FINANCIAL STRATEGY

INTRODUCTION

This financial strategy sets the overall direction for the Council's finances over the next ten years. It outlines a fundamental change to the Council's approach to its investment and reserves income from the last financial strategy and higher rates increases than the last long term plan. These changes better reflect our responsibilities to look after both current and future ratepayers and provide a more robust financial position to cater for future infrastructure needs.

We intend to optimise our financial position and resources by rating at levels that enable prudent management of the use of financial reserves for asset renewals and investment protection; allow us to better meet our inter-generational equity responsibilities and allow us to fund future expansion of necessary infrastructure for the growth of the district.

OUR FUTURE APPROACH

Be prudent in our financial management

- Responsible management of our reserves and investments to ensure we are meeting the inter-generational equity principle.
- Prudent use of our reserves to ensure we use the right reserve for the right use at the right time.
- Align our debt protection tools with the current financial situation.

Future proof the district's infrastructure

- Have capacity to fund improvements for potential increases in quality standards of key infrastructure.
- Have capacity to fund expansion of our current networks (planned to be investigated) subject to affordability.
- Rebuild and maintain the Council's disaster reserve to address damage from recent events and have provision for future events.

Address the past under delivery in asset management

- Improve our levels of asset maintenance and renewals, especially for some of our community facility assets and property assets.
- Commence asset management of 24 Council owned roads that have been previously unmaintained by Council.

In taking the above approach to our financial strategy we aim to simplify our processes and systems wherever possible and appropriate.

THE COUNCIL'S FINANCIAL MANAGEMENT RESPONSIBILITIES

This financial strategy includes the limits on rates, rate increases and borrowing and describes our ability to provide and maintain service levels within these limits. It also outlines the Council's policy on giving security for borrowing, and financial investments and equity securities.

This financial strategy is closely linked to the Council's infrastructure strategy. The infrastructure strategy details the capital and operational budgets and specific projects in the areas of transportation and roads, water supply, stormwater, and wastewater.

SOME USEFUL CONTEXT

What do you know about Council's rates subsidy?

Since at least 1996 the interest earned by most of the Council's financial reserves has been applied to reduce the rates requirement of the UAGC (uniform annual general charge payable by all ratepayers); in effect providing a rates subsidy. These financial reserves include our depreciation reserves, the insurance excess reserve, disaster reserve, retained earnings, reserve contributions, development contributions and the Power New Zealand Shares reserve. In recent years the rates subsidy has been approximately $4 million annually.

The rates subsidy has not been highlighted in recent long term plans. The use of the reserves' interest is recorded in the Council's Revenue and Financial Policy (included in the supporting information and final LTP) and the Special Financial Reserves Policy. The Council considers the rates subsidy every three years with those policies.

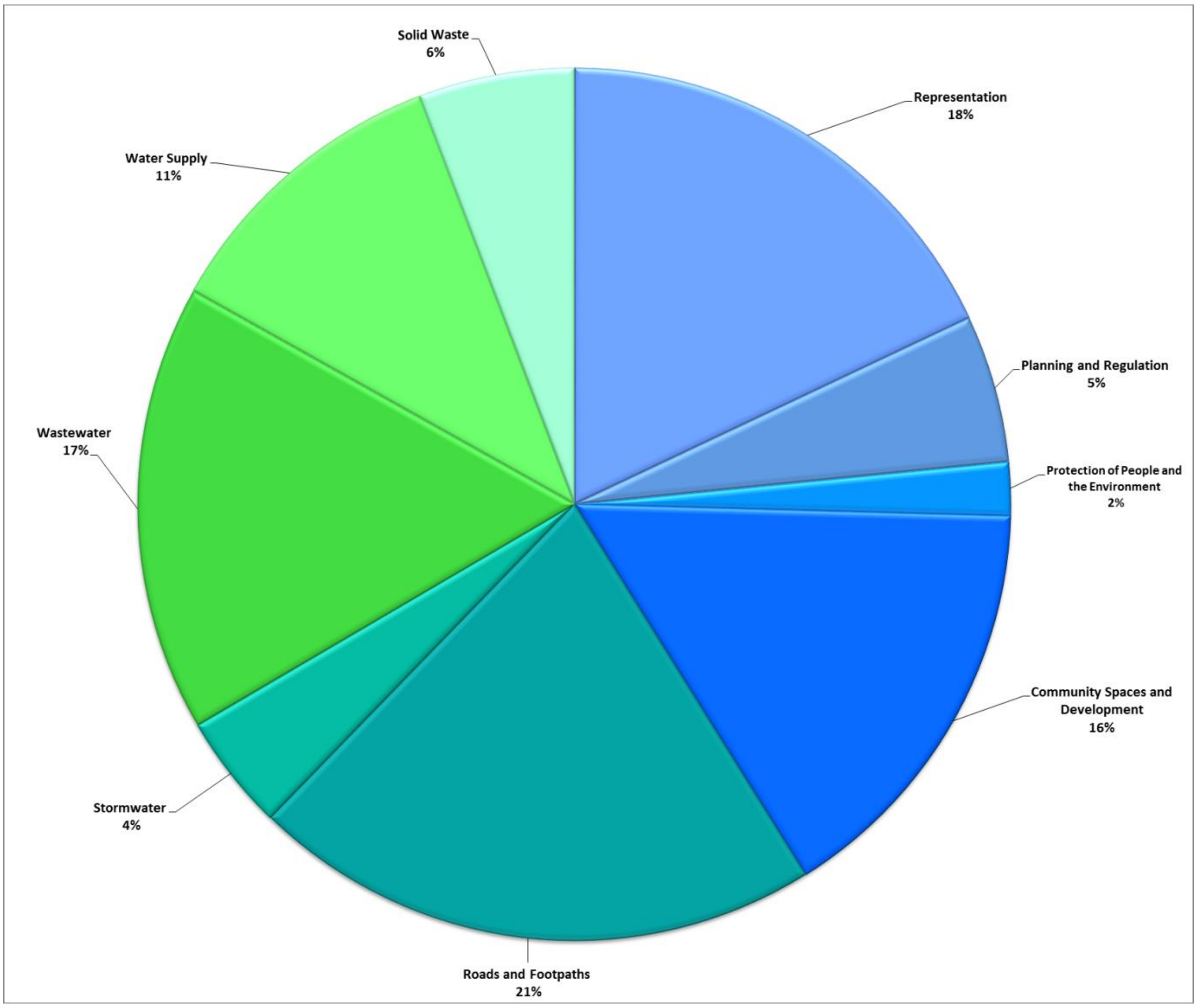
What is the Power New Zealand Reserve?

Council currently has some $24.9 million in its Power New Zealand Reserve. The fund was created using proceeds from the sale of the Power NZ shares that were originally vested in Council in 1994 following the national electricity reforms. The reserve is another Council asset that Council has a responsibility to maintain for the benefit of both current and future ratepayers.

What is internal borrowing?

The Council currently has $106 million of total debt. Only $35 million is borrowed externally through the Local Government Funding Agency and New Zealand banks. The balance is borrowed against the Council's reserves. This saves on the fixed costs associated with borrowing and safeguards against interest rate fluctuations. The activity that borrows from the reserves pays interest at the going rate and this interest is utilised as part of the rates subsidy. For example some of the wastewater debt to build the three eastern seaboard treatment plants utilised reserve funding and pays interest on that portion of debt in the same way the activity pays interest on its external debt.

Where is all the money spent?
The pie chart below shows the allocation of expenditure to the different activities.



FINANCIAL POSITION AND THE FUNDAMENTAL CHANGE

Depreciation reserves

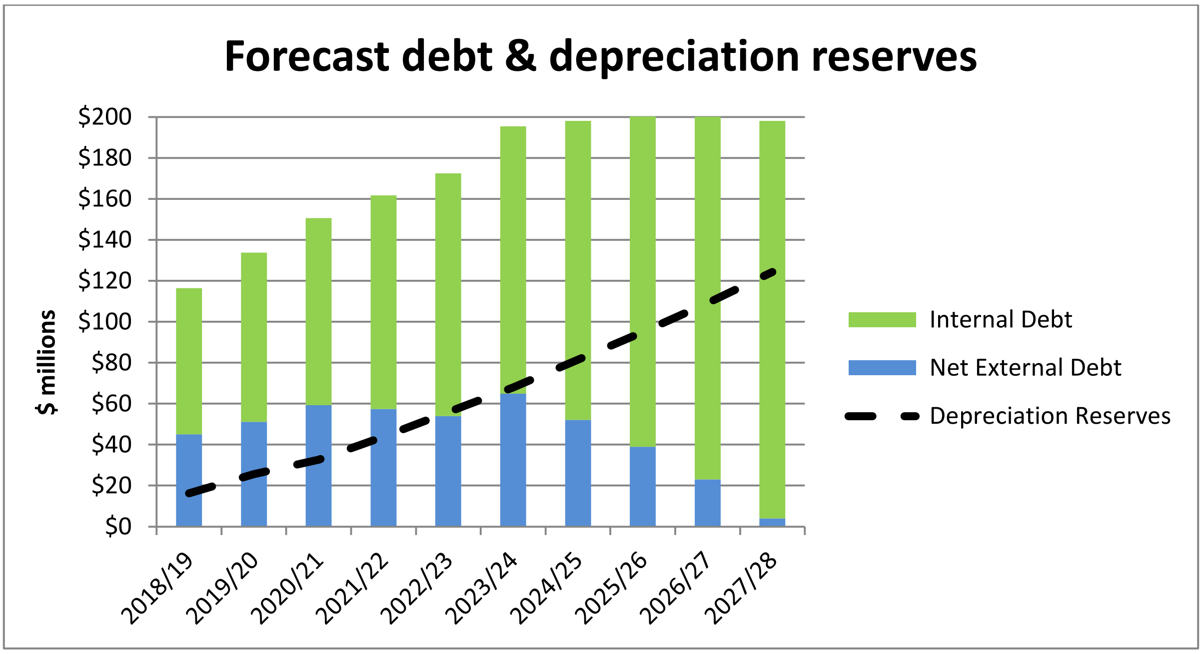
We are responsible for ensuring the community's assets are maintained and renewed on time to ensure best value from the asset for the benefit of ratepayers now and in the future. We do this by annually funding the depreciation on our assets to build up depreciation reserves which we use to fund the renewals of our assets. This allows all the generations that enjoy the benefits from these assets to pay a share of the capital cost.

These renewal projects can involve renewing just a component of the asset (e.g. roof of a building) or the full replacement of the asset when its useful life ends. At times we have utilised these reserves for building new assets which has reduced the cost for today's ratepayers for these new assets but has reduced the reserves available for renewals. The infrastructure and community facility assets across the district have a mix of ages but as they all continue to age we will start needing to renew a greater number of them.

We intend to stop using the depreciation reserves for funding new assets (ones that are not replacing an old asset) so that we have the appropriate reserves in place for our future renewals programme. The depreciation reserves currently have $6.8 million and we have $153 million of renewals planned in the next 10 years. By disconnecting the new asset funding we will fund the plan's renewals and have $124 million by 2028 for future years. Disconnecting the new asset funding from depreciation reserves means that all new assets will be loan funded.

Council's debt

The Council has total debt of $106 million. This debt has funded a mix of renewals and new assets. By the end of 2027/28 our total debt will be $199 million. The extra debt is to loan fund new assets and fund renewals for activities that do not have depreciation reserves large enough to cover the forecast renewals programme. Only $35 million is external debt with the rest borrowed from our depreciation and other financial reserves (called internal borrowing). By the end of 2027/28 our external debt is forecast to decrease to $4 million (as we will be borrowing the majority of our debt internally from our financial reserves).



Current rates subsidy

We pay interest on all our debt. The interest charged on the internally borrowed funds, which for now is approximately $4 million each year, has been subsidising the general rate (specifically the uniform annual general charge).

Protecting our financial reserves

We intend to start to protect the capital value of the Power New Zealand Reserve by increasing the reserve each year by inflation. We will utilise some of the interest earned from the reserve which means reducing the rates subsidy by that amount. This results in an increase to total average rates of 0.5% in Year 1. The Power New Zealand Reserve is another Council asset that must be managed for the benefit of ratepayers now and in the future. It needs to maintain its value and that means applying some of the interest it earns back to the capital fund (inflation-proofing). The reserve is currently $25 million and by the end of 2027/28 it will be $29 million.

How did we get this much debt?
We only started funding depreciation in the late 1990s so at times since then, as the reserves built up, we have loan funded some asset renewals. A significant example was the replacement of the three eastern seaboard wastewater treatment plants. These collectively cost approximately $105 million but the plants were a huge step up in performance and value on the old oxidation treatment plants that they replaced so the reserves could not cover the expense. We loan funded the balance and also had developers pay a contribution for the additional capacity created. We have also built brand new assets for new purposes and have loan funded some of these assets when the reserves were too small.

CONSULTATION OPTION - INCREASING UNIFORM RATES
We propose to maximise the use of uniform rates to legislative limits reducing the complexity of the Council's Revenue and Financing Policy and rating system. The Council considers that many of its services provide the same or similar level of benefit to all ratepayers regardless of a ratepayer's location in the district, the size of the property and/or value of the property. The best match for funding services that benefit all ratepayers in an equal manner is a uniform rate where all ratepayers pay exactly the same amount.

The legislation about rating allows councils to charge 30% of the total rating revenue from rates set on a uniform basis. The water and sewerage rates are exempt from this calculation.

The Council proposes to increase the amount of rating collected from the Uniform Annual General Charge and reduce the amount collected from the land valued based rating for the general rate. The overall increase in uniform rates will be set to reach the 30% limit. This means the Uniform Annual General Charge, one of the tools within the general rate, will increase from $437.43 (as set in the 2017/18 Annual Plan) to $661.95.

ABOUT OUR DISTRICT - THE PENINSULA
Our economy today is strongly reliant on the discretionary spend of visitors and our holiday-home owners, making us particularly vulnerable to recessionary pressures. We have extreme peaks in demand for essential services at key holiday times. Our physical advantages also come with some additional costs: small settlements supporting a relatively large number of separate infrastructure networks, our coastal settlements are vulnerable to sea level rise and coastal inundation and our hilly terrain and infrastructure sustain damage from extreme weather events.

Our new population and growth projections are very similar to the last long term plan. The changes in our demographics, with the larger proportion of people 65 years and over, has not yet had a significant impact on the services delivered by Council. The small projected increase in rating units continues to assist in easing the impact of rating increases. Land use is predicted to largely remain the same as now as there is already sufficient capacity within the main settlements to accommodate the growth projections.

Population projections indicate that our usually resident population, as a whole, is expected to increase between 2018 and 2028, followed by a gradual decline in population from 2028 to 2048. Overall, our usually resident population is projected to decrease slightly over the next 30 years. The usually resident population of Mercury Bay is projected to grow, by around 0.5% each year, over the next 30 years while the rest of our usually resident population is expected to decline.

Our district has an aging population. In 2013 around 27% of our usually resident population was aged 65 and over. This is nearly twice the national average (14%) and is described by statisticians as reflecting New Zealand in another 20 years. This increasing trend is projected to continue, with the proportion of people aged 65 and over expected to increase to around 45%, of the usually resident population, by 2048.

The average household size is also expected to decline across all parts of the district, decreasing from 2.2 residents per household in 2013 to around 2.0 residents per household in 2048. This lower household size contributes to the projected increase in dwelling numbers for the district.

In general, the income of residents of the district is lower than for New Zealand as a whole. In 2013, 43% of our people, aged 15 years and over, had personal income of less than $20,000, compared to 38% across New Zealand. Furthermore, fewer residents received personal income in excess of $50,000 than for New Zealand (17% compared to 28%).This reflects the high proportion of retired residents living off low fixed incomes.

The number of houses is projected to increase across all parts of the district over the next 30 years; with an increase of around 3,580 new houses between 2018 and 2048. Much of the projected growth is expected to occur in the popular holiday settlements with Tairua and Whitianga projected to experience relatively strong housing growth, with around 1.2% (23 dwellings) and 0.8% (32 dwellings) per year respectively. Growth in other settlements is expected to occur at a more modest rate.

The proportion of unoccupied dwellings (houses owned by non-resident ratepayers) is projected to increase from 48% in 2018 to around 52% in 2048. The number of rating units across the district is expected to increase by around 4,135 between 2018 and 2048; an increase of around 0.5% (138 rating units) per year. Growth in rating units is largely driven by housing growth.

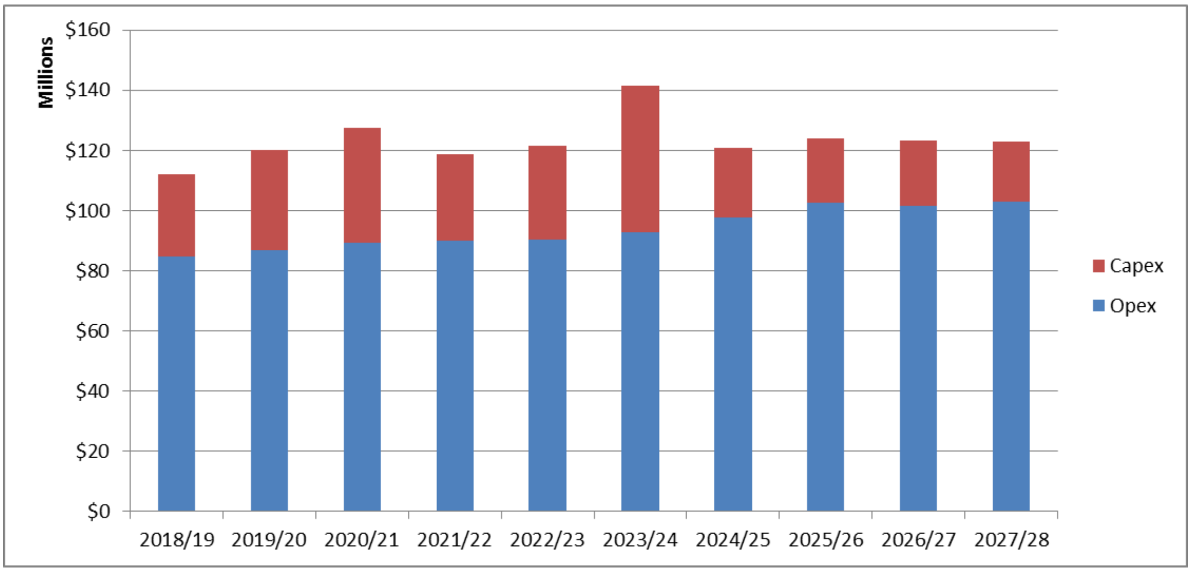
SIGNIFICANT FACTORS

- Capital expenditure to maintain levels of service – a large proportion of the capital programme is required to renew our core infrastructure: roading; water supply; wastewater and stormwater.
- Capital expenditure to improve current levels of service – there are several large projects (the new aquatic centre, the roading maintenance for 24 roads, the water treatment upgrades for drinking water standards).

The cost impacts of renewing or replacing existing assets have been assessed for the next 10 years. Of the total capital cost of $294 million for the period, $153 million (52%) is required because of renewals. Most of the renewal expenditure is funded from rates or borrowing. The largest portion of renewal expenditure is provided for core infrastructure activities: Roading $59 million Water Supply $16 million Wastewater $23 million Stormwater $15 million Total $113 million. This amounts to 74% of the total renewal expenditure over the 10 year period ($153 million).

The cost impacts of capital expenditure to improve existing levels of service have been assessed for the next 10 years. Of the total capital cost of $294 million for the period, $126 million (43%) is required for this purpose.

To deliver our services to the community and maintain the district's assets to the level forecast over the next 10 years (2018-2028) will require $938 million for operating expenditure and $294 million for capital expenditure.



The impact on services and rates of specific funding and expenditure proposals are included in the Consultation Document. The capital expenditure proposals within the Consultation Document have alternative options with greater expenditure than the proposed option which is included in the rating projections. In the event that an option with greater expenditure is adopted then this additional expenditure would be loan funded and add to Council's debt. The Council's level of debt would still be within the borrowing limits. There is no effect on the Council's level of investment from the proposals included in the Consultation Document.

BALANCED BUDGET

Section 100(1) of the Local Government Act 2002 requires Councils to balance the budget. This means that we must raise sufficient revenue to cover our operating expenses for each year of the long term plan. However, section 100(2) allows Councils to set revenue at a different rate to operating expenses in instances when it is considered prudent to do so.

We consider it prudent to only fund depreciation on our share of the roading expenditure. The component attributable to New Zealand Transport Agency (NZTA) will not be funded as this is paid for by the NZTA subsidy. We also consider it prudent to loan fund large one-off operational expenditure projects that benefit current and future ratepayers. This distributes the cost of the service more equitably across those ratepayers that will benefit from it.

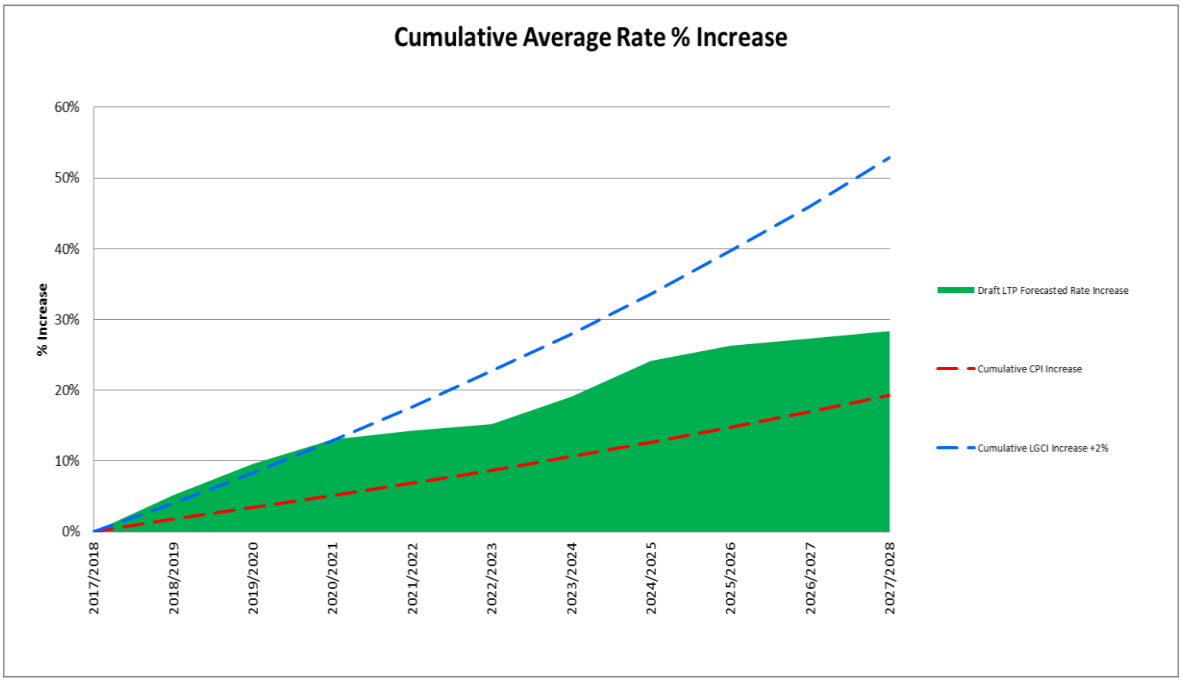
The forecast statement of financial performance over the 10 years of the long term plan shows consistent operating surpluses, which demonstrates that we are balancing our budget requirements.

QUANTIFIED LIMIT ON RATES AND RATES INCREASES

It is always a balancing act between meeting the wants and needs of our communities while keeping rates affordable and sustainable. This long-term plan has been prepared with this in mind and has resulted in a cumulative increase (using 2017/18 as the base year) of rates revenue of 28.5% (2015: 23%) over the 10 years.

Rates are influenced by a number of factors including core recurring operating costs; growth in the district; inflation and our capital works programme. Previous year's capital expenditure affects future year's rates by repayment of borrowings, depreciation and interest costs. Rates can also be affected if the community demands or central government requires an improvement in levels of service for a particular activity.

In order to come up with a sensible quantified limit on rates, it has been necessary to take into account the various influences on rating levels. Rates are increasing by an average of 2.5% over the 10 years. However, the increase is not even because the impact of increased costs varies according to what we are proposing to do and when. For example, the average forecast rates increase for the first three years and again in years six and seven of the long-term plan is between 3% and 5.2%. This reflects the increased costs of ensuring we have adequate reserves to react to disasters; one-off operating budget projects such as the Te Ara O Hei (Coromandel Walks); the cost of improving our information technology systems and the operating costs of the new sub regional aquatic facility.



To help achieve what we think is a good balance we have set the following limits on rates:

- Total rates revenue must not exceed 80% of operating revenue
- Total rates revenue will increase by no more than Local Government Cost Index (LGCI) plus 2%.

Local Government infrastructure costs, as measured by the LGCI increase at a higher rate than the Consumer Price Index (CPI). We have built this higher cost into the long-term plan to make sure that we can afford to do the things we say we will and to maintain our current levels of service.

For the first two years of this long term plan, we are forecasting to not meet our own self-imposed rate increase limit that rates revenue will increase by no more than LGCI plus 2%. This reflects the change in our approach to our investment and reserves income from the last financial strategy. We believe it is prudent to do this to better reflect our responsibilities in looking after both current and future ratepayers and provide a more robust financial position to cater for future infrastructure needs. This includes the need to protect the capital value of the Power New Zealand reserve by reducing the general rate subsidy. This means we are applying some of the interest the fund earns back to the capital fund (inflation-proofing).

We believe the limits we have set for rates and borrowings (see below) still allow us to provide for and maintain existing levels of service and to meet any additional demand for services.

QUANTIFIED LIMITS ON BORROWING

We use borrowing when funding Council assets that will service ratepayers, both today and into the future. This is commonly referred to as intergenerational equity. Using debt this way means that future residents and ratepayers contribute a fair share towards the cost of the assets and facilities that they use. However, we need to be careful not to overburden future ratepayers by living beyond our means today. To find an appropriate balance and provide safeguards for future generations, we need to set some limits on borrowings.

The following specific borrowing limits have been set:

- Net external debt as a percentage of total income will not exceed 150%
- Net external interest expense as a percentage of annual rates income will not exceed 15%
- Net interest expense as a percentage of total income will not exceed 15%.

POLICY ON SECURITIES AGAINST BORROWING

We secure our borrowings and interest rate risk management instruments against rates and rates revenue by way of a Debenture Trust Deed. Borrowing is secured by a floating charge over all Council rates levied under the Local Government Act. The security offered by Council ranks equally with other lenders.

In unusual circumstances, security may be offered by providing a charge over one or more of our specific assets. Securities are not provided on our own internal borrowing. Further information on borrowing can be found in our Liability Management Policy accessed at www.tcdc.govt.nz.

MANAGING FINANCIAL INVESTMENTS AND EQUITY SECURITIES

Our philosophy on the management of investments is to optimise returns in the long term while balancing risk and return considerations. We recognise that as a responsible public authority any investments that we hold should be low risk where the primary objective when investing is the protection of our investment capital. Accordingly, only approved creditworthy counterparties are acceptable and we recognise that lower risk generally means lower returns in our investment activity, We will act effectively and appropriately to:

- protect the Council’s investments;
- ensure the investments benefit the Council’s ratepayers; and
- maintain a prudent level of liquidity and flexibility to meet both planned and unforeseen cash requirements.

We do not hold equity investments in our own name, rather all equity investments are externally managed by Council’s appointed investment manager in accordance with the Statement of Investment Policy and Objectives (SIPO). However, the Council may hold equity for non-investment purposes, provided that the holding is in furtherance of its community well-being objectives as outlined in the long-term plan, and may include investments held in CCO/CCTO and other shareholdings.

Objectives

Our objectives are to:

- manage investments in a manner consistent with current governing legislation and Council's strategic and commercial objectives;
- optimise returns while minimising credit and liquidity risks;
- manage the overall cash position of the Council's operations;
- hold investments that are necessary to carry out Council operations consistent with

Annual Plans, to implement strategic initiatives, or to support inter-generational allocations.

- hold assets for commercial returns.
- provide ready cash in the event of a natural disaster. The use of which is intended to bridge the gap between the disaster and the reinstatement of normal income streams and assets.
- invest amounts allocated to accumulated surplus, Council created restricted reserves and general reserves.
- invest proceeds from the sale of assets.
- maintain professional relationships with the Council's bankers, the LGFA and financial institutions;
- monitor, evaluate and provide timely and accurate reporting of treasury activity and performance; and
- ensure adequate internal controls exist to protect Council’s financial assets and to prevent unauthorised transactions.

Further information can be found in our Investment Policy accessed at www.tcdc.govt.nz.