LGFA New Zealand Local Government Funding Agency

Statement of Intent 2014/15

1. Introduction

This Statement of Intent (SOI) sets out the intentions and expectations of New Zealand Local Government Funding Agency Limited (LGFA).

The LGFA is enabled under the Local Government Borrowing Act 2011 and is a council-controlled organisation (CCO) for the purposes of the Local Government Act 2002.

The SOI is prepared in accordance with section 64(1) of the Local Government Act 2002.

2. Nature and scope of activities

LGFA will raise debt funding either domestically and/or offshore in either NZ dollars or foreign currency and provide debt funding to New Zealand local authorities, and may undertake any other activities considered by the Board of LGFA to be reasonably related or incidentally to, or in connection with, that business.

The LGFA will only lend to local authorities that enter into all the relevant arrangements with it (Participating Local Authorities) and comply with the LGFA's lending policies.

In lending to Participating Local Authorities, LGFA will:

- Operate in a manner to ensure LGFA is successful and sustainable in the long-term;
- Educate and inform Participating Local Authorities on matters within the scope of LGFA's operations;
- Provide excellent service to Participating Local Authorities;
- Ensure excellent communication exists and be professional in its dealings with all its stakeholders; and
- Ensure its products and services are delivered in a cost effective manner.

3. Objectives

Principal Objectives

In accordance with the Local Government Act 2002, in carrying on its business, the principal objectives of LGFA will be to:

- achieve the objectives and performance targets of the shareholders (Shareholders) in LGFA (both commercial and non-commercial) as specified in this SOI;
- be a good employer;
- exhibit a sense of social and environmental responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so; and
- conduct its affairs in accordance with sound business practice.

Primary objective

LGFA will operate with the primary objective of optimising the debt funding terms and conditions for Participating Local Authorities. Among other things this includes:

- Providing estimated savings in annual interest costs for all Participating Local Authorities of at least 30 basis points, based on the methodology set out in LGFA's Annual Report 2012-2013;
- Making longer-term borrowings available to Participating Local Authorities; and
- Enhancing the certainty of access to debt markets for Participating Local Authorities, subject always to operating in accordance with sound business practice.

Additional objectives

LGFA has a number of additional objectives which complement the primary objective. These objectives will be measurable and achievable and the performance of the company in achieving its objectives will be reported annually. These additional objectives are to:

- Operate with a view to making a profit sufficient to pay a dividend in accordance with its stated Dividend Policy set out in section 6;
- Provide at least 50% of aggregate long-term debt funding for Participating Local Authorities;
- Ensure its products and services are delivered at a cost that does not exceed the forecast for issuance and operating expenses set out in section 4;
- Maintain LGFA's credit rating equal to the New Zealand Government sovereign rating where both entities are rated by the same Rating Agency;
- Achieve the Financial Forecasts set out in section 4;
- Meet or exceed the Performance Targets outlined in section 5; and
- Comply with its Treasury Policy, as approved by the Board.

4. Financial forecasts

LGFA's financial forecasts for the three years to 30 June 2017 are:

Financial Year ($m)	2014/15	2015/16	2016/17
Comprehensive income			
Net interest revenue	11.97	12.40	13.38
Issuance and operating expenses	4.67	6.00	6.20
P & L	7.30	6.38	7.13
Financial position			
Dividend	(1.75)	(1.75)	(1.75)
Retained earnings	9.13	13.76	19.13
Total assets	4,550.30	5,554.92	6,560.30
Total LG loans	4,484.00	5,484.00	6,484.00
Total bonds	4,435.00	5,435.00	6,435.00
Total borrower notes	71.74	87.74	103.74
Total equity	34.13	38.76	44.13
Shareholder Funds/Total Assets	0.8%	0.7%	0.7%

Issuance and operating expenses are forecast to be significantly higher in SOI 2014/15 relative to SOI 2013/14. This is due to:

1. Implementing and maintaining a new treasury system. This includes the cost of consultants to advise and assist with the project, depreciation on the capital cost of the new treasury system, and ongoing system maintenance costs.

2. Increasing LGFA staff as key operational services (bond tendering, settlements, risk reporting and accounting) are migrated from NZDMO to LGFA. The cost of additional LGFA staff is forecast to significantly exceed the outsourced services fee currently paid to NZDMO.

3. Undertaking more marketing activity to increase offshore holdings of LGFA bonds.

4. Increasing Approved Issuer Levy (AIL) payments. This cost increase is directly associated with the rise in offshore holdings of LGFA bonds.

5. Potentially incurring significantly higher fees associated with the NZDMO liquidity facility. We had previously assumed that the facility size chosen by LGFA would be reduced in February 2015 to offset a contractual doubling of the facility fee. For SOI 2014/15, we have adopted a more conservative assumption that the maximum facility size ($1 billion) will be chosen for the 2015/16 and 2016/17 years.

   It may be possible to substantially reduce the cost of the NZDMO liquidity facility. In this regard, LGFA intends to consult with shareholders in the 2014/15 year on ways to reduce the cost of this facility, including possible changes to its capital structure and any amendments to the Foundation Policies.

5. Performance targets

LGFA has the following performance targets:

- LGFA's average cost of funds relative to the average cost of funds for New Zealand Government Securities for the period to:
  - 30 June 2015 will be less than 0.50% higher.
  - 30 June 2016 will be less than 0.50% higher.
  - 30 June 2017 will be less than 0.50% higher.
- The average margin above LGFA's cost of funds charged to the highest rated Participating Local Authorities for the period to:
  - 30 June 2015 will be no more than 0.15%.
  - 30 June 2016 will be no more than 0.10%.
  - 30 June 2017 will be no more than 0.10%.

  Relative to SOI 2013/14, there has been a 5 bps reduction in LGFA's base margin target for the financial years ended June 2015 and June 2016.

  In relation to the 2014/15 financial year, the 5 bps reduction (to 15 bps) in base margin simply reflects the current margin being charged to AA rated councils.

  Although issuance and operating expenses are forecast to rise significantly in SOI 2014/15, LGFA's financial position is expected to be sufficiently strong to enable a reduction in the base margin per the targets above, subject to shareholder consultation on future options for capital structure and the liquidity facility.
- LGFA's annual issuance and operating expenses for the period to:
  - 30 June 2015 will be less than $4.67 million.
  - 30 June 2016 will be less than $6.0 million.
  - 30 June 2017 will be less than $6.2 million.
- Total lending to Participating Local Authorities at:
  - 30 June 2015 will be at least $4,400 million.
  - 30 June 2016 will be at least $5,400 million.
  - 30 June 2017 will be at least $6,400 million.

6. Dividend policy

LGFA will seek to maximise benefits to Participating Local Authorities as Borrowers rather than Shareholders. Consequently it is intended to pay a limited dividend to Shareholders.

The Board's policy is to pay a dividend that provides an annual rate of return to Shareholders equal to LGFA cost of funds plus 2.00% over the medium term.

Retained earnings are forecast to increase to $19.1 million by June 2017. As a result, LGFA will review its capital structure and report to shareholders by 31 March 2015.

At all times payment of any dividend will be discretionary and subject to the Board's legal obligations and views on appropriate capital structure.

7. Governance

Board

The Board is responsible for the strategic direction and control of LGFA's activities. The Board guides and monitors the business and affairs of LGFA, in accordance with the Companies Act 1993, the Local Government Act 2002, the Local Government Borrowing Act 2011, the Company's Constitution, the Shareholders' Agreement for LGFA and this SOI.

The Board will comprise between four and seven directors with a majority of independent directors.

The Board's approach to governance is to adopt "best practice" with respect to:

- The operation of the Board.
- The performance of the Board.
- Managing the relationship with the Company's Chief Executive.
- Being accountable to all Shareholders.

All directors are required to comply with a formal Charter, to be reviewed from time to time in consultation with Shareholders.

The Board will meet on a regular basis and no less than 6 times each year.

Shareholders' Council

The Shareholders' Council is made up of between five and ten appointees of the Shareholders (including an appointee from the Crown). The role of the Shareholders' Council is to:

- Review the performance of LGFA and the Board, and report to Shareholders on that performance on a periodic basis (no less frequently than quarterly).
- Make recommendations to Shareholders as to the appointment, removal, replacement and remuneration of directors.
- Make recommendations to Shareholders as to any changes to policies, or the SOI, requiring their approval.

- Ensure all Shareholders are fully informed on LGFA matters and to coordinate Shareholders on governance decisions.

8. Information to be provided to Shareholders

The Board aims to ensure that the Shareholders are informed of all major developments affecting LGFA's state of affairs, while at the same time recognising that commercial sensitivity may preclude certain information from being made public. The LGFA will adhere to a 'no surprises' approach in its dealings with its Shareholders.

Annual Report

The LGFA's balance date is 30 June.

By 30 September each year, the Company will provide to the Shareholders an Annual Report complying with Sections 67, 68 and 69 of the Local Government Act 2002, the Companies Act and Financial Reporting Act. The Annual Report will contain the information necessary to enable an informed assessment of the operations of the company, and will include the following information:

- Directors' Report.
- Financial Statements incorporating a Statement of Financial Performance, Statement of Movements in Equity, Statement of Financial Position, Statement of Cashflows, Statement of Accounting Policies and Notes to the Accounts.
- Comparison of the LGFA's performance with regard to the objectives and performance targets set out in the SOI, with an explanation of any material variances.
- Auditor's Report on the financial statements and the performance targets.
- Any other information that the directors consider appropriate.

Half Yearly Report

By 28 February each year, the Company will provide to the Shareholders a Half Yearly Report complying with Section 66 of the Local Government Act 2002. The Half Yearly Report will include the following information:

- Directors' commentary on operations for the relevant six month period.
- Comparison of LGFA's performance with regard to the objectives and performance targets set out in the SOI, with an explanation of any material variances.
- Un-audited half-yearly Financial Statements incorporating a Statement of Financial Performance, Statement of Movements in Equity, Statement of Financial Position and Statement of Cashflows.

Quarterly Report

By 30 April, 31 July, 31 October and 31 January each year, the Company will provide to the Shareholders' Council a Quarterly Report. The Quarterly Report will include the following information:

- Directors' commentary on operations for the relevant quarter, including a summary of borrowing margins charged to Participating Local Authorities (in credit rating bands).

- Comparison of LGFA's performance with regard to the objectives and performance targets set out in the SOI, with an explanation of any material variances.

- Commentary in relation to implementation of the new treasury system and the migration of operational services from NZDMO to LGFA.

- Analysis of the weighted average maturity of LGFA bonds outstanding.

- In the December Quarterly Report only, commentary on the Net Debt/Total Revenue percentage for each Participating Local Authority that has borrowed from LGFA (as at the end of the preceding financial year).

- To the extent known by LGFA, details of all events of review in respect of any Participating Local Authority that occurred during the relevant quarter (including steps taken, or proposed to be taken, by LGFA in relation thereto).

Statement of Intent

By 1 March in each year the Company will deliver to the Shareholders its draft SOI for the following year in the form required by Clause 9(1) of Schedule 8 and Section 64(1) of the Local Government Act 2002.

Having considered any comments from the Shareholders received by 30 April, the Board will deliver the completed SOI to the Shareholders on or before 30 June each year.

Shareholder Meetings

The Board will hold an Annual General Meeting between 30 September and 30 November each year to present the Annual Report to all Shareholders.

The Company will hold a meeting with the Shareholders' Council approximately every six months – prior to the Annual General Meeting and after the Half Yearly Report has been submitted. Other meetings may be held by agreement between the Board and the Shareholders' Council.

9. Acquisition/divestment policy

LGFA will invest in securities in the ordinary course of business. It is expected that these securities will be debt securities. These investments will be governed by LGFA's lending and/or investment policies as approved by the Board and/or Shareholders.

Any subscription, purchase or acquisition by LGFA of shares in a company or organisation will, if not within those investment policies, require Shareholder approval other than as concerns the formation of wholly-owned subsidiaries and the subscription of shares in such wholly-owned subsidiaries.

10. Activities for which compensation is sought from Shareholders

At the request of Shareholders, LGFA may (at its discretion) undertake activities that are not consistent with its normal commercial objectives. Specific financial arrangements will be entered into to meet the full cost of providing such as activities.

Currently there are no activities for which compensation will be sought from Shareholders.

11. Commercial value of Shareholder's investment

LGFA will seek to maximise benefits to Participating Local Authorities as Borrowers rather than Shareholders.

Subject to the Board's views on the appropriate capital structure for LGFA, the Board's intention will be to pay a dividend that provides an annual rate of return to Principal Shareholders equal to LGFA cost of funds plus 2.00% over the medium term.

As the Shareholders will have invested in the LGFA on the basis of this limited dividend, the Board considers that at establishment the commercial value of LGFA is equal to the face value of the Shareholders' paid up Principal Shares - $25 million.

Based on observed share transfers on 30 November 2012, the Board considers the current commercial value of LGFA continues to equal the face value of the Shareholders' paid up Principal Shares - $25 million.

The commercial value of LGFA will be assessed annually.

12. Accounting policies

LGFA has adopted accounting policies that are in accordance with the New Zealand International Financial Reporting Standards and generally accepted accounting practice. A Statement of accounting policies is attached to this SOI.

This statement is taken from the Financial Statements presented as part of LGFA's Annual Report 2012-2013.

ATTACHMENT: Statement of accounting policies

a Reporting Entity

The New Zealand Local Government Funding Agency Limited (LGFA) is a company registered under the Companies Act 1993 and is subject to the requirements of the Local Government Act 2002.

LGFA is controlled by participating local authorities and is a council-controlled organisation as defined under section 6 of the Local Government Act 2002. LGFA is a limited liability company incorporated and domiciled in New Zealand.

The primary objective of LGFA is to optimise the debt funding terms and conditions for participating local authorities.

The registered address of LGFA is Level 13, 342 Lambton Quay, Wellington Central, Wellington 6011.

The financial statements are as at and for the year ended 30 June 2013. The comparatives are for the seven month period to 30 June 2012 as LGFA was first registered as a company on 1 December 2011.

These financial statements were authorised for issue by the Directors on 27 September 2013.

b Statement of compliance

LGFA is registered under the Companies Act 1993 and is a reporting entity as defined by the Financial Reporting Act 1993. LGFA is a profit orientated entity as defined under the New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS).

The financial statements and accounting policies comply with the specific recognition, measurement and disclosure requirements of NZ IFRS and New Zealand Generally Accepted Accounting Practice (NZGAAP). The financial statements comply with International Financial Reporting Standards.

c Basis of Preparation

Measurement base

The financial statements have been prepared on a historical cost basis modified by the revaluation of certain assets and liabilities.

The financial statements are prepared on an accrual basis.

Functional and presentation currency

The financial statements are presented in New Zealand dollars rounded to the nearest thousand, unless separately identified. The functional currency of LGFA is New Zealand dollars.

Foreign currency conversions

Transactions denominated in foreign currency are translated into New Zealand dollars using exchange rates applied on the trade date of the transaction.

Changes in accounting policies

There have been no changes in accounting policies.

Early adoption standards and interpretations

The following accounting standard has been early adopted by LGFA.

NZ IFRS 9: *Financial Instruments*. The first two phases of this new standard (which is incomplete as at 30 June 2013) were approved by the Accounting Standards Review Board in November 2009 and November 2010. The standard addresses the issues of classification and measurement of financial assets and financial liabilities and becomes effective for annual reporting periods commencing on or after 1 January 2015.

Standards not yet adopted

LGFA does not consider any standards or interpretations in issue but not yet effective to have a significant impact on its financial statements. Those which may be relevant to LGFA are as follows:

- Amendments to NZ IAS 32: Financial Instruments: Disclosures. Effective for periods beginning on or after 1 January 2014. This amendment provides clarification on the ability to set-off financial instruments.

- NZ IFRS 13: Fair Value Measurement. Effective for periods beginning on or after 1 January 2013. This standard provides a single source of guidance on determining fair value.

<u>d Financial instruments</u>

Financial assets

Financial assets, other than derivatives, are recognised initially at fair value plus transaction costs and subsequently measured at amortised cost using the effective interest rate method.

Cash and cash equivalents include cash on hand; cash in transit, bank accounts and deposits with an original maturity of no more than three months.

Purchases and sales of all financial assets are accounted for at trade date.

At each balance date an assessment is made whether a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the asset(s), and that the loss event has an impact on the future cash flows of the asset(s) that can be estimated reliably.

Financial liabilities

Financial liabilities, other than derivatives, are recognised initially at fair value less transaction costs and subsequently measured at amortised cost using the effective interest rate method.

Derivatives

Derivative financial instruments are recognised both initially and subsequently at fair value. They are reported as either assets or liabilities depending on whether the derivative is in a net gain or net loss position respectively.

Fair value hedge

Where a derivative qualifies as a hedge of the exposure to changes in fair value of an asset or liability (fair value hedge) any gain or loss on the derivative is recognised in profit and loss together with any changes in the fair value of the hedged asset or liability.

The carrying amount of the hedged item is adjusted by the fair value gain or loss on the hedged item in respect of the risk being hedged. Effective parts of the hedge are recognised in the same area of profit and loss as the hedged item.

e Other assets

Property, plant and equipment (PPE)

Items of property, plant and equipment are initially recorded at cost.

Depreciation is charged on a straight-line basis at rates calculated to allocate the cost or valuation of an item of property, plant and equipment, less any estimated residual value, over its remaining useful life.

f Other liabilities

Employee entitlements

Employee entitlements to salaries and wages, annual leave and other similar benefits are recognised in the profit and loss when they accrue to employees.

g Revenue and expenses

Revenue

Interest income

Interest income is accrued using the effective interest rate method.

The effective interest rate exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount. The method applies this rate to the principal outstanding to determine interest income each period.

Expenses

Expenses are recognised in the period to which they relate.

Interest expense

Interest expense is accrued using the effective interest rate method.

The effective interest rate exactly discounts estimated future cash payments through the expected life of the financial liability to that liability's net carrying amount. The method applies this rate to the principal outstanding to determine interest expense each period.

Income tax

LGFA is exempt from income tax under Section 14 of the Local Government Borrowing Act 2011.

Goods and services tax

All items in the financial statements are presented exclusive of goods and service tax (GST), except for receivables and payables, which are presented on a GST-inclusive basis. Where GST is not recoverable as input tax, then it is recognised as part of the related asset or expense.

The net amount of GST recoverable from, or payable to, the IRD is included as part of receivables or payables in the statement of financial position.

The net GST paid to, or received from the IRD, including the GST relating to investing and financing activities, is classified as a net operating cash flow in the statement of cash flows.

Commitments and contingencies are disclosed exclusive of GST.

h Lease payments

Payments made under operating leases are recognised in profit or loss on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

i Segment reporting

LGFA operates in one segment being funding of participating local authorities in New Zealand.

j Judgements and estimations

The preparation of these financial statements requires judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. For example, the present value of large cash flows that are predicted to occur a long time into the future depends critically on judgements regarding future cash flows, including inflation assumptions and the risk free discount rate used to calculate present values. Refer note 2b for fair value determination for financial instruments.

The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised, if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods. Where these judgements significantly affect the amounts recognised in the financial statements they are described below and in the following notes.