TO: PERFORMANCE, POLICY AND PARTNERSHIP COMMITTEE

FROM: MICHAEL DAY – GROUP MANAGER FINANCE AND ASSURANCE

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MEETING DATE: TUESDAY 9 FEBRUARY 2021

IN COMMITTEE

Reason for Exclusion:
Local Government Information and Meetings Act 1987 –

(7) Other reasons for withholding official information:
(2) (i) enable any local authority holding the information to carry on, without prejudice or disadvantage, negotiations (including commercial and industrial negotiations);

INVERCARGILL CITY COUNCIL TREATMENT OF INVERCARGILL CITY HOLDINGS LIMITED – UNCALLED CAPITAL

SUMMARY

Council has a debt cap set as a function of its income and other matters. Relevant for the purpose of this discussion, Council's net debt cap is set at 250% of its income.

The net debt is determined according to normal accounting principles and as set by the Local Government Funding Authority. The cap is set based on historical precedent and good practice to ensure that Council complies with its obligations of financial management. It is a hard ceiling which Council cannot go beyond.

Council however must determine its risk appetite and tolerance when determining to what extend it is prepared to borrow within that debt cap. Part of this process must include an assessment of its contingent liabilities and other foreseeable calls for funds.

RECOMMENDATIONS

That the Performance Policy and Partnership Committee:

1. **Receive the report "Invercargill City Council Treatment of Invercargill City Holdings Limited – Uncalled Capital".**

2. **Endorse Council receiving the report "Invercargill City Council Treatment of Invercargill City Holdings Limited – Uncalled Capital" with the following recommendations, and**

   a. **Notes the value of its uncalled shares in Invercargill City Holdings Limited are $100,000,000 ($100 million)**

   b. **Notes that the uncalled capital does not form part of the Council debt for accounting purposes**

c. **Notes that the uncalled capital is a contingent liability and should be included as such**

d. **Determines that it will, acting prudently, allow headroom in its forecast borrowing to allow for contingent liabilities and other foreseeable expenses within its debt cap**

e. **Notes that Council will continue to monitor and review its debt and foreseeable expenses**

3. **That the Committee recommend a redacted version of this report is released publicly at the next Performance, Policy and Partnership Committee meeting.**

IMPLICATIONS

1.	*Has this been provided for in the Long Term Plan/Annual Plan?* No
2.	*Is a budget amendment required?* No
3.	*Is this matter significant in terms of Council's Policy on Significance?* No
4.	*Implications in terms of other Council Strategic Documents or Council Policy?* N/A
5.	Have the views of affected or interested persons been obtained and is any further public consultation required? No

SUMMARY

Debt, for the purposes of Council's debt cap, is a defined accounting concept. Using the accounting concept, Council had currently set a self-imposed limit on its debt of 150% of Council's operating revenue.

Council is required to manage its liabilities and general financial dealings prudently in a manner that promotes the current and future interests of the community. Prudently, in this context, includes leaving capacity for events that may occur in the future even though those specific events may not be identifiable. This includes consideration of Council's contingent liabilities, including the Invercargill City Holdings Limited (ICHL) uncalled capital.

Council's current debt cap, as set by the Local Government Funding Authority (LGFA), is $250 million (250%). Although it may go higher due to changes following COVID-19, hence this is not recommended. Factors that will impact this debt cap in the coming Long Term Plan include potential changes to the three waters.

Council can currently borrow at a very low rate. While there is no indication that interest rates will increase in the short term, there are movements upwards in the longer term rates. Further there is a reduced likelihood that the next movement in interest rates will be lower, and almost no expectation that interest rates will be negative. It is prudent for Council to consider the impact of increased interest rates on the ability of Council to meet the increased payments and / or the consequence on rates increases in the event that this occurs.

Council, when acting prudently, should take into consideration all these factors when determining an appropriate level of borrowing.

BACKGROUND – DEBT

The LGFA provides the following information for the purposes of calculating the net debt to total revenue covenant (250%).

> Net debt is defined as total debt less liquid financial assets and investments.

Liquid financial assets are those that can be readily converted to cash without having a significant impact on their value. This includes cash held at the bank.

For the purposes of this discussion there are two other assets held by Council that should be considered for their impact on net debt.

Loans to ICHL

There are a number of reasons to suggest that this may not be a liquid asset. In the ordinary course a loan may be called, subject to its terms, or potentially sold to a third party. Due to the specific terms on ICHL borrowing, it is unlikely that the debt could be easily on sold, and even if it was, this may cause ICHL to breach its debt covenants.

Shares in ICHL

If ICHL shares were publicly traded this would be a liquid asset. They are not. Further, there are limitations under the Local Government Act (LGA) for the sale of significant assets, of which ICHL is one. It is therefore unlikely that these shares, or indeed Council shares in any other CCO / CCTO would be deemed a liquid asset.

BACKGROUND – ICHL BORROWING FROM COUNCIL

ICHL's external borrowing is capped at $100 million by the uncalled capital. In addition, ICHL has borrowed funds from Council.

ICHL resolved to sell the Invercargill City Forests Limited (ICFL) forest estate. It is estimated that ICFL will receive approximately $38 million after tax from the sale.

It has always been ICHL's intention, and preference, to use the sale of the forest estate to repay the loan from Council for Aniwhenua.

For ICHL borrowing to remain within the $100 million external debt cap set by the uncalled capital it must:

1. Repay the current $30 million loan from Council
2. Council must convert the $13.5 million loan to equity
3. Purchase a further $2 million shares in ICHL when required

This would leave ICHL with approximately $72 million of debt, increasing to $88 million by the end of 2021.

Impact of ICHL Proposal on Council Net Debt

$30 million Aniwhenua Debt

There is a risk that if ICHL does not repay the $30 million loan from Council then this will be included in Council's net debt without an offset attributed to the loan to ICHL. This is because the debt to ICHL may be considered non-liquid as ICHL could not repay it by drawing on its current banking facility. As a result, although the borrowing is offset by a loan in the group accounts, the $30 million forms part of Council's current net debt.

Repayment of the $30 million by ICHL will have no effect on Council's net debt as Council has used borrowing for this transaction. Council should use the cash to repay existing loans as they fall due.

Purchase of Shares in ICHL to Fund Purchase in ICL

Council had currently lent $13.5 million to ICHL for investment in Invercargill central Limited (ICL). ICHL's preference is for this loan, and any further investment in ICL to be funded by Council purchasing shares in ICHL.

Any further loans to ICHL, to the extent that they cannot be satisfied by a call on ICHL's current banking facilities, should be treated in the same way as the $30 million above. ICHL could currently draw down $13.5 million to repay that loan under its current banking facility. On this basis Council could determine that this debt is liquid and could be used to offset Council's borrowing. [redacted]

s7(2)(i)

Conversion of the $13.5 million loan to equity would result in $13.5 million being added to Council's net debt position.

Other Net Debt Factors to Consider

Cash Holdings

Cash is considered part of the net debt, but Council should manage cash debt to a minimal level to ensure minimum interest cost are incurred on debt. A continued focus on Council's cash levels is performed as part of the Treasury function. The cash balance at the end of December 2020 was $20 million. Treasury function will be considering a repayment of debt when it next falls due.

Other Factors to Consider for borrowing

The LGA section 101 provides that Council must manage its revenues, expenses, assets, liabilities, investments and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

Prudence requires that Council:

- Act with competence and due diligence, including where appropriate using the advice of prudent experts
- Have a process and procedure for the determination of appropriate borrowing levels

Prudence involves more than just accepting a forecast. It requires an assessment of the risks associated with the forecast and other factors, not included in the forecast that may impact the total debt requirements of Council.

Discussed below are some of the specific issues relating to ICHL that should be considered and form part of the assessment of a prudent level of borrowing.

Uncalled Capital

As discussed, ICHL is moving to borrowing from the LGFA. The LGFA states that this will occur provided, that:

- the borrowing is supported by uncalled capital; and
- Council is a guarantor of the LGFA.

Council therefore has some exposure to this debt in the event of a default by ICHL. Council has received advice that the debt is defined as a contingent debt, unless the likelihood of Council having to pay the debt is assessed at greater than 50%. There is no evidence that this is the case. As a result, the uncalled capital does not have to be included in the net debt calculations for the purposes of Council's debt cap.

Having said that, $100 million is a significant debt if it was called. It would be prudent for Council to consider whether it should borrow to the point where it is at its debt cap knowing that there is the potential for this liability to be realised.

Other Investments

ICHL has invested in Invercargill Central Limited (ICL) on behalf of Council. A requirement of all the other funders (Provincial Growth Fund, CTS and the bank) is that ICHL (Council) and O'Donnell CBD Limited are responsible for any shortfall in funding or overrun in construction costs. While some funders require confirmation of funds to complete, the bank will not release any funds until the funds to complete the project are available.

This exposes Council and ICHL to a contingent liability. [redacted]

s7(2)(i)

It would be prudent of Council to allow for further borrowing associated with the investment in ICL.