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Research Update:

Ratings On Taupo District Council Raised To 'AA' On Lower Debt; Outlook Stable

Primary Credit Analyst:
Anthony Walker, Melbourne (61) 3 9631 2019; anthony.walker@standardandpoors.com

Secondary Contact:
Anna E Hughes, Melbourne (61) 3-9631-2010; anna.hughes@standardandpoors.com

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Overview

- We are raising our long-term rating on Taupo District Council to 'AA' from 'AA-'. At the same time, we affirmed our short-term rating at 'A-1+'.
- Taupo's improving budgetary performance will reduce and sustain its total tax-supported debt to less than 200% of operating revenues in 2017. We consider that this debt burden no longer represents a significantly higher level of risk compared to 'AA' peers.
- The ratings reflect the extremely predictable and supportive institutional framework within New Zealand, plus Taupo's very strong financial management, budgetary flexibility and budgetary performance, and its strong liquidity and low contingent liabilities.
- The outlook is stable, reflecting our expectations that the council's debt will continue to fall in line with our base-case forecast.

Rating Action

On May 25, 2015, Standard & Poor's Ratings Services raised its long-term local and foreign ratings to 'AA' from 'AA-' on Taupo District Council, a New Zealand local government. We also affirmed the short-term rating on Taupo at 'A-1+'. The outlook on the long-term rating is stable.

Rationale

The upgrade reflects our expectations that Taupo's strengthening budgetary performance will reduce and sustain its total tax-supported debt to less than 200% of operating revenues in 2017. As such, Taupo's debt burden no longer significantly underperforms the benchmark as set out in our criteria. We therefore no longer lower the rating by one notch to reflect the additional risk associated with a significantly higher debt level compared to peers.

The ratings on Taupo reflect the extremely predictable and supportive institutional framework within New Zealand, plus the council's very strong financial management, budgetary flexibility and budgetary performance, and its strong liquidity and low contingent liabilities. Partially offsetting these strengths is our view of its very high debt burden, and average economy.

We perceive the institutional framework within which New Zealand local governments operate as being one of the strongest and most predictable globally. The New Zealand local government system promotes a strong management culture and fiscal discipline among New Zealand councils. This provides a source of credit strength for Taupo, and allows it to support higher debt burdens than some of its international peers can tolerate.

Taupo's financial management is very strong. The preparation of a Long-Term Plan (LTP) by all New Zealand councils at least every three years ensures councils have a forward-looking approach to prudent financial management, and sets an important baseline for the council's operating and capital-expenditure requirements, and funding strategy. Supporting our view is Taupo's policy of cash funding its depreciation and the council's fiscal consolidation following a period of large infrastructure spending. Furthermore, Taupo has not been involved in property development since 2010.

We consider Taupo's budgetary flexibility to be very strong with modifiable revenues of about 90% of operating revenues (after Standard & Poor's adjustments) between 2013 and 2017. Further, improving its budgetary performance is the reduction in its capital expenditure, which is about 24% of total expenditure over the same period, down from 44% between 2006 and 2013. Taupo's revenue flexibility is supported by its above-average capability to generate revenues from asset sales such as the sale of property and land, term deposits, commercial paper, and other liquid assets held in its investment fund, which could generate more than 20% of its operating revenues. In 1995, the council invested proceeds from the sale of Taupo Electricity Ltd. (TEL) and Taupo Generation Ltd.

Taupo's budgetary performance is also very strong, reflecting higher operating surpluses of 19.5% of operating revenues from 2013-2017 and after-capital account surpluses of 2.5% of total revenues over the same period. Taupo's operating position continues to improve with surpluses of about 20% of operating revenues, after averaging about 4.6% between 2006 and 2011. This is a result of increasing rates income and user charges while restricting operating expenditures. Taupo's after-capital account position has also improved significantly with surpluses of about 5% of total revenue forecast from 2014-2017, after years of large deficits averaging more than 25% from 2006-2013, when it undertook large infrastructure spending.

Taupo's contingent liabilities are low and do not affect the ratings. The council's insurance policies and its investment fund limit its exposure to contingent liabilities that could arise from potential natural disasters.

Partially offsetting these strengths is Taupo's very high, though improving, debt burden. We expect Taupo's total tax-supported debt to reduce to less than 200% of operating revenues in 2017, from more than 250% in 2012. The council's stronger operating position, combined with its small capital-expenditure program, is driving after-capital account surpluses that will reduce its debt burden. Taupo's interest expenses are forecast to average 14.6% of operating revenues from 2014-2017 and remains very high, in our opinion. It is expected to fall, reflecting Taupo's lower debt burden and better margins from its participation in the Local Government Funding Agency (LGFA).

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We consider Taupo's economy to be average compared to peers. Taupo's average per capita income of US$36,800 is relatively lower than New Zealand's US$39,500. Taupo's economy is supported by a large proportion of non-residents that own holiday homes and a strong tourism sector. This brings some concentration risk and increases susceptibility to tourism preferences. Further, it also exposes Taupo's property market to New Zealand's broader economic conditions, which could weaken revenue streams in the event of an economic downturn.

Liquidity

Taupo's liquidity is strong with a debt-servicing ratio of free cash and liquid assets (after haircuts) as a percentage of the next 12 months' debt service of about 115%. When including unutilized bank facilities of NZ$50 million, Taupo's debt-servicing ratio reaches 194%.

We forecast Taupo to hold approximately NZ$63 million in cash, NZ$9.8 million in liquid assets (after Standard & Poor's haircuts), and undrawn bank facilities of NZ$50 million available to cover debt of NZ$53 million maturing within the next 12 months (including commercial paper of NZ$28 million) and interest of NZ$10.3 million.

Taupo's debt-servicing ratio is likely to remain strong with long-term debt evenly spread between March 2016 and March 2018 and NZ$25 million maturing each year (excluding commercial paper). However, cash and liquid assets could fall below 100% of the council's debt servicing in the future, depending on the composition of the council's cash and liquid assets (i.e. bonds will attract a higher haircut relative to cash) and its total amount of debt maturing within a 12-month period (including commercial paper). We expect the council will successfully refinance or repay its upcoming maturities.

We consider Taupo's access to external liquidity as being satisfactory. New Zealand's capital markets are comparatively liquid, but, given its small size, are not considered by Standard & Poor's as being particularly deep. This was highlighted during the severe market dislocation in 2008 and 2009, during which some New Zealand councils had difficulty issuing unrated commercial paper.

Taupo is participating in the New Zealand LGFA. LGFA is a mutual body representing participating New Zealand local governments, and aims to access funding at a cheaper rate than many individual New Zealand councils can. Participation in the LGFA has helped improve the council's liquidity by lengthening its maturity profile.

Outlook

The stable outlook reflects our expectations that Taupo will manage its financial position in line with our financial forecasts, in particular,

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reducing and sustaining its total tax-supported debt to less than 200% of operating revenues in 2017.

Upward pressure on the ratings is unlikely in the next two years, particularly given that the rating on the council is currently constrained by the New Zealand sovereign rating. We do not believe that a local council in New Zealand can withstand a default scenario better than the sovereign, and that its credit characteristics are likely to deteriorate together with those of the sovereign in severe macroeconomic stress scenarios.

Downward rating pressure could occur if there was a change in policy direction such as Taupo undertaking a large capital program without additional revenues measures that offset this spending. This could result in after-capital account deficits averaging more than 5% of total revenues over a sustained period, and the council's total tax-supported debt rising back toward 250% of operating revenues. We consider this very unlikely in the next two years.

Key Statistics

Table 1

Taupo District Council					
Years ending June 30	**2013 A**	**2014 A**	**2015 (BC)**	**2016 (BC)**	**2017 (BC)**
CASH OPERATING RESULTS (MIL. NZ$)					
Council rates	51.34	53.61	58.24	59.38	61.04
User charges	8.59	10.59	10.49	11.12	10.22
Interest income	4.74	3.91	4.12	4.58	4.70
Other operating revenues	3.23	3.76	2.16	2.38	3.76
Adjusted Operating Revenues	67.90	71.87	75.01	77.46	79.72
Payments to suppliers and employees	44.52	52.09	48.92	49.46	50.16
Interest payments	10.62	11.14	11.20	10.32	10.27
Other operating expenditure	0.00	0.00	0.00	0.00	0.00
Adjusted Operating Expenditures	55.14	63.23	60.12	59.78	60.42
Operating Balance	12.75	8.64	14.89	17.68	19.30
+ Adjusted capital revenues	7.06	10.98	3.29	6.85	4.71
- Adjusted capital expenditures	25.32	14.85	16.62	20.68	17.72
Balance After-Capital Accounts	(5.50)	4.77	1.56	3.85	6.28
FINANCIAL PERFORMANCE INDICATORS (Cash basis)					
Operating balance (% of adj. operating revenues)	18.78	12.02	19.85	22.83	24.20
Balance after-capital accounts (% of adj. total revenues)	(7.34)	5.76	1.99	4.57	7.44
Modifiable revenues (% of adj. operating revenues)	88.26	89.33	91.63	91.01	89.39
Capital expenditures (% of total expenditures)	31.46	19.02	21.66	25.70	22.68
KEY BALANCE SHEET ITEMS (MIL.)					
Cash and equivalents	41.65	51.44	47.03	43.08	43.86
Current debt	58.06	88.11	81.51	51.21	74.62

Table 1

Taupo District Council (cont.)					
Non-current debt	105.10	80.04	85.08	111.53	81.84
FINANCIAL POSITION INDICATORS					
Direct debt (adj. for operating leases)	163.15	168.18	166.59	162.74	156.46
Direct debt (% of adj. operating revenues)	240.30	234.01	222.10	210.08	196.26
Consolidated operating revenues	67.90	71.87	75.01	77.46	79.72
Tax-supported debt	163.15	168.18	166.59	162.74	156.46
Tax-supported debt (% of cons. operating revenues)	240.30	234.01	222.10	210.08	196.26
Interests (% of adj. operating revenues)	15.64	15.50	14.93	13.32	12.88

A--Actual. BC--Base case.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Average
Financial Management	Very Strong
Budgetary Flexibility	Very Strong
Budgetary Performance	Very Strong
Liquidity	Strong
Debt Burden	Very High
Contingent Liabilities	Low

*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

Key Sovereign Statistics

Sovereign Risk Indicators, March 31, 2015. Interactive version available at http://www.spratings.com/sri

Related Criteria And Research

Related Criteria

- Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009

Related Research

- New Zealand's Reforms Are Strengthening Councils' Financial Management And Long-Term Planning, Nov. 24, 2014
- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Upgraded; Outlook Action; Ratings Affirmed

	To	From
Taupo District Council		
Issuer Credit Rating	AA/Stable/A-1+	AA-/Positive/A-1+
Taupo District Council		
Senior Secured	AA	AA-
Taupo District Council		
Commercial Paper	A-1+	

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