Financial Strategy

Introduction

This strategy sets the direction for financial decision making, allowing Council to carry out its work programmes and fulfil its legal responsibilities, in a sustainable and affordable way.

Council's Vision is "For our future – a prosperous and sustainable future for Otago". For the 10 year period of this plan, work programmes and initiatives have been developed that will contribute to the achievement of Council's overall vision, ensuring the sustainable use of its natural resources, water, air and land, to protect them now and future generations.

These programmes and initiatives do however come at a cost. Council is mindful of the affordability of what it wants to achieve, and the potential burden on ratepayers to fund the programme. Council has developed a Revenue Policy which details how each of its activities should be funded, whether through rating, fees and charges, or some other funding tool, and in doing so, has given consideration to who will benefit from each activity and how much they will benefit.

With the Revenue Policy as the basis for how our activities are to be funded, this strategy sets out the financial direction Council wishes to take on matters such as levels of future rating, borrowings and investments, and discusses factors that influence those.

Affordability for ratepayers is a key aspect of this strategy. Council holds a number of investments, and most of the income derived from those investments is used to contribute to the cost of our work. All ratepayers benefit from this income, as the contribution is used to reduce the general rate requirement each year. One such investment is Council's ownership of Port Otago Limited. This investment is considered to be a strategic asset, and Council has no intention of disposing of it, because it is a valuable regional asset, and its annual dividend provides a significant contribution to the cost of our 10 year programme.

Council has a strong balance sheet. Its aim is to use its balance sheet strategically, to preserve the financial stability it currently enjoys.

Key issues that have a significant financial impact

Council faces a number of key issues that have significant financial impacts. Those key issues include:

- The increasing demand for water and the need for greater efficiency in water use;
- The requirement for Otago to have high quality water without limiting land use activities that may impact on water quality; and
- The significant investment needed in developing the Leith Flood Protection Scheme and the need to invest in new assets to maintain the levels of service provided on existing schemes.

Council will address those issues in the following ways:

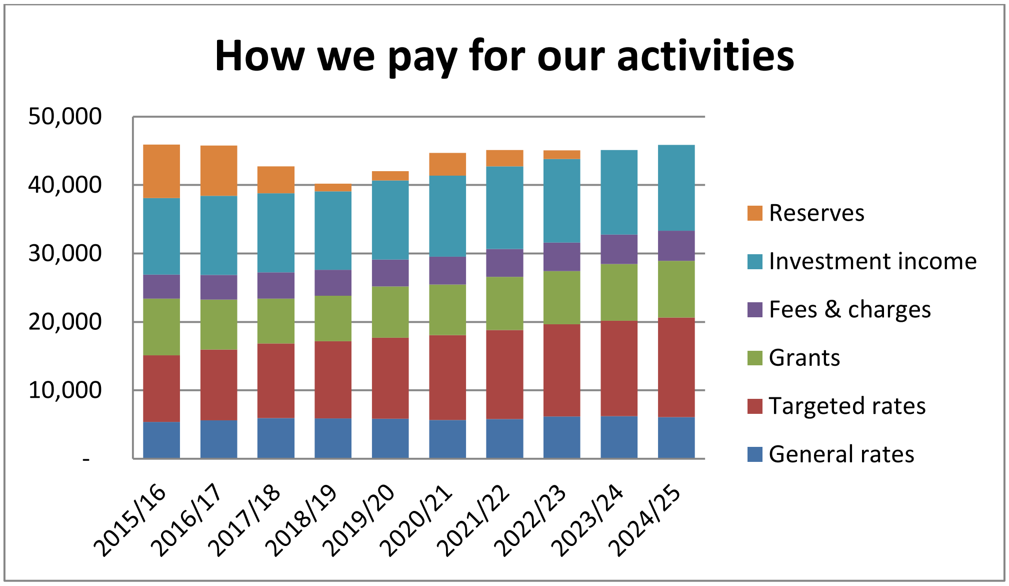
- Council will engage with communities to assist in the demand for water. The establishment of a water management reserve will be used to provide funding assistance to community groups, for feasibility studies and identifying possible infrastructure requirements to aid efficiency in water use.

- New water quality standards are to be met by 2020. Council will invest in research and development, education, and new science and monitoring to assist landholders in achieving the compliance date.

- Council is planning to complete the construction of the Leith Flood Protection Scheme by 2019/20. It will use its balance sheet to provide internal borrowings for funding its construction. Targeted rates will be used to repay those internal borrowings over a period of 20 years through to 2029/30.

Funding Sources

Council pays for its services through a variety of funding sources. The graph below shows the mix of sources for each year of this 10 year plan.



Rates and Rate Increases

There are approximately 115,000 ratepayers in Otago. Whilst the population of Otago may change over the ten year period, the change is not expected to impact significantly on the level of activity undertaken by Council. Historically, the nature of work has not been sensitive to population growth. Further, should there be major changes in population over the next 10 years, the impact on individual rate accounts would be minimal. For example, the general rate payable in 2014/15 on a $250,000 home in Dunedin was approximately $37. A 10% growth in population, and therefore rateable properties would reduce this rate to approximately $33.

Council uses general rates and targeted rates to assist funding its various activities. Targeted rates are used where there is a defined area of benefit, or a defined group benefiting from an activity. General rates are charged where there is a wider community benefit.

General Rates

Each year general rates are subsidised by dividends received from Port Otago Limited, and by income earned on council's managed fund, cash balances and investment properties. Generally, subsidies reduce the general rate requirement by more than half.

As a result, the revenue from general rates is a very low funding source, contributing to around 15% of council's total expenditure. This low general rate means that any general rate increases, whilst small in monetary terms, are generally high in percentage terms. For example a 1% increase in general rates equates to approximately $50,000. This spread across 115,000 ratepayers, averages out to around $0.43 per annum, per rate payer.

Both the community and Council have identified a need for us to increase our activities around water quality and water quantity, and so an increase in the level of our expenditure in these areas is planned. This results in the need for us to increase our general rates. The first year of the long term plan provides for a general rate increase of 5.2% to reflect the increase in activities. In monetary terms, this is around $260,000.

Of the total general rate to be collected each year, 25% is to be charged as a uniform annual general charge (UAGC). General rates regional are allocated across the districts and city. 25% of each district and city general rates is then charged as a UAGC, which means that each area may have a different UAGC value. This ensures that the districts and city are paying their fair share of these rates, and no one district is being subsidised by the others.

The movement in rates from year to year ranges from a rate increase of 5.2% in the first year of the plan, to a decrease of 2.88% in later years. This plan provides for inflation each year of between 1.9% and 3.6% over the 10 year period on its expenses. General rate increases will be capped at 6.9% per annum.

If a specific project shows major fluctuations in the level of rate from year to year, council may smooth the impacts of those charges over a period of time, ensuring that the full contribution is achieved.

Targeted Rates
Council has approximately 18 targeted rates established for river management works, flood and drainage schemes, and public transport services provided in Dunedin and Queenstown. Two new rates are being proposed in the 2015/16 year, in respect of permitted activity (dairy) inspections and water quality implementation works.

Each of the targeted rates has its own reserve and so any unspent rating is allocated to the appropriate reserve.

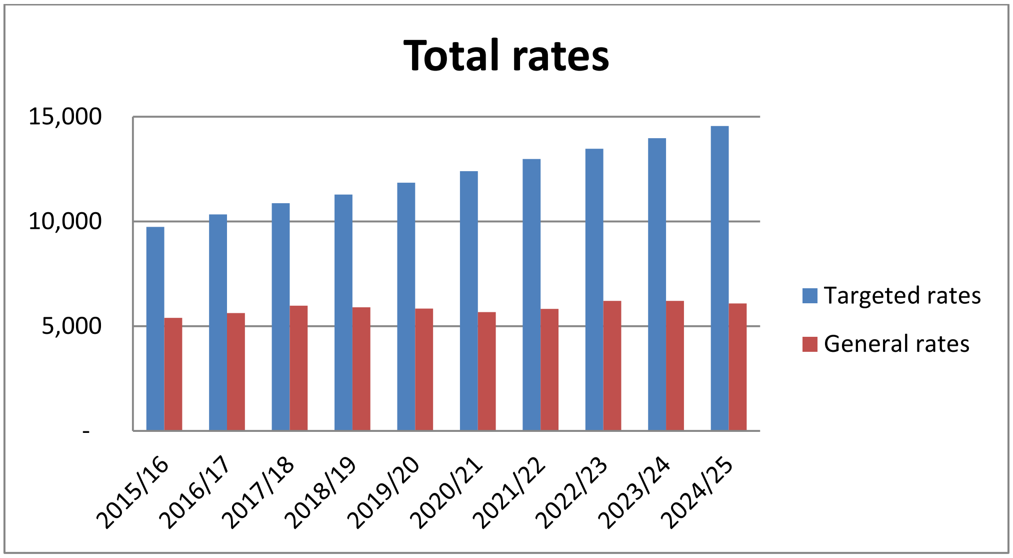
With respect to the river management rates, Council aims to have reserves in funds equating to approximately one year worth of rating. This provides some financial security, should a flood event occur, so that additional work can be undertaken as necessary without the need for a significant rate increase in any one year.

Council has recognised that a greater level of intervention in river management issues is needed, and so a programme for developing and implementing river management plans for many of the major rivers in Otago has been incorporated into the Long Term Plan. The costs for the river management areas have therefore increased beyond inflationary rates, and this is reflected in the targeted rates.

Where significant capital expenditure is required on our flood and drainage schemes, Council will not support the repayment of scheme works over a period longer than 20 years. The interest expense associated with longer repayment terms is not considered justifiable in terms of future rate payments. The 20 year term however, recognises the spread in benefits to future generations.

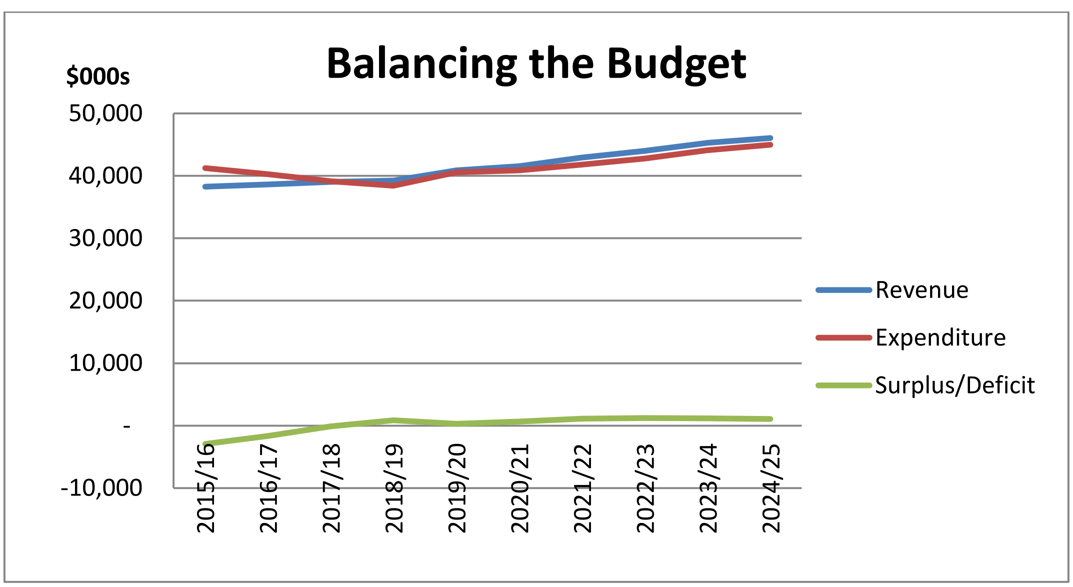
The movement in targeted rates from year to year ranges from a rate increase of 14.3% in the first year of the plan, and then is around 6% each year thereafter. This first year sees the introduction of the two new targeted rates. Targeted rate increases will be capped at 14.3% per annum, which includes inflationary increases. Targeted rates will be limited to no more than $14.5 million in any year.

Total Rates
Total rates to be charged over the 10 year period are as follows:



Rate Limits
The limits on rates to be collected over the life of the plan are as follows:
- General rates will be no more than $6.2 million per annum.
- Targeted rates will be no more than $14.5 million per annum

Balancing the Budget
Under the Local Government Act, council is required to ensure that for each year, the estimated revenue is sufficient to cover its estimated operating costs. It does however, also allow council to set its revenue at a different level, if council resolves that it is financially prudent to do so. It is estimated that in the first three years of this plan, the estimated revenue will not cover estimated operating costs.



The primary reason for the shortfall in revenue is the use of reserves to fund operating expenditure. This has been planned for three activities of council as follows:

- Council intends investing approximately $1 million over the next three years on research and development for two activities. Improving Otago's water quality has been identified as a key issue for council and so it has provided to invest in researching and developing tools for real time water quality monitoring. Council also recognises that there are limited tools available to address our pest rabbit problem, and so it will research and invest in new non biological control tools. The use of reserves for research and development is considered prudent, and is in accordance with council's revenue and financing policy.
- The Dunedin Transport Reserve has funds available of approximately $4.5 million. Approximately $1.2 million of these reserves are going to be used to implement over the next two years, a new electronic bus ticketing system, and approximately $900,000 will be used to develop a bus hub in Dunedin city. The transport reserve has been established to fund operating revenue, and its use in these circumstances is considered prudent.

Borrowing

Council currently has no borrowing.

Council may borrow for the following primary purposes:

- Fund special one off type projects.
- Fund expenditure for items of an intergenerational nature.
- Short term borrowing to manage timing differences between cash inflows and outflows.

Borrowing limits are set in terms of interest expense, in that interest can not exceed 20% of the total rates per annum. Note is made that there is no plan for council to borrow during the next 10 years.

It is Council policy to offer security for any borrowing by way of a charge over its rates. In the normal course of business, Council policy is not to offer security over any of the other assets of the Council. However, in special circumstances and if it is considered appropriate, Council may resolve to offer such security on a case by case basis.

Internal Borrowing

When considered appropriate, the Council uses accumulated reserves as a borrowing mechanism primarily for the flood and drainage schemes, thereby reducing the level of external borrowings required. The following operational guidelines apply to the use of reserves for funding rather than external borrowings:

- Interest is charged on the month end loan balances.
- The interest rate charged is equivalent to the Councils investment rate of return.
- Reserves available for internal borrowing are limited to 50% of total reserves.

The interest earned from internal borrowing is used in the same way as interest earned on investments, that is, to fund interest on reserve balances in funds, and to subsidise general rates.

Scheme Infrastructure Asset Investment

Significant expenditure is required during the life of this plan on flood and drainage scheme infrastructure. Generally, capital works in established schemes are funded by the depreciation reserve built up for each of the schemes, and maintenance work is funded by targeted scheme rates. However, depreciation reserves are not always sufficient to cover capital investment, and so increases in targeted rating have been planned where appropriate, along with the utilisation of internal borrowings.

The planned capital expenditure for each scheme is as follows:

Capital Expenditure 2015 - 2025			
	Increase in Levels of Service $000s	**Renew / Replace $000s**	**Total $000s**
Alexandra Flood		77	77
Leith Flood	12,288		12,288
West Taieri Drain	114	1,281	1,395
East Taieri Drain	677	660	1,337
Lower Taieri Flood	6,072	1,102	7,174
Lower Clutha Flood & Drain	1,296	2,185	3,481
Total	**20,447**	**5,305**	**23,752**

Each scheme has its designed level of service (or protection). On the Lower Taieri, there are areas where the planned level of service is not being achieved, and so works are programmed to increase the current level of service to those of the design standards.

Other scheme works involve renewing and replacing existing scheme assets to maintain the levels of services being provided. Such works include the replacement of drainage pumps and the replacement of culverts and bridges.

The Leith Flood Protection Scheme is a new scheme, and is treated as an increase in the level of service.

Investments

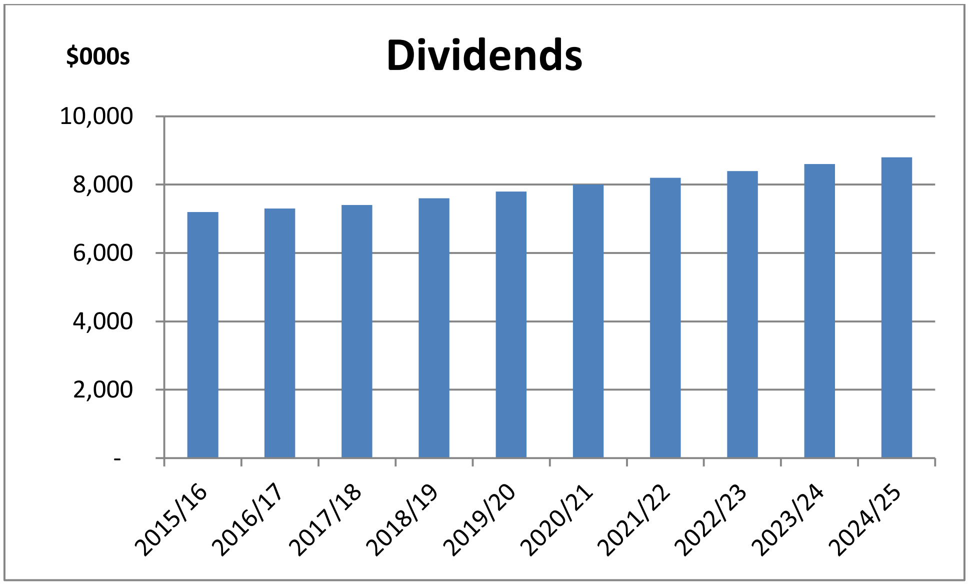
Council's primary objective when investing is to earn a return whilst protecting its initial investment. Accordingly, the risk profile of all investment portfolios must be conservative. Within approved credit limits, Council seeks to maximise investment returns, and manage potential capital losses due to interest rate movements, currency movements and price movements. Council's investments are discussed below.

Port Otago Ltd

Council holds 100% ownership of Port Otago Ltd. Each year, a significant dividend is received from Port Otago Ltd that is used to reduce the general rate requirement, usually by more than half of the rate requirement. Council is of the view the this is a strategic asset held on behalf of the Otago community, and through subsidising general rates, every ratepayer enjoys the benefit of that ownership.

From time to time, special dividends are received from Port Otago Ltd. They are requested by Council when an appropriate specific project is identified. Before requesting special dividends, Council will discuss with Port Otago its ability to pay such dividends, taking account of factors such as the company's own programme of capital expenditure. No requirement for special dividends has been identified in this Long Term Plan.

Over the next 10 years, dividends are estimated to be as follows:



Investment Property

Council owns investment property within Dunedin City.

Some of the land is leased by the Dunedin Teachers College and the Otago Polytechnic.

Council also owns land on the Dunedin harbour basin, being the Custom House building and the Monarch building.

The return by way of rentals on all of these properties is at commercial rates, and is used to subsidise general rate funding each year.

Managed Funds

The objectives of the investment portfolio are the preservation of capital and the generation of moderate capital gains, and are to be provided through a balanced investment portfolio incorporating classes of New Zealand cash and bonds, Australasian equities and international equities. The asset allocation ranges for investments are:

Asset Class	Target Allocation	Acceptable Range	
		Minimum	Maximum
NZ Cash	5%	1%	10%
NZ Fixed Interest	50%	45%	55%
International Fixed Interest	10%	5%	15%
NZ Property	7.5%	5%	10%
Australasian Equities	12.5%	7.5%	17.5%
International Equities	10%	5%	15%
Hedge Funds	2.5%	1%	5%
Commodities	2.5%	1%	5%
Total	100%		

Investment income comprises dividends and interest. Our assumption on interest income over the 10 year period is that we will achieve 5% per annum. This income is used to pay interest on reserve balances that are in funds, such as scheme reserves, Emergency Response Reserve etc., and the remaining balance is used to subsidise general rates.