Auckland City Council
Level 15, 135 Albert Street
Auckland 1023

For the attention of: Stephen Town – Chief Executive

29 November 2017

Dear Stephen,

Thank you for your email dated 21 November 2017 and the questions relating to Auckland Council's (Council) debt funding strategy. Before answering these questions, we believe it would be useful that we put some context around Council's approach to debt management including how this has been interpreted under the clear statutory background context and requirements that Council is obliged to undertake on behalf of rate payers

Legislation

Council's statutory obligations are outlined in The Local Government Act 2002 and The Local Government (Auckland Council) Act 2009 as follows

S 14(1)(g) – Principles relating to local authorities

A local authority should ensure prudent stewardship and the efficient and effective use of its resources in the interests of its district or region, including by planning effectively for the future management of its assets

S 101(i) – Financial management

A local authority must manage its revenues, expenses, assets, <u>liabilities</u>, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community

S 100 – Balanced budget requirement

(1) A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses.

(2) Despite subsection (1), a local authority may set projected operating revenues at a different level from that required by that subsection if the local authority resolves that it is financially prudent to do so, having regard to—

(a) the estimated expenses of achieving and maintaining the predicted levels of service provision set out in the long-term plan, including the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and
(b) the projected revenue available to fund the estimated expenses associated with maintaining the service capacity and integrity of assets throughout their useful life; and

(c) the equitable allocation of responsibility for funding the provision and maintenance of assets and facilities throughout their useful life; and

(d) the funding and financial policies adopted under section 102.

S 107 – Local Government (Auckland Council) Act 2009 Borrowing in foreign currency

Despite section 113 of the Local Government Act 2002, the Auckland Council may borrow or enter into incidental arrangements, within or outside New Zealand, in currency other than New Zealand currency.

Background Context

Council currently has external debt exceeding NZD7.5 billion and this figure is likely to exceed NZD12.0 billion within 10 years. Council is New Zealand's 2nd largest debt issuer behind the New Zealand Government (NZD83.0 billion) and alongside the LGFA (NZD8.3 billion). In this comparison, we have excluded New Zealand registered banks.

Council is considered a significant borrower in both a New Zealand and international context. Council's significant borrowing requirements were anticipated in 2011 when Council became the only New Zealand Local Authority permitted to borrow from foreign debt markets in a foreign currency. The required legislation change was supported by Treasury (government) acknowledging that Council's forecast debt path required greater access to global debt markets in order to fully future proof debt funding capacity in a prudent and efficient manner.

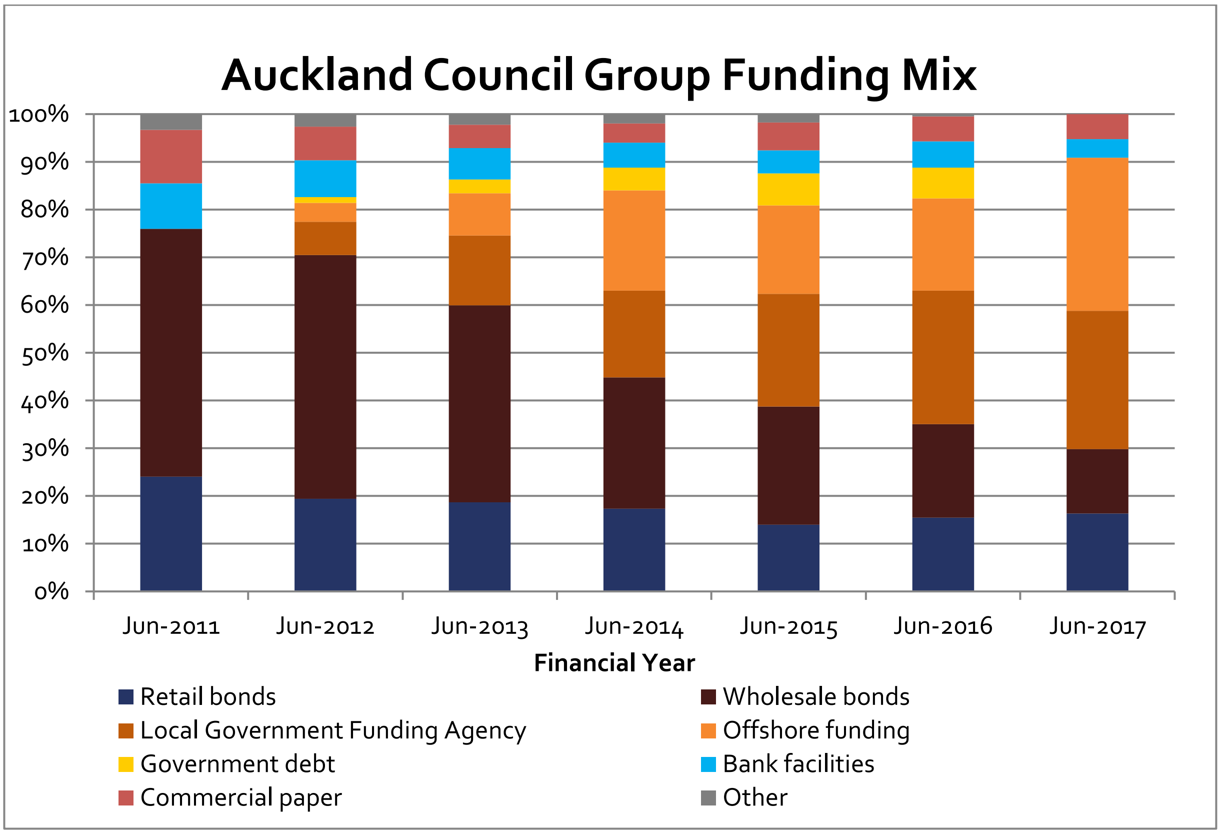
Consistent with Council's statutory obligations to act in a financially prudential manner for intergenerational ratepayers and the Auckland community as a whole, Council's funding programme and execution of borrowing strategies have been required to take a long term approach to the stewardship of Council's liabilities.

The combination of the funding context and statutory requirements are key considerations in responding to the following four questions.

1) What are your views on Council's funding strategy and the role of the offshore markets?

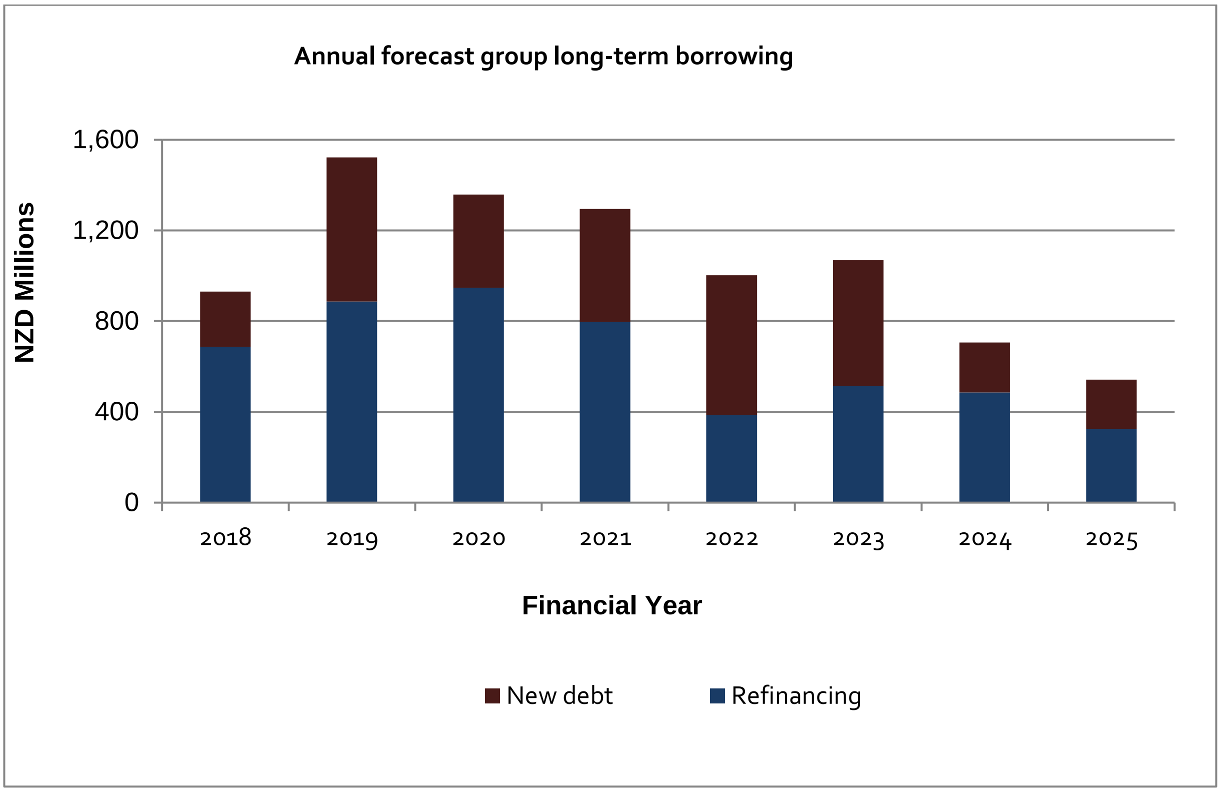
We believe Council's funding strategy and use of offshore debt markets is a consistent, prudent and efficient means of satisfying the above underlying statutory objectives to future proof Council's ability to access long term funding and in ensuring liquidity capacity.

Increased diversity and capacity of funding sources is a lynchpin of Council's funding strategy and is illustrated by the following chart:



source: Auckland Council

Council has significant funding risk in relation to its debt refinancing profile and forecast new borrowings as the following chart illustrates:



source: Auckland Council

Over the next eight years, Council must raise an average of NZD 1 billion of funds per annum.

Council has access to both New Zealand and offshore debt markets and although the New Zealand market is currently providing the best all up pricing, it is limited in its capacity to fully satisfy Council's current and future funding needs (i.e. lack of investor appetite for required funding quantum).

The following charts illustrate the size of the New Zealand debt market relative to the overall size of Council's funding requirements (i.e. small) and also compares the significant depth of the EUR bond market:

New Zealand bond issuance (NZ issuers)

	Domestic issuances	Domestic amount issued (NZDm)
2017	30	4,760
2016	40	5,839
2015	26	6,353
2014	43	5,601
2013	30	5,711
2012	18	5,924

source: Bloomberg

The domestic amount annually issued is a key indicator of market capacity for a borrower such as Council. Annual domestic issuance has averaged NZD 5.7 billion over the past six years. It is important to note that this capacity does not cover Council's total debt of NZD 7.5 billion.

EUR bond issuance

	Amount issued (NZDm)
2017	1,206,215
2016	1,562,484
2015	1,651,272
2014	2,095,287
2013	2,207,308
2012	2,559,447

source: Bloomberg

By contrast, the EUR bond market has had annual average issuance equivalent to NZD 1.8 trillion, illustrative of the vastly superior funding market capacity compared to New Zealand's annual domestic issuance of NZD 5.7 billion.

New Zealand Debt Market

Council accesses funding in the New Zealand debt market predominantly from domestic retail investors, wholesale institutions (both domestic and offshore), banks and the LGFA.

LGFA has been the local government sector's most efficient and cheapest provider of term debt since its inception in 2011. However, Council is limited in its access to borrowings from the LGFA to a maximum of 40% of LGFA's balance sheet (Council has borrowed NZD 2.40 billion from LGFA representing 28% of LGFA's balance sheet). The current "headroom" availability totals NZD 800 million and this is carefully managed by Council in terms of utilising it prudently in terms of pricing, term and capacity availability compared with alternative diversified funding from other debt markets. There is a close relativity between the LGFA and Council's balance sheets and it is likely that LGFA will only be able to satisfy between 35% and 45% of Council's funding requirements on an ongoing basis. There is potential volatility around LGFA's balance sheet given recent government funding initiatives such as the Housing Infrastructure Fund (HIF). This fund will deflect funding away from the LGFA and accordingly impact on Council's LGFA headroom.

The retail and wholesale market is very closely aligned as domestic wholesale investors tend to use retail market debt issuances as a strategic investment mechanism when considering pricing and liquidity for issuers such as Council. The actual amount of "true" retail investors in this segment is very low. This segment is considered the second cheapest source of funding for Council, however, it is also limited in its capacity and can be unreliable in terms of consistent capacity availability and pricing expectations. Debt maturities are also constrained with appetite for long dated bonds being inconsistent with Council's needs (typically seven years or less). Debt issuance sizes are limited to NZD100-250 million and the total capacity of this market to efficiently absorb Council debt is estimated between NZD2.5 billion and 3.0 billion. Council takes an opportunistic approach to accessing this market, having issued NZD430 million in the 2016 year. Council has issued a total of NZD2.2 billion in this market segment, suggesting that there is approximately NZD800 million of head room capacity at the upper end of estimates. It should be noted that the wholesale investors largely dominating this funding segment also invest in LGFA bonds and their investment limits consider exposures linked to the wider local government sector and Council's dominant position within LGFA's asset portfolio. This can therefore, constrain the investment capacity of domestic wholesale investors for Council debt.

Offshore wholesale investors in NZD debt markets tend to restrict themselves to New Zealand Government bonds, Kauri bond issuance and more recently, LGFA bonds. They are often restricted by their investment policies with regards to minimum credit rating criteria such as AAA supra national and sovereign agencies and they usually require a minimum issue size for liquidity. LGFA is considered a semi-sovereign agency with a credit rating commensurate to the New Zealand government. It has also only been in recent years that the LGFA grew the size of tender tranche maturities (in excess of >NZD750 million) that has encouraged offshore investors to have significantly invested in LGFA bonds. Offshore investors currently represent >30% of LGFA bond investors.

Bank debt is considered to be the most expensive available domestic funding mechanism for Council and the debt capacity provided by this segment of the market is most efficiently utilised through the provision of liquidity via committed standby facilities. Council has established a $1.2 billion syndicated facility to support liquidity requirements. Council does not intend to draw down under this facility.

Accordingly, consideration of the three key sources being LGFA, retail/ wholesale bond markets and bank debt highlight the New Zealand debt market has limited capacity to prudently accommodate Council's current and future debt requirements. Council must consider offshore debt markets which remain the funding and liquidity buffer for Council and will be heavily relied on to provide between 35-50% of Council's current and future debt requirements. Council uses offshore debt markets as opportunistic sources of privately placed long term debt such as the NOK 15-year placement and most importantly, as access to the largest and most liquid public bond markets (such as the EUR bond market).

Offshore debt markets have many moving parts when considering the timing of accessing different markets in different currencies. Many of these considerations are quite complex such as the cost of currency hedging as well as moving credit curves and yield curves. It is often necessary that Council engages with specific offshore debt markets when these markets are "working" and this can sometimes conflict with Council's own timing preferences.

2) How do New Zealand organisations with similar debt levels and credit ratings conduct their debt funding?

Conduct of debt funding requires consideration of sector (public/ private) type along with scale. In this regard and from a public sector perspective the New Zealand Government and LGFA currently fund their debt issues in NZD. For the government, this is well supported by domestic and offshore investors as the "risk free" entry to NZD fixed income investment and participation in New Zealand's comparatively high interest rate environment. New Zealand sovereign debt is able to be invested in by the full complement of the world's largest debt investors, meeting their investment policy parameters as a highly rated sovereign issuer (AA+).

The New Zealand Government has issued debt totalling NZD 83.0 billion. As a highly rated and stable sovereign issuer in a country that has comparatively high interest rates, New Zealand sovereign debt will always represent an attractive risk free investment choice. It is important to note that some investors such as global central banks have very strict policies around the profile of issuer they can invest with and in many cases only invest in government bonds. The sheer scale of global investment capacity for debt instruments and the comparatively small amount of funding required by the New Zealand Government has meant that the New Zealand Debt Management Office (NZDMO) has not needed to consider offshore foreign currency issuance for many years.

The following chart illustrates the relatively small annual issuance conducted by the NZDMO over recent years;

	Number of issuances	Amount issued (NZDm)
2017	24	5,896
2016	3	8,408
2015	1	3,978
2014	2	12,282
2013	2	14,483
2012	1	6,411

source: Bloomberg

LGFA has also specifically obtained funding in the New Zealand domestic market and has been considered a semi-sovereign agency by many large wholesale investors who require high credit ratings and debt liquidity as minimum investment policy criteria. Similarly, the LGFA has also been able to attract a sub group of the above offshore investors by deliberately creating a largely economic and liquid tranche size of issuance maturities that complements their high credit rating and status as a semi-sovereign agency.

Offshore investors currently comprise approximately 30% of LGFA debt. It is becoming evident that the capacity of the New Zealand debt market is too small to efficiently cater to the LGFA's increasing debt profile. Whilst LGFA has successfully tapped into offshore investors of NZD debt, the cost has been to create large NZD 1 billion issue maturity tranches and this presents refinancing risk as it is evident that the NZD debt market is not large enough to support single maturities of this magnitude on a regular basis.

We understand that LGFA has recognised the requirement of having the ability to access offshore debt markets as a key funding risk mitigant. To this end, LGFA is currently in the process of establishing an AUD bond programme.

Fonterra and Transpower are the next largest comparable New Zealand debt issuing organisations (Banks have been excluded from this comparison).

Fonterra is rated A- and manages debt of NZD6 billion and it is clear that its funding strategy includes a significant emphasis on offshore debt markets with over 50% of term debt sourced from the following offshore debt markets;

Maturity date	Amount	Currency	NZ equivalent (NZDm)
Perpetual	35	NZD	35
Nov-27	300	AUD	333
Jun-26	180	AUD	200
Jul-25	800	CNY	176
Jun-25	100	NZD	100
Nov-24	350	EUR	583
Feb-24	175	AUD	194
Dec-23	225	GBP	409
Mar-23	150	NZD	150
May-22	150	AUD	167
Feb-22	100	NZD	100
Oct-21	350	NZD	350
Jun-21	400	AUD	444
Nov-20	100	NZD	100
Jun-20	1,000	CNY	220
Feb-20	150	NZD	150
Jan-19	1,250	CNY	276

source: S&P Capital IQ

Transpower is rated AA- and manages debt of NZD3 billion. It has a significant emphasis on offshore debt markets with over 50% of term debt sourced from the following offshore debt markets;

Maturity date	Amount	Currency	NZ equivalent (NZDm)
Aug-23	300	AUD	333
Aug-21	150	AUD	170
Mar-20	400	HKD	75
Sep-19	75	USD	112
Oct-21	232	USD	332
Dec-22	150	USD	215
Oct-23	78	USD	112
Oct-26	145	USD	200
Jun-28	75	USD	100

source: S&P Capital IQ

It is our general observation that New Zealand organisations with debt in excess of NZD1 billion have a strong emphasis on offshore debt markets in relation to the prudential management of their funding and liquidity risks. It is generally accepted that single name debt capacity in the New Zealand market from the banking sector is NZD 1 billion and that wholesale and retail market capacity is significantly influenced by the issuer's credit rating. Diversification of debt from accessible debt markets is a key requirement for New Zealand issuers with material debt.

An analysis of other New Zealand debt issuers such as Auckland International Airport, Spark, Powerco and Vector (debt >NZD750 million) illustrates that 25-50% of their debt is funded from key offshore debt markets, with lower rated entities often focusing on the US Private Placement market.

3) What is your view on the merits or otherwise of the recent follow up EUR benchmark issue?

The offshore debt markets are critical to Council's funding strategy. There are three key considerations around offshore debt issuance; size and liquidity of markets, available maturity terms and all up pricing (when fully hedged back to NZD). Smaller issuance opportunities can present themselves to Council where both maturity and pricing can be attractive such as the NOK and CHF issues, however, these transactions are usually small in the context of managing a NZD 7.5 billion debt portfolio. Where large offshore markets such as the EUR bond market have their advantage is in their massive scale and capacity to provide significantly large amounts of debt in single issues.

Council's decision to focus on the EUR bond market was primarily based on prudentially future proofing Council's access to funding and liquidity (i.e. safeguarding the 35% to 50% of Council's debt requirements which are unlikely to be adequately accommodated by the New Zealand debt market, including LGFA). The debut EUR 500 million (NZD 750 million) 10-year issue completed in January 2017 was the first step for Council in carefully establishing itself as a serious issuer into this important debt market. Planning for this issue began as early as 2012 following Council's preparation of a comprehensive Medium Term Note program and supporting documentation. It is important to add that the EUR bond market is a debt market that satisfies a significant component of global debt investment requirements and many large investors will not waste their internal resources on understanding debt issuers risk/ return metrics unless they are going to be meaningful issuers. Accordingly, size and repetitive issue presence is required in order to preserve funding access and pricing optimisation.

Council's decision to do a repeat issue in November was well judged and proved to be very successful.

This issue was oversubscribed (4.2x from 72 investors), compared to the debut issue's 47 investors. There was aggressive demand following what was considered an excellent preparation and supporting road show and this was reflected with pricing closing in through the issue's book build by 28%.

The follow up EUR issue was a significant achievement in Council's long term funding strategy and was more deserving of bouquets than brickbats.

4) What are your views on Council's debt investor relationship strategy, particularly the focus on face to face meetings? Are you able to estimate the benefit these meetings have relative to the cost?

Global debt markets are no different to equity markets in that if you want to sell your investment proposition then you have to dance to the tune of the investor base you are courting. Investor relationships are about respect and physical face to face time, at least yearly, is the expected market norm.

Council must therefore have a physical presence and present a face to investors. The cost of this is usually incorporated into the overall issue costs and seen as a necessary component of debt funding in the same way that other costs such as legal and advisory costs associated with the issue are considered. It is difficult to estimate the cost of remotely issuing in this market, however, the feedback from the EUR issue suggested that the pre issue roadshow was very well received and contributed to the closing-in of pricing representing an annualised amount of NZD2.8 million in present value terms. This is simply the benefit of a well-run road show. It is more likely that a "no show" issue would have seen higher pricing reflecting a multiple on this figure.

Conclusion

- Council's recent debt funding activities have been consistent with Council's statutory obligations to act in a financially prudential manner for intergenerational ratepayers and the Auckland community as a whole. Council's funding programme and execution of borrowing strategies have been required to take a long term approach to the stewardship of Council's liabilities.
- Council's decision to access the EUR bond market has been consistent with the strategy of future proofing Council's funding risk on a material debt portfolio currently totalling NZD8.3 billion. This has been achieved through diversifying Council's funding reliance away from the New Zealand debt market given the limited debt capacity of the domestic market for an issuer such as Council. It is estimated that between 35%-50% of Council's future debt requirements are unlikely to be satisfied by the New Zealand debt market in a reliable and prudential manner.
- Council cannot rely on the LGFA for all of its funding needs and must be strategic in how it utilises the LGFA's 40% debt capacity constraint. It would be imprudent for Council to simply utilise the full head room availability as this would limit Council's future choices around liquidity and funding management. Council would also be at risk in the event that LGFA reduced its balance sheet.
- Global debt markets are no different to equity markets in that if you want to sell your investment proposition then you have to dance to the tune of the investor base you are courting. Debt investors expect Council to be physically present at investor road shows. Council's presence at the EUR bond investor road show certainly contributed to the closing-in of pricing, representing an annualised benefit of NZD2.8 million in present value terms. The cost of not being present would likely have resulted in pricing significantly higher than this figure.
- It is our general observation that New Zealand organisations with debt in excess of NZD1 billion have a strong emphasis on offshore debt markets in relation to the prudential management of their funding and liquidity risks. Diversification of debt from accessible debt markets is a key requirement for significant New Zealand debt issuers with approximately 25-50% of their debt being funded from offshore debt markets. Most major borrowers preserve capacity in their "home" market as when other markets are closed to them typically the "home" market will continue to provide funding liquidity, as evidenced during the Global Financial Crisis (GFC).

Please feel free to contact me should you wish to clarify any of the matters covered above.

Yours sincerely

Stuart Henderson
Partner
Treasury and Debt Advisory

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The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this paper are based on information available as at the date of the paper.

We reserve the right, but will be under no obligation, to review or amend our paper, if any additional information, which was in existence on the date of this paper was not brought to our attention, or subsequently comes to light.

We have relied on forecasts and assumptions prepared by the Council about future events which, by their nature, are not able to be independently verified. Inevitably, some assumptions may not materialise and unanticipated events and circumstances are likely to occur. Therefore, actual results in the future will vary from the forecasts upon which we have relied. These variations may be material.

This paper is issued pursuant to the terms and conditions set out in our engagement letter signed 14 November 2012 and the Terms of Business attached thereto.