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Supplementary Analysis:

Taupo District Council

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Supplementary Analysis:

Taupo District Council

This report supplements our research update "Ratings On Taupo District Council Raised To 'AA' On Lower Debt; Outlook Stable," published on May 25, 2015. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Issuer Credit Rating
AA/Stable/A-1+

The ratings on Taupo District Council 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).

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, 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.

Extremely Predictable and Supportive Institutional Framework

We consider New Zealand's institutional framework as being extremely predictable and supportive, and expect it to remain so. We view New Zealand's institutional framework as one of the strongest in the world (see "New Zealand's Reforms Are Strengthening Councils' Financial Management And Long-Term Planning," published Nov. 24, 2014 on RatingsDirect).

Average Economy: Concentration In Tourism Partially Offsetting High Per Capita Income

Taupo's economy is average compared to peers, with average per capita income of about US$36,800 between 2011 and 2013, compared to 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 its 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.

The Taupo district surrounds Lake Taupo in the centre of New Zealand's north island and is a major events and holiday destination. Real economic growth was estimated at 3.4% in 2014, up from 0.2% in 2013. The New Zealand Institute of Economic Research estimated that real growth averaged about 2.1% between 2011 and 2013 after falling in 2009 and 2010.

Taupo's permanent population is about 35,100 and has grown by about 0.8% per year since 2009. Its population fluctuates throughout the year because about 45% of residential properties are owned by non-residents (mainly from Auckland and Wellington) as holiday homes. This seasonal population brings sound economic activity during peak seasons, but also substantial demand on the council's infrastructure assets. Taupo's population almost doubles during holiday periods and it officially recorded more than 530,000 visitors staying in commercial accommodation in 2014. As a result, tourism, hospitality, and the retail sectors are key contributors to the local employment and economic output. Further, developments and expansion of dairy plants and geothermal power in Taupo have contributed to growth in the past 12 months.

The structure of a New Zealand council's local economy is not important in the short term for determining credit quality, primarily because the council's main source of revenue--property rates--is typically not affected by cyclical economic factors. Nevertheless, a council's economic structure will influence the body's credit quality over the medium term, as the economy affects the revenue and expense pressures placed on a council, plus a council's ability to attract ratepayers.

Very Strong Financial Management Supported By Experienced Finance Team

Taupo's financial management is very strong and is supported by an experienced and well-qualified financial management team. Taupo's focus on fiscal consolidation following years of infrastructure spending is stabilizing its borrowings, and reducing its debt burden. Further, the council is no longer involved in property development and is not expected to re-engage in this activity. The preparation of a LTP by all New Zealand local authorities 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 its funding strategy.

Like all New Zealand councils, Taupo prepares accrual accounts in accordance with New Zealand International Financial Reporting Standards (NZ IRFS) and New Zealand Generally Accepted Accounting Practices (NZ GAAP), which are audited by Audit New Zealand. Accounting policies are disclosed in the annual report, with liability management and investment policies clearly set out.

In managing its borrowings, Taupo adopts a number of key financial targets in its Treasury Management Policy. These targets are not onerous, but ensure a debt-management strategy that focuses on borrowing for capital expenditure. Policy parameters also manage the volume of borrowing as well as the maturity profile. The council has no foreign currency exposure, and hedges most of its interest rate risk.

The council's Treasury Management Policy includes a separate investment strategy statement for the TEL investment fund, which manages proceeds from the sale of TEL and Taupo Generation Ltd. The fund is currently producing good returns on its large cash holdings. The fund is currently outside some of its investment limits with cash holdings of 72% compared to policy limits of 0%-35%, and diversified fixed interest assets of 19% compared to policy limits of 25%-75%. This doesn't affect our view of the council's very strong financial management because the council is holding more cash than normal as it waits for better investment opportunities to present themselves. These cash holdings have earned about 5% return so far this year.

Councilors are mostly independent, and vote in accordance with the issue rather than in a voting bloc. Further supporting Taupo's financial management is an experienced management team that includes individuals with relevant expertise and qualifications.

Above-Average Capability To Generate Revenue From Asset Sales Supports Very Strong Budgetary Flexibility

We consider Taupo's budgetary flexibility to be very strong. Modifiable revenues are about 90% of operating revenues (after Standard & Poor's adjustments) from 2013-2017, and capital expenditure averages about 24% of total expenditure of this period.

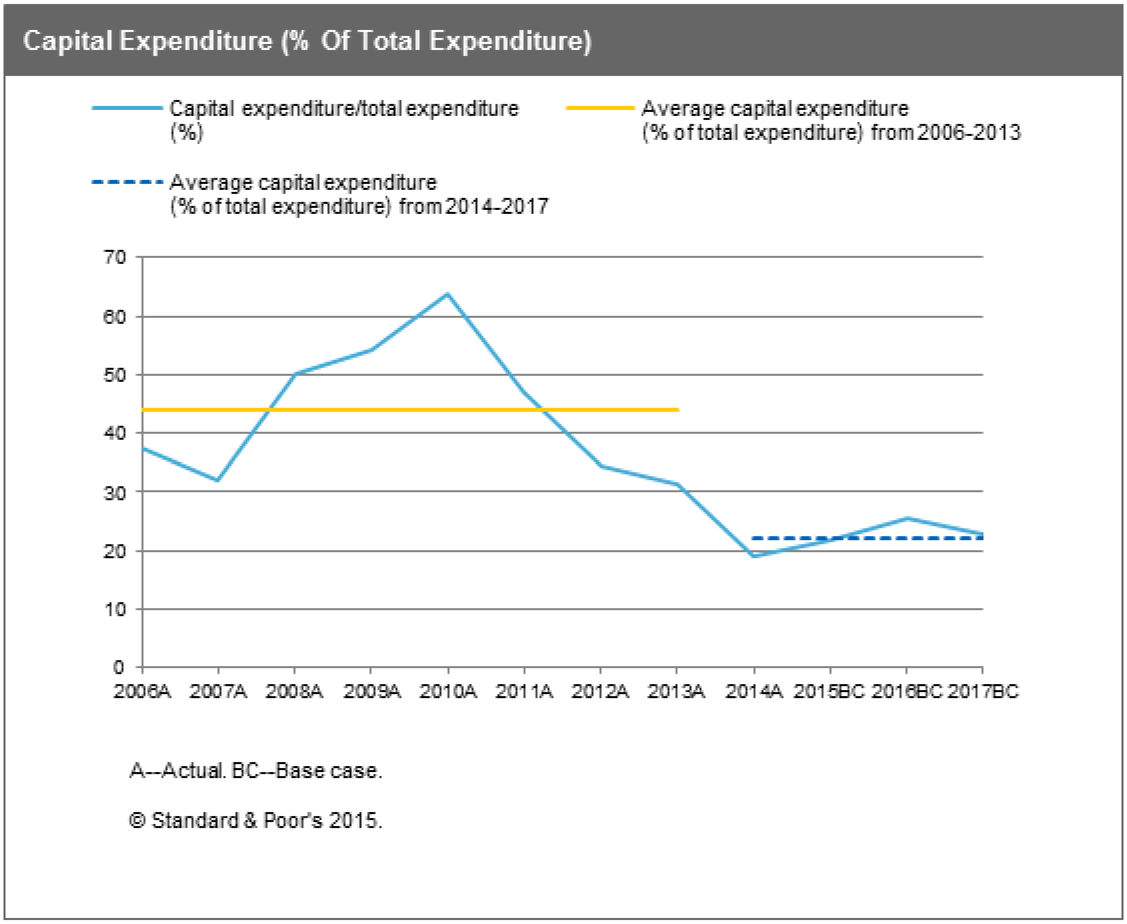
Taupo's budgetary flexibility is supported by its above-average capability to generate revenues from asset sales. Taupo's TEL investment fund has about NZ$54 million of assets with the majority invested in cash. At April 30, 2015, the fund was 72% invested in cash, 19% invested in diversified fixed interest, and 6% invested in equities. The council will reduce its cash holdings once better investment opportunities present themselves. The TEL investment fund provides regular income to the council and subsidized rates. Income from the TEL investment fund will contribute more than 5% of operating revenues in each of the next three years, and will eventually help the council pay for community projects. Council policy is to continue investing these funds over the medium-to-long term, which should provide Taupo with a long-term revenue stream. In 2003, the council repaid NZ$10 million of debt with the TEL investment fund assets.

In addition, the council also has a large residential and commercial land bank that could be sold if required to raise funds such as surplus land from the East Taupo Arterial (ETA) project.

There are no restrictions on the ability of Taupo to increase rates, other than a political imperative to keep increases low. As part of the legislative requirements, Taupo set a target for rate increases in its 2015-2025 LTP at between 2%-3% which, on average, may be less than the forecast local government cost index. This is not a hard cap, in our view, and when taking into consideration Taupo's very strong budgetary performance and large investment fund, it is unlikely to change our opinion of the council's budgetary flexibility. Taupo is implementing lower rate increases than in the past because of efficiency improvements within the council over the past several years.

Taupo's capital expenditure of 24% of total expenditure from 2013-2017 is lower than in the past, where it averaged 44% between 2006 and 2013 due to its previous capital-expenditure program (see chart 1). We forecast Taupo's capital expenditure to average 22% of total expenditure from 2014-2017 as the council consolidates its financial position and has no new significant capital projects due to commence in the next three years. Taupo plans to spend 50% of its capital expenditure for new projects and has largely upgraded its infrastructure--factors which provide the council with ample room to delay or postpone expenditure if needed. This supports Taupo's very strong budgetary flexibility, in our view.

Chart 1



Falling Capital Expenditure Requirements Driving Very Strong Budgetary Performance

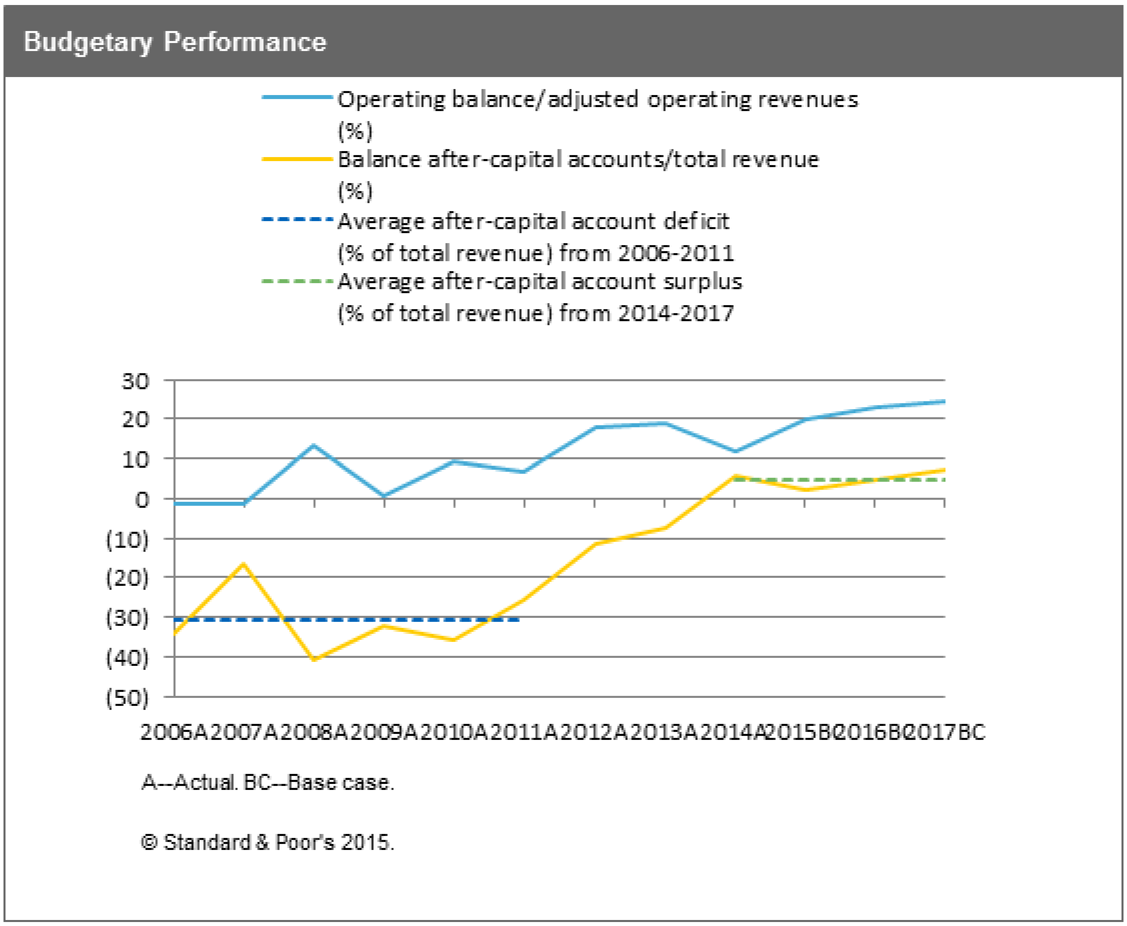
We consider Taupo's budgetary performance to be very strong. We forecast cash operating surpluses to average 19.5% of operating revenues (after Standard & Poor's adjustments) between 2013 and 2017, and after-capital surpluses of 2.5% of total revenues over the same period.

Taupo's budgetary performance has improved significantly over the past few years as the council consolidates its financial position after a period of weak operating surpluses and large infrastructure spending, including upgrades to wastewater treatment plants, water supply facilities, and the construction of the ETA. These projects occurred between 2008 and 2011 and significantly increased its debt. Taupo's operating surpluses averaged 4.6% of operating revenues from 2006-2011 and its after-capital account deficits averaged more than 31% of total revenues.

In 2012, operating surpluses improved to about 18% of operating revenues and we forecast them to average 22% from 2014-2017 as income growth outpaces expenditure growth. Revenues from rates and user charges have grown by about 50% from 2009-2014, while the council has managed to restrict growth in payments to suppliers and employees to just 7% over this period. Growing interest expenses offset some of this small increase in payments to suppliers and employees. Taupo's operating balance fell temporarily in 2014 when it paid an expense that had been incurred over a number of years. This is reflected in the council's lower accounts payable.

After-capital account surpluses further support the council's very strong budgetary performance. We forecast Taupo to average surpluses of 2.5% of total revenue from 2014-2017. This reflects the council's policy to focus on fiscal consolidation by reducing its capital expenditure (see chart 1 above). Because of its previous infrastructure upgrades and spending, Taupo has no plans or pressing needs for major infrastructure expenditure within the next three years.

Chart 2



Standard & Poor's makes some accounting adjustments to Taupo's finances so that international comparisons can be made. The major adjustments relate to the exclusion of capital grants from both operating revenue and cash flow from operating activities. This adjustment is made because these grants generally are tied to specific capital projects and cannot be used to service debt if required. Developer contributions are considered a key risk to fiscal outcomes being achieved, primarily because of uncertainty as to whether they are received as projected.

The size of future deficits depends on the council's delivery of capital projects (i.e. the longer the delay in delivering capital expenditure, the lower the deficit) as well as the council's future revenue policies.

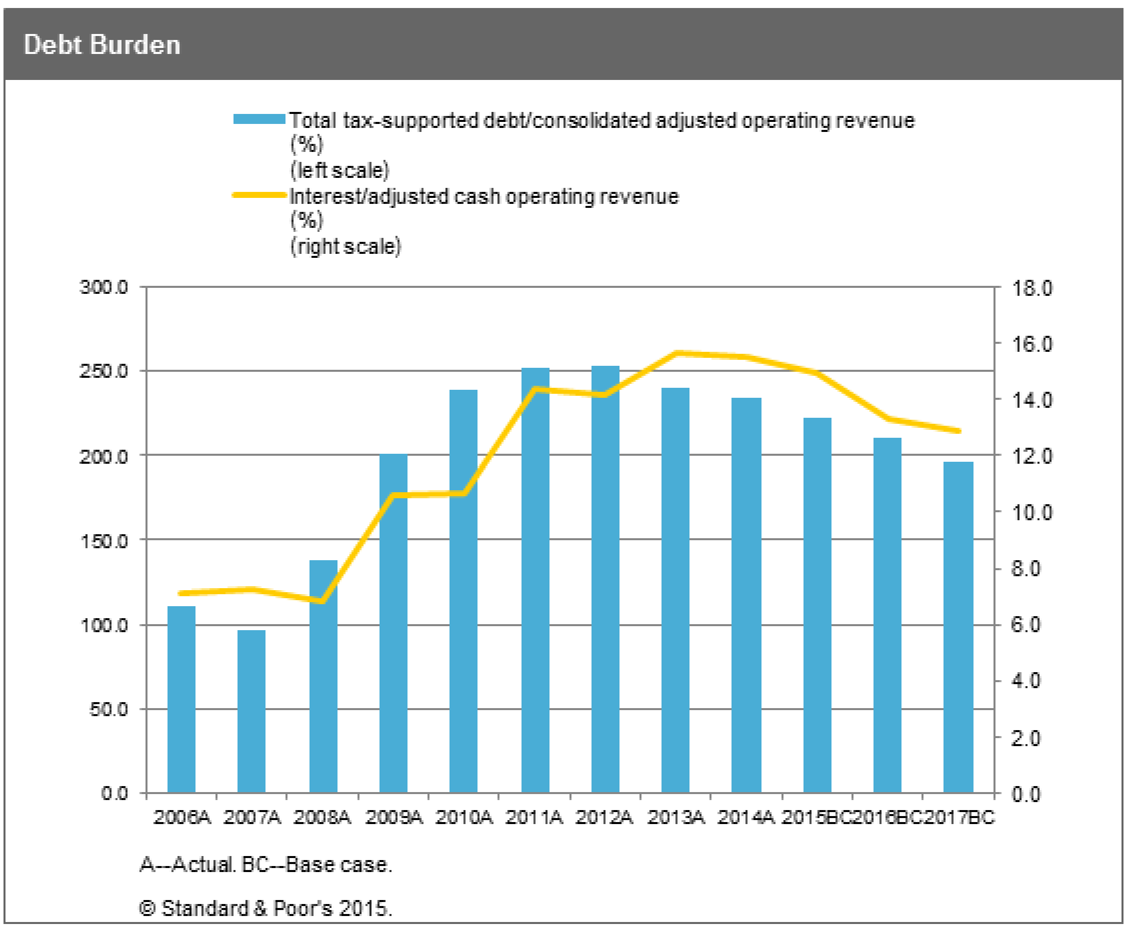
Debt Burden Forecast To Reduce, But Remains Very High Relative To Peers

We consider Taupo's debt burden, while improving, to be very high compared to international peers. We forecast Taupo's total tax-supported debt to fall to less than 200% of adjusted cash operating revenues from its peak of more than 250% in 2012. In our view, Taupo's total tax-supported debt no longer significantly underperforms the benchmark as set out in our criteria.

The council's stronger operating position combined with its small capital-expenditure program is driving after-capital account surpluses. We expect these surpluses to help reduce Taupo's debt levels below NZ$160 million and reduce its debt burden as a percentage of operating revenues. Taupo's previous large capital-expenditure program including upgrades to wastewater treatment plants, water supply facilities, and the ETA contributed to its total-tax supported debt rising to NZ$165 million in 2012 from NZ$45 million in 2006.

Contributing to its very high debt burden score is Taupo's interest expenses of 14.6% of operating revenues from 2014-2017. This remains very high, in our opinion. Interest expenses are expected to fall, reflecting Taupo's lower debt burden and better margins from its participation in the LGFA.

Chart 3



New Zealand's strong institutional framework provides a source of credit strength for Taupo, and allows it to support higher debt burdens than some of its international peers can tolerate.

The council's Treasury Management Policy aims to prevent concentration in its debt-maturity profile. Participation in the LGFA has helped Taupo lengthen the maturity profile of its debt obligations with three separate issuances accounting for about half of Taupo's borrowings. Taupo's debt maturing within the next 12 months includes NZ$28 million of commercial paper.

Table 1

Taupo District Council Debt Maturity Profile

(%)	June 2011	June 2012	June 2013	April 2014*
0-1 year	26.8	54.4	35.6	16.3
1-2 years	56.6	15.3	15.4	0.0
2-5 years	16.6	15.2	30.7	54.2
More than 5 years	0.0	15.2	18.4	29.4
Total	100.0	100.0	100.0	100.0

*Latest available data.

Low Contingent Liabilities

We consider Taupo's contingent liabilities to be low mainly due to a small likelihood of a natural disaster in the region. We consider Taupo's insurance policies, disaster recovery fund, and TEL investment fund provide the council with sufficient flexibility in the event of a natural disaster. Further, the Crown would likely provide extraordinary support to the region in the event of a natural disaster.

The council has a number of other small contingent liabilities, including a guarantee that the council has extended to the LGFA, claims relating to weather tightness building defects, and the potential erosion and flooding of Lake Taupo's foreshore. We do not expect these to be significant.

As part of the arrangements supporting the LGFA, Taupo is party to a joint and several guarantee, which we consider a contingent liability. Given the strength of the institutional framework in New Zealand and the requirement that all debt must be secured over rates, we believe that the likelihood of a default scenario that would trigger the joint and several guarantee is low.

Published Rating Factor Scores

Table 2

Ratings Score Snapshot

Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Average
Financial Management	Very Strong
Budgetary Flexibility	Very Strong

Table 2

Ratings Score Snapshot (cont.)	
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 Statistics

Table 3

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
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

Table 3

Taupo District Council (cont.)					
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.

Key Sovereign Statistics

- Sovereign Risk Indicators, March 31, 2015. Interactive version available at http://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

Ratings Detail (As Of May 27, 2015)		
Taupo District Council		
Issuer Credit Rating		AA/Stable/A-1+
Commercial Paper		
Local Currency		A-1+
Senior Secured		AA
Issuer Credit Ratings History		
25-May-2015	*Foreign Currency*	AA/Stable/A-1+
30-May-2014		AA-/Positive/A-1+
28-Oct-2012		AA-/Stable/A-1+
28-Oct-2012		AA-/Stable/--
25-May-2015	*Local Currency*	AA/Stable/A-1+
30-May-2014		AA-/Positive/A-1+
28-Oct-2012		AA-/Stable/A-1+
28-Oct-2012		--/--/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.