNZ"). The facility limit is $5.366 million and the original term was for 5 years, with a current maturity date of 28 June 2019. The facility offers a floating rate option and a fixed term option. The pricing structure applicable to the facility as at 28 January 2019 was provided by the BNZ. This has enabled us to calculate the implied margins being charged and these are summarised below:-

Term	Rate	Market Base Rate	Implied Margin
3 month floating	4.03%	1.92%	2.11%
1 year fixed	4.11%	1.92%	2.19%
2 years fixed	4.10%	1.91%	2.19%
3 years fixed	4.15%	1.95%	2.20%
4 years fixed	4.37%	2.03%	2.34%
5 years fixed	4.62%	2.13%	2.49%

Based on the above pricing the CARL facility is considerably more expensive than bank pricing we have observed for other rural local authorities of a similar size to KDC. However, it should be noted that typically funding is by way of a wholesale product, for example a Committed Revolving Cash Advance Facility ("CCAF"). The table below shows current pricing to the Council sector for CCAFs. We would expect the all up cost for a 5 year facility for KDC to be circa 1.60%. Thus even a renegotiation of the current bank funding arrangements when they mature in June this year would deliver material savings to KDC.

When comparing potential savings for KDC in using the LGFA we have used CCAF pricing rather than the current implied CARL margins as we believe this is the appropriate basis to compare future funding costs.

Term	Facility Fee	Margin	All up Cost
2 years fixed	0.37%	0.73%	1.10%
2 years fixed	0.35%	0.95%	1.30%
3 years fixed	0.275%	1.00%	1.275%

3.2 LGFA PRICING

The LGFA provides funding for terms ranging from 1 month to 14 years on both a floating and fixed rate basis. Pricing varies according to whether the borrower has a credit rating or not and whether the borrower is a guarantor or non-guarantor. If total debt with the LGFA is less than $20.0 million then the Council does not have to be a guarantor, over $20.0 million it must join as a guarantor.

If KDC were to join the LGFA, either as a non rated guaranteeing borrower the current margins over BKBM floating rates for Commercial Paper ("CP") and Floating Rate Notes ("FRN") and the relevant swap rate for Fixed Rate Bonds ("FRB") is summarised in the table below. The BKBM and swap rates are the applicable base rates for CCAF based bank funding.

Commercial Paper is borrowings for a term of up to 12 months whereas FRN's set the margin for the full term of the loan but the base rate is reset quarterly, depending on the floating rate at the time. The rate on a fixed rate bond, including margin, is locked in for the term of the borrowing. To enable a direct comparison between an assumed CCAF facility and LGFA pricing we have obtained LGFA pricing as at 28 January 2019 for a guaranteeing and non-guaranteeing Council and interpolated (see definition in Appendix 2) these for standard terms to enable a comparison with generic swap rates. This has enabled us to calculate the implied margins for bank funding compared to debt sourced from the LGFA.

For information purposes we have also included the implied margin on the current CARL facility. This analysis is summarised in the table below.

Maturity	Credit Spread floating	Guarantor Credit Spread Fixed	Non Guarantor Credit Spread Fixed	CCAF 5 year	CARL
1 month	0.22%	N/A	N/A	1.60%	
3 months	0.22%	N/A	N/A	1.60%	2.11%
6 months	0.27%	N/A	N/A	1.60%	
12 months	0.27%	N/A	N/A	1.60%	2.19%
2 years	0.65%	0.60%	0.70%	1.60%	2.19%
3 years	0.72%	0.67%	0.77%	1.60%	2.20%
4 years	0.82%	0.77%	0.87%	1.60%	2.34%
5 years	0.88%	0.83%	0.93%	1.60%	2.49%
7 years	1.06%	1.01%	1.11%	1.60%	
10 years	1.22%	1.17%	1.27%	1.60%	

As can be seen LFGA sourced debt is cheaper than an implied CCAF 5 year facility and significantly less than the implied margins on the current CARL facility from BNZ. It should also be noted that it would be extremely difficult to get a bank facility (or fixed rate loan) with a term for more than 5 years at a realistic margin. This means that 10 year funding for example would not be locked in fully, as while a swap rate for 10 years could be fixed the credit margin would only be locked in for the term of the underlying bank facility. LGFA borrowing on the other hand locks in all costs for the term of the debt.

3.3 Savings to KDC Utilising LGFA Borrowing

There are a number of assumptions we have made in calculating the savings (summarised in the table below) to be gained from accessing the LGFA compared to via a CCAF bank facility. These are detailed below.

- LGFA access from by 1 July 2019.
- All new debt prior to 1 July 2019 and any refinancing will be on a floating rate basis with an aim to term out as appropriate post 1 July.
- Current BNZ fixed rate debt that matures beyond 1 July 2019 is held to maturity and then refinanced via LGFA.
- Assume that a five year CCAF facility commencing on 1 July 2019 would have an all-up cost (facility fee and margin) of 1.60%. Fixed rate swap transaction costs would be 0.05% per annum including credit charges.
- All new debt requirements are pre-funded on 1 July. Repayments decrease floating rate debt from the end of the financial year. New and refinanced debt is assumed to be split, 30% on a floating rate basis and 70% fixed, assumed term 5 years.
- We have ignored the potential interest income that might accrue from this pre-funding although this would be a positive benefit given TD rates are above LGFA debt costs.
- We have used current interest rates.
- KDC maintains a committed $1.0 million bank facility (on a rolling 2 year term) with assumed facility fee of 0.50% per annum or $5,000. The margin assumed at 0.80% but we would not expect the facility to be utilised for any significant period.

Financial Year	Margin Costs LGFA	LGFA 'Extra' Costs	Total LGFA Margin Costs	Margin Costs CCAF	Margin Costs CARL
2019/2020	71,627	24,000	95,627	176,903	248,855
2020/2021	74,173	13,000	87,173	177,712	249,703
2021/2022	80,113	13,000	93,113	182,077	255,300
2022/2023	78,223	13,000	91,223	170,877	239,200
2023/2024	77,413	13,000	90,413	166,077	232,300
2024/2025	76,333	13,000	89,333	159,677	223,100
2025/2026	75,253	13,000	88,253	153,277	213,900
2026/2027	75,253	13,000	88,253	153,277	213,900
2027/2028	72,314	13,000	85,314	147,435	205,756
2028/2029	71,380	13,000	84,380	141,900	197,800
Total Margin 2019/2029			893,081	1,629,212	2,279,814
Savings from LGFA				736,132	1,386,734

The calculations in the preceding table also take into account of the initial setup costs associated with joining the LGFA of circa $19,000, the subsequent annual ongoing costs of circa $8,000 per annum and the $5,000 per annum cost to maintain a $1.0 million committed bank facility for liquidity purposes only. We have also included implied savings based on the current margins applicable to the CARL facility.

As can be seen over the 10 year period there are substantial savings, even if KDC moved to cheaper CCAF bank borrowing instead of a continuation of the CARL facility.

The actual savings that would accrue would depend on actual debt levels over the next 10 years, the timing of Council cash flows and related debt drawdowns. However, it is clear that even if debt levels are much lower than expected there would still be considerable savings.

4. FINANCIAL COVENANTS AND REQUIRED REPORTING

4.1 FINANCIAL COVENANTS

If KDC joined the LGFA it would need to meet the financial covenants that the agency requires borrowers to adhere to. The covenants vary according to whether the borrower has a credit rating or not. In our experience the minimum debt level required to make a credit rating cost effective is in excess of $50.0 million, therefore it is not our intention to recommend that KDC investigates obtaining a credit rating. Assuming KDC is unrated, the covenants that KDC would be required to adhere to are detailed below.

Net debt shall not exceed 175% of total revenue.Net debt is defined as total consolidated debt less liquid financial assets and investments. Total revenue is defined as cash earnings from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue and excludes non-government capital contributions (e.g. developer contributions and vested assets).

Net interest payable shall not exceed 20% of total revenue. Net Interest is defined as the amount equal to all interest and financing costs less interest income for the relevant period.

Net interest shall not exceed 25% of annual rates income Annual rates income is defined as the amount equal to the total revenue from any funding mechanism authorised by the Local Government (Rating) Act 2002 together with any revenue received from other local authorities for services provided and for which the other local authorities rate.

Liquidity shall exceed 110%. Liquidity is defined as external debt plus committed loan facilities plus liquid investments divided by external debt. Liquid investments include cash, term deposits and capital markets products such as CP, FRNs and FRBs.

We have calculated the appropriate financial ratios based on the latest information supplied by KDC and this is summarised in the table on the following page.

As can be seen KDC has considerable headroom for all the covenants that are monitored over the timeframe reviewed.

Covenant	Net debt to total revenue*		Net interest to total revenue*		Net interest to annual rates income		Liquidity	
Limit	< 175%		< 20%		< 25%		> 110%	
2019/2020	25.0%	✓	2.0%	✓	7.7%	✓	135.4%	✓
2020/2021	35.6%	✓	1.8%	✓	5.6%	✓	116.1%	✓
2021/2022	65.6%	✓	4.1%	✓	5.7%	✓	127.0%	✓
2022/2023	51.9%	✓	3.1%	✓	5.1%	✓	125.0%	✓
2023/2024	44.8%	✓	2.7%	✓	4.7%	✓	125.5%	✓
2024/2025	51.8%	✓	3.3%	✓	4.4%	✓	131.4%	✓
2025/2026	50.1%	✓	3.1%	✓	4.1%	✓	129.5%	✓
2026/2027	45.3%	✓	2.9%	✓	3.9%	✓	132.0%	✓
2027/2028	42.6%	✓	2.7%	✓	3.6%	✓	133.2%	✓
2028/2029	37.8%	✓	2.5%	✓	3.4%	✓	134.7%	✓

* *excludes development contributions*

4.2 Reporting Requirements

The reporting requirements associated with LGFA borrowing are not onerous as virtually all of the information that the LGFA requires will be contained in KDC's Annual Report. In addition to the statutory requirement to complete the Annual Report by 31 October an LGFA borrower must file an Annual Compliance Certificate. Additionally the LGFA can make any 'reasonable' request for information that it deems necessary.

5. THE PROCESS AND COST OF JOINING THE LGFA

5.1 THE PROCESS OF JOINING THE LGFA

There are a number of steps that KDC would need to go through to join the LGFA.

Public Consultation

KDC would need to consult with the public prior to joining LGFA. This can be done either through the Annual Plan, LTP or by special consultation. Consultation needs to be undertaken even if the KDC does not intend to be a guarantor, as there needs to be consultation in regard to the investment in LGFA Borrower Notes. All borrowers from the LGFA are required to contribute 1.6% of the total amount borrowed as capital, known as Borrower Notes. These can be converted to equity at the discretion of the LGFA. Because of the potential for the Borrower Notes to convert to equity, all local authorities need to go through the Special Consultative Process before joining the LGFA. This is because of the law relating to a local authority's holding of an equity stake in a CCO or CCTO.

A consultation document which sets out the business case for joining the LGFA needs to be prepared.

Treasury Policy

The council will need to amend its Treasury Policy to make sure that it is consistent with the requirements related to joining the LGFA. This will involve:

- Amending the Liability Management Policy to allow the council to borrow from LGFA.
- Amending the Investment Policy to incorporate the ability to invest in LGFA Borrower Notes. It may also include the ability to invest in LGFA bonds and LGFA Commercial Paper.

There may also be other parts of the Treasury Policy that requiring amending such as counterparty credit risk, ability to subscribe to LGFA equity, ability to subscribe to LGFA subordinated debt and ability to provide a charge over the council's rates. The changes will also be dependent upon whether KDC is a shareholder, guarantor or non-guarantor.

Debenture Trust Deed

If it wishes to join the LGFA, KDC would need to establish a Debenture Trust Deed ("DTD"). A DTD is an overarching security document under which all lenders share the same security, with the way in which they share it dictated by the DTD. Without a DTD, a new security sharing arrangement would need to be entered into each time a new lender was added,

which can be cumbersome and expensive. The DTD is prepared by solicitors; the two most recognised firms in this area are Simpson Grierson and Buddle Findlay.

Appointment of a Trustee

The council needs to appoint a Trustee to administer the DTD. The two most commonly used firms in this area are Covenant Trustee Services and Trustees Executors.

Appointment of a Registry

A council needs to appoint a Registry to maintain the register of the LGFA debt on issue and also to act as the paying agent. The two most commonly used firms in this area are Computershare and Link Market Services.

Documentation

There are two key documents that need to be signed prior to joining the LGFA, these are:-

- Accession Deed to the Multi-Issuer Deed. The Multi Issuer Deed documents the agreed arrangements between a borrowing council and LGFA in relation to borrowing. All borrowers must accede to the Multi Issuer Deed either as a borrower and guarantor or as a non guaranteeing borrower.
- Accession Deed to the Notes Subscription Agreement. The Notes Subscription Agreement documents the arrangements agreed between borrowing councils and LGFA in relation to the issue of Borrower Notes. All borrowers must accede to the Notes Subscription Agreement not just shareholding Councils.

In addition the following documents need to be executed prior to each new tranche of debt.

- Stock Issuance Certificate
- Section 118 Chief Executives Certificate
- Officers Certificate
- A borrowing council also needs to issue a Security Stock Certificate for each borrowing (although for CP only one per year is required).

KDC would need to use a law firm to assist them with the required legal documentation LGFA currently use Russell McVeigh as its legal advisors. A council will require its own legal advisor; presumably this will be the firm that prepares the DTD.

Formal Application to Join LGFA

A council needs to formally apply to the LGFA to become a member. Once the application is received, the LGFA Board will consider the application. Historical and forecast future compliance with LGFA's financial covenants will form part of the consideration although any other material issues relevant to a council's credit worthiness will also be taken into account.

5.2 Costs Associated with Joining the LGFA

The following tables detail the initial costs in the first year that KDC would incur if it joined the LGFA and the ongoing costs in subsequent years.

Initial Establishment Costs	
Establishment of Debenture Trust Deed	$9,000
Initial Trustee legal costs	$4,000
Legal fees for joining the LGFA	$6,000
Total	**$19,000**

Ongoing Fees (per annum)	
Trustee Fees	$4,000
Registry fees	$4,000
Total	**$8,000**

6. ADVANTAGES AND DISADVANTAGES OF LGFA DEBT

6.1 POTENTIAL ADVANTAGES

There are a number of advantages of borrowing from the LGFA. These can be summarised as follows.

Pricing: The analysis contained in Section 3 of this review indicates that there would be a significant benefit to KDC from accessing LGFA funding compared to current arrangements and also a vanilla CCAF bank facility. This is in 'normal market conditions but in times of market stress, such as experienced at times during the Global Financial Crisis, we would expect this benefit would increase further due to the LGFA's 'AA+' credit rating, its strong liquidity provisions and its diversification of lending.

Immediacy of Funding: LGFA CP, FRNs and FRBs can be accessed on a continuous basis from the scheduled tenders the dates for which are published well in advance. Additionally the LGFA offers bespoke borrowing whereby borrowers can access funds within two days of giving notice to borrow.

Longer Funding Tenors: Currently the LGFA offers funding out to April 2033 and is considering offering an April 2037 maturity. KDC would be able to access significantly longer term funding than it could obtain from the banking sector.
We would not envisage KDC extending its borrowing horizon with LGFA debt merely because it was available. Such decisions are part of the ongoing risk management process. Given the 3 year election cycle, LTP refresh cycles and the inherent uncertainty around long term capex projections, we see significant risk in Council's in general locking in funding costs beyond 5 to 10 years.

Increased Funding Flexibility: With LGFA funding the borrower can nominate both the type of debt to be issued (fixed or floating) and any term (currently out to April 2033). This assists with managing the debt maturity profile and could also be beneficial from an overall interest rate risk management perspective. Bank debt is constrained from a duration perspective as bank pricing for KDC for terms in excess of 5 years (if it was offered) would likely be prohibitively expensive.

Ease of Issuance: Once the initial setup process has been completed it is a relatively straightforward procedure to issue LGFA debt which does not involve excessive management time. The borrowing documentation is limited to the stock issuance certificate, stock security

certificate, the Section 118 notice or Chief Executives Certificate, Officers Certificate and the term sheet. We understand that the LGFA is looking to streamline the process further by eliminating some of the documentation required to be completed.

6.2 Potential Disadvantages

There are some potential negatives associated with LGFA borrowing that need to be considered.

Being a Guaranteeing Borrower: If KDC joined the LGFA as a guarantor (this is discussed in Section 7) it would be subject to the joint and several guarantee. While there is a contingent risk associated with this, there are significant mitigating factors which substantially lessen this risk to KDC and all other guaranteeing borrowers.

The Need to Consult: Prior to Joining the LGFA KDC would need to go through the Special Consultative Process because of the potential for the Borrower Notes to be converted to equity. There is some administrative time associated with this process and Councils choose to do it as a one off, or through the Annual Plan or LTP process. However it is a one off occurrence that doesn't have to be repeated.

The Setup Process: This process does take up administrative time and there are associated legal costs, for example KDC would need to put in place a Debenture Trust Deed and we would envisage legal costs of $9,000 for this. There would be other costs of circa $10,000, for example the initial Trustee legal costs and LGFA linked legal costs. As with the need to consult this is a one off occurrence.

7. THE JOINT AND SEVERAL GUARANTEE

7.1 DETAILS OF THE JOINT AND SEVERAL GUARANTEE

One of the fundamental aspects of the LGFA is the Joint and Several Guarantee which helps the agency to achieve its S&P Global Ratings ("S&P") long term credit rating of 'AA+', the same rating as the New Zealand government. To be able to achieve the pricing that the LGFA does, it needs its credit rating to remain at this level.

The security granted by each of the guarantors under their respective Debenture Trust Deeds secures their obligations under the guarantee. The guarantee has the following features.

The guarantee applies to all participating borrowers who will be liable in the event of a default by any of the borrowers. The exception to this is that, if a local authority borrows less than $20.0 million, it is not compulsory to participate in the guarantee but it will be charged an additional 0.10% on its borrowing.

KDC, with its maximum projected debt of $12.2 million, could obtain all of its debt from the LGFA without exceeding the $20.0 million threshold. Of the 61 borrowing councils to date, 48 are guarantors.

In relation to the potential liability there are a number of factors which significantly lessen the possibility that the guarantee would be called and these include:-

The financial position of the LGFA. The agency has paid up capital of $25.0 million, unpaid capital of $20.0 million and retained earnings of $33.0 million. In addition it has $135.0 million of Borrower Notes that can be converted to equity at the sole discretion of the LGFA

Access to Liquidity. The LGFA has access to a standby funding facility from the Debt Management Office (in effect the New Zealand Government) of $600.0 million, which can be increased to $1.0 billion at the request of the LGFA. The current level of $600.0 million helps the agency to avoid paying unnecessary commitment fees. In addition the LGFA had $100.0 million invested in financial market instruments as at 31 January 30 June 2018. This is considerably lower than normal due to the refinancing of the March 2019 maturity. The intention is to build the liquidity back up to around $500.0 million by 30 June 2019.

Initial and ongoing credit analysis by the LGFA. Prior to being accepted as a borrower from the LGFA all Councils have their financial metrics analysed by the LGFA to ensure that they meet the financial covenants required. Credit analysis is updated annually to ensure ongoing compliance with covenants and this analysis is also forward looking, based on the latest Annual Plan and LTP.

The LGFA Board approves all new LGFA borrowers and in doing so must be satisfied that the applicant Council currently meets, and is able to maintain, compliance with the financial covenants. Also at the outset of a Council joining the LGFA the senior management and sometimes the Chairman of the agency meet with a Council's Mayor, Chief Executive Officer and sometimes the full Council to ensure that the Council is aware of the importance of complying with the financial covenants on an ongoing basis.

Oversight. The Office of the Auditor General, Audit New Zealand and the Department of Internal Affairs all provide oversight of the local government sector. Under the Local Government (Financial Reporting and Prudence) Regulations Act 2014 Councils are required to report annually on performance against six benchmarks, these are as follows.

- Rates affordability
- Debt affordability
- Essential services
- Debt servicing
- Debt control
- Operations control

If the central government becomes concerned about the operational integrity of individual councils a six step intervention processes is possible, this is as follows.

- Request information
- Appoint a Crown Review Team
- Appoint a Crown Observer
- Appoint a Crown Manager
- Appoint a Commission (Kaipara DC, Environment Canterbury)
- Call an election

A covenant breach is an event of review and after 30 days the LGFA can seek repayment of loans. If a Council is in default the remedies flow from the Debenture Trust Deed which is the overarching security arrangement. The Trustee can appoint a receiver and a special rate

(property tax) can be levied on all properties in the region to meet the Councils obligations to the LGFA. The property tax is unavoidable and is a first ranking security over the property. Thus the property can be sold if the owner does not pay the special rate.

If all these measures were unsuccessful then the LGFA Board could call on the guarantee from all Councils. The guarantee is calculated on a pro rata basis comparing a Council's rating base with the total rating base of all guarantors. Based on the latest rates revenue figures (which the guarantee is based on) KDC's implied exposure would be around 0.10% of the total amount called or $100,000 for every $100.0 million called.

Current Council guarantors must quantify the value of the potential obligation faced when accounts are prepared. The Audit Office accepts Councils ascribing a nil value to this contingent liability. This implies that the 'risk' attached to the guarantee is immaterial. This is further reinforced by the comments of S&P in relation to the guarantee when reviewing Council ratings.

In its latest Auckland Council ratings report S&P made the following comments in relation to the contingent liability associated with the LGFA guarantee. *"As part of the arrangements supporting the Local Government Funding Agency (LGFA), Auckland is party to a joint and several guarantee, which we consider a contingent liability. Given the strength of the institutional framework in New Zealand and the requirement that all debt be secured over rates, we believe that the likelihood of a default scenario that would trigger the joint and several guarantee is low. Therefore, the LGFA liability doesn't affect our view of Auckland's contingent liabilities."*

It is important to note that no Council has ever been placed in receivership in New Zealand. Prior to this occurring we would expect that there would be some form of government intervention such as happened with Kaipara District Council and Environment Canterbury (albeit the latter for non-financial reasons). However it must be noted that the Government does not guarantee the obligations of either the LGFA or its members.

The LGFA requires a Compliance Certificate from all LGFA borrowers to be sent by 30 November each year. This includes an affirmation that the Council has adhered to the four financial covenants detailed earlier in this appendix. The certificate must also include the following information which is supplied to all guaranteeing councils.

- Rates revenue and non-rates revenue
- Finance expenses

- Borrowings including details of financial instruments
- Grants, subsidies and capital expenditure contributions
- Cash and cash equivalents held

7.2 KDC'S PARTICIPATION AS A GUARANTOR OR NON GUARANTOR

For KDC it is not essential from a financial or cost saving perspective that it joins the LGFA as a guarantor. The savings from joining as a non-guarantor are significant and as such the decision as to whether or not to join the LGFA does not centre on whether KDC participates as either a guarantor or a non guarantor. If it were to be a guarantor the savings would be circa $10,000 per annum higher, based on an average debt level of $10.0 million.

If KDC joins the LGFA the full Council would need to decide whether it views a saving of approximately $10,000 per annum offsets the extremely minor risk of being called under the guarantee. There is also the more philosophical decision as to whether KDC wants to be a part of the 'greater good' in that it supports the joint and several guarantee which is essential to the existence and success of the LGFA.

8. INTEREST RATE RISK MANAGEMENT

KDC has indicated that the parameters for managing its debt are effectively contained in the Liability Management Policy Compliance Report ("LMR"). Comment on this is provided below.

The table below which governs interest rate risk management is reproduced from LMR, with the top portion of the table containing the interest rate risk management parameters, and the lower portion the maturity profile of the fixed rate debt.

Total borrowings: Term of exposure	Policy levels	Actual Proportion	Compliant?
Floating	10% - 25%	20%	✓
Fixed	75% - 90%	80%	
The following terms of exposure apply to that portion of borrowings that are fixed:			
Term of exposure	Policy levels	Actual Proportion	Compliant?
0 - 1 year	20% - 27%	21%	✓
1 - 2 years	20% - 27%	29%	✗
2 - 3 years	20% - 27%	25%	✓
3 - 4 years	20% - 27%	25%	✓
4 years +	0% - 20%	0%	✓

The parameters in the table appear to require the debt to be micro managed as there are five timeframes in the fixed rate portion of the table. Bancorp Treasury recommends that the table is amended to incorporate three timeframes with varying hedging percentages applying to each one. We regard the interest rate risk management parameters in the following table as being appropriate.

Fixed Rate Hedging Percentages		
	Minimum Fixed Rate	**Maximum Fixed Rate**
Years 1 and 2	40%	100%
Years 2 and 3	20%	90%
Years 4 to 7	0%	60%

These parameters incorporate sufficient flexibility to operate an effective interest rate risk management programme risk through multiple economic and monetary policy cycles and avoid the necessity to micro manage interest rate exposures merely to comply with policy.

An example of the above hedging parameters in graphical form is contained in Appendix 3.

9. OPERATIONAL PROCEDURES AND REPORTING

9.1 Operational Procedures

KDC has indicated that its treasury exposures are primarily managed by the Finance Manager ("FM") who consults with the Finance and Commercial Manager ("FCM") prior to making strategic decisions. The FM undertakes the funding transactions while the Assistant Accountant initiates transfers between bank accounts and places excess funds on term deposit. In the absence of the FM, the FCM undertakes the responsibilities of that executive.

The above describes what happens in practice, but it has been indicated that there is no formal document that sets out the duties and responsibilities of those personnel involved in KDC's treasury function. Bancorp Treasury recommends that a list of the duties and responsibilities relating to treasury management is compiled. Included in this would be the back-up personnel who assume responsibility for treasury activities in the absence of other personnel. From our observations we would see the following as having a role in the operation of the treasury function.

- The full Council
- Chief Executive
- Finance and Commercial Manager
- Finance Manager
- Assistant Accountant

A list detailing the duties and responsibilities of the treasury personnel should ideally be included in a wider Treasury Policy document. Key headings which should be incorporated into a Treasury Policy include the following.

- Objectives of the treasury function.
- Duties and responsibilities of the treasury personnel.
- Identification of risk
- Authorised borrowing instruments including reference to the LGFA
- Authorised interest rate risk management parameters (fixed to floating ratios)
- Funding and Liquidity risk
- Counterparty credit exposures
- Cash management
- Internal controls
- Reporting

9.2 REPORTING

In addition to the comment provided in Section 8 on Interest Rate Risk Management contained in the LMR we make the following additional comments.

Reporting on KDC's treasury exposures is contained in the LMR. This report is supposed to be compiled on a quarterly basis, but due to lack of resourcing and the increased workload resulting from the earthquake the last LMR covered the June 2018 quarter.

The LMR is brief and does not contain some key information. In reality a treasury report should form the basis for the reporting of KDC's funding and associated interest rate risk management activity and provide the elected members and management with details about the Council's borrowing activities. Such a report should contain the following:

- Total debt facility utilisation, including any debt sourced from a bank, the capital markets and the LGFA.
- Interest rate maturity profile against percentage hedging limits.
- New hedging transactions completed - interest rate risk management.
- Weighted average cost of funds.
- Funding profile against the policy limits.
- Liquidity profile against the policy limits.
- Exception reporting as required.
- Summary of any unresolved exception reports.
- Statement of policy compliance.
- Commentary on economic conditions and the debt markets.

APPENDIX ONE - THE LGFA

BACKGROUND TO THE LGFA

The LGFA was established in late 2011 by a group of local authorities and the Crown with the expectation that it would enable local government entities to borrow at lower margins than were currently available. The Crown holds a 20% stake in the LGFA, while currently thirty local authorities hold the remaining 80%. LGFA is a 'council-controlled organisation' under the Local Government Act 2002.

The LGFA has an S&P long term rating of 'AA+' and a short term rating of 'A-1+' and a Fitch Ratings long term rating of "AA+' and a short term rating of 'F-1+' At the end of January 2019 the LGFA had approximately $9.27 billion of council advances including short term debt

The LGFA currently has 61 eligible borrowers of which 58 have borrowed from the agency to The LGFA has advanced 51.0% of the total sector debt outstanding.

FUNDING OFFERED BY THE LGFA

The LGFA offers three types of funding,

- CP for terms between 30 days and 364 days.
- FRNs to a maximum maturity date of April 2033 whereby the margin is set for the life of the FRN and the base interest rate will be the applicable three month bank bill rate.
- FRBs to a maximum maturity date of April 2033 whereby the interest rate is set for the life of the bond.

The majority of local authority borrowing from the LGFA is via a scheduled tender process and these are usually conducted at six weekly intervals. Borrowers can also borrow from the LGFA on any date between tenders. There is usually a 2 basis point add on for borrowing conducted outside of a scheduled tender.

Borrowers can request any of the standard maturity dates offered by the LGFA. Currently there are seven maturity dates that range from March 2019 to April 2033. Alternatively, a borrower can nominate a specific maturity date out to a maximum maturity date of April 2033.

For FRNs and FRBs, the LGFA charges an operating margin for all debt beyond one year of 10 basis points. Additional credit add on costs apply, which vary according to the credit standing of the borrower. For KDC, the add-on would be 0.20%, or 0.30% if it were a non guaranteeing borrower.

The Processes Required to be Undertaken each time the LGFA is Used as a Funding Source

Tenders are held approximately every six weeks with the published tender schedule extending over 12 months. Details of the tender timeframe are on the LGFA's website.

Three weeks prior to each tender LGFA will send out an email to all councils outlining key dates, the bonds it is offering, estimated pricing and market commentary. This is a Council's opportunity to express any indicative interest it may have in borrowing from the LGFA in the next tender.

Final commitment for participation in a tender is required by 12.00 pm on the Friday prior to the tender. This is followed by the LGFA announcing the tender to the market and the NZX.

Councils are then contacted by Russell McVeagh (the LGFA's lawyers) setting out the conditions precedent and outlining the documents required for execution prior to settlement.

Following completion of the tender, Councils receive term sheets from the LGFA which outline the final terms of the transaction. The LGFA requires an authorised signatory of the borrowing Council to countersign and return the term sheets prior to settlement. The Councils' registrar will require an issue notice be sent to them prior to settlement.

The LGFA will contact the Council's Registry to arrange for tender settlement. Transactions are settled between LGFA and the Council's Registry via NZClear three business days after the tender (T+3).

Long term borrowing either to an existing LGFA maturity date or a bespoke date outside of an LGFA tender cycle is initiated by the borrowing Council via an email 'Notice of Request' to LGFA at least three business days' prior to settlement.

Borrowing short term is initiated by a borrowing Council via an email 'Notice of Request.' The LGFA requires at least one business days' notice.

The LGFA outsources the completion of legal documentation for all borrowing transactions to Russell McVeagh. Once a Council has confirmed the details of its borrowing with the LGFA, Russell McVeagh will email the Council outlining conditions precedent and will provide templates of the following documents required to enable borrowing to occur:

- Officer's Certificate
- Chief Executive Certificate (s118 Certificate)
- Security Stock Certificate (which goes to Registry)
- Stock Issuance Certificate

On settlement day the following steps take place (in order):

- Executed Stock Issuance Certificate is forwarded to the Trustee.
- Executed copies of the Stock Issuance Certificate, Security Stock Certificate, Officer's Certificate and Chief Executive Certificate forwarded to Russell McVeagh;
- Copy of the Security Stock Certificate forwarded to the Registry;
- Original documents sent to Russell McVeagh.
- Additionally if the applicable Registry is Computershare then an issue notice is required.

For short term CP borrowing LGFA accepts a single Security Stock Certificate securing all zero coupon securities issued over a calendar year, meaning Councils only need to complete this this the first time they borrow short term each calendar year.

THE LEGAL AND ADMINISTRATIVE REQUIREMENTS ASSOCIATED WITH JOINING THE LGFA

In order for KCC to be able to access the LGFA there are a number of legal requirements to be met. The Liability Management Policy and the Investment Policy needs to incorporate reference to KDC's use of the LGFA. There is standard wording for this which has been approved by Russell McVeagh. If KDC decides to join the LGFA Bancorp Treasury can assist with the necessary amendments required.

Reference in both the Liability Management Policy and the Investment Policy to the Borrower Notes is required. All borrowers from the LGFA are required to contribute 1.6% of the total amount borrowed as capital, known as Borrower Notes. These can be converted to equity at the discretion of the LGFA. Because of the potential for the Borrower Notes to convert to equity, all local authorities need to go through the Special Consultative Process before

joining the LGFA. This is because of the law relating to a local authority's holding of an equity stake in a CCO or CCTO. This is also referenced in Section 5.

The Special Consultative Process required to be undertaken can be done as a one off or as part of the Annual Plan or the Long Term Plan process.

APPENDIX TWO - DEFINITIONS

BKBM is the one to six-month Bank Bill Market (BKBM) rate, which is a weighted-average interest rate for unsecured lending between contributing New Zealand banks and is set every business day. The usual benchmark term for floating rate debt and FRN's is 3 months.

Capital Markets are the markets where securities such as CP, FRNs and FRBs are issued to raise medium to long-term financing, and where the securities are issued in the primary market and thereafter traded on the secondary.

Covenants are financial metrics that give lenders and investors' some confidence in the financial viability of the borrower and the ability to protect their position if the financial position deteriorates below agreed metrics.

Commercial Paper (or CP) is a short term discounted debt instrument with a fixed maturity date of not more than 364 days (but most commonly 90 or 180 days) issued by institutional or corporate borrowers and with recourse only to the borrower.

Fixed Rate Bond or FRB is a debt instrument with a fixed interest rate issued by non-government organisations such as corporates, registered banks, State Owned Enterprises, financial organisations and local authorities which have recourse only to the borrower. The fixed interest rate is set at the time of issuance and does not change during the life of the FRB.

Floating Rate Note or FRN is a debt instrument with a variable interest rate issued by non-government organisations such as corporates, registered banks, State Owned Enterprises, financial organisations and local authorities which have recourse only to the borrower. The FRNs' base interest rate is tied to a benchmark such as 3 month BKBM but with a fixed margin which is set at the outset for the life of the FRN.

Interpolated interest rate - In order to calculate an interest rate for an interim period, you have to interpolate a rate from the two nearest given rates. The interpolation assumes that the interest rate increases or decreases uniformly from one date to the next – in other words, the relationship is a straight line.

APPENDIX THREE – SAMPLE DEBT AND COVER GRAPH

The example hedging parameters graph below is based off the recommended Fixed Rate Hedging Percentages contained in Section 8 and incorporates KDC's projected external debt requirements.

We would recommend that the Treasury Policy gives management discretion around actual hedging activity unless core debt exceeds $5.0 million and at that time the proposed hedging parameters are activated.