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Institutional Framework Assessment:

New Zealand Councils' Extremely Predictable And Supportive Institutional Settings Are At Risk

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This report does not constitute a rating action.

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Institutional Framework Assessment:

- **Extremely predictable and supportive**
- Very predictable and well-balanced
- Evolving but balanced
- Evolving and unbalanced
- Volatile and unbalanced
- Very volatile and underfunded

Trend:

- Improving
- Stable
- **Weakening**

Major Factors

Key strengths	Key risks
Extremely predictable system with changes flagged well in advance.	Large infrastructure responsibilities increase the sector's borrowings and weigh on the revenue and expenditure balance compared to similar systems.
Highly transparent and accountable system, with strong disclosure and reporting standards.	Uncertainty around the implementation and potential impact of the central government policies such as water reforms.
High operating balances with strong security of rates revenue.	

Rising infrastructure budgets and responsibilities are putting growing pressure on the New Zealand local government sector's finances. The councils' own-sourced revenues and grants from the New Zealand government (Crown) are not rising enough to adequately cover this additional spending. This is widening revenue and expenditure mismatches, as seen with large deficits and rising debt levels compared with similar systems.

We believe these imbalances will persist for longer than we expected. This is because of rising inflation and infrastructure budgets, and given the new National Party-led coalition government's promise to repeal existing water reform legislation by Feb. 23, 2024. These reforms were aimed at removing water-related operating and infrastructure responsibilities from councils.

The new government plans to institute its own version of water reform, dubbed "Local Water Done Well". While specifics around this plan are yet to be publicly disclosed, the Crown has outlined its key principles and indicated that it aims to pass its own legislation by mid-2025. Key principles include the restoration of ownership and control of water assets to councils, and the setting of stricter rules and regulation of water infrastructure for local authorities. The new program could see councils opt for alternative delivery models, such as jointly council-controlled organizations that aim to notionally separate water activities from council finances, but without the complex "co-governance" aspects promoted by Labour. The net effect of the program on the sector will depend on further developments.

Our view of New Zealand's institutional framework is also based on a predictable system with a high level of transparency and accountability.

Trend: Weakening

We have revised the trend for New Zealand's local government institutional framework to weakening from stable. The sector's debt has continued to rise since the start of the pandemic as councils grapple with large infrastructure needs and persistent inflation in operating and capital budgets. Sectorwide deficits and debt levels are much higher than we forecast last year, weighing on our assessment of New Zealand's revenue and expenditure balance.

The final design of the new National Party-led government's reform will be vital to address the rising revenue and expenditure mismatches across the sector. Reforms will also be important to curtail the upward trajectory of the sector's debt levels as a proportion of operating revenues.

In addition, uncertainty is elevated given the shift in political support for key sector reforms, including water reform and the Resource Management Act (RMA). The former government's water legislation was developed after many years of reviews and working groups, and the sudden reversal makes it difficult for councils to prepare their upcoming ten-year long-term plans. Policy uncertainty could weigh on our view of the system's predictability compared to other highly rated systems internationally.

We could revise our assessment of New Zealand's institutional framework to stable if we observed greater policy stability that could narrow the sector's revenue and expenditure mismatches, leading to a sustainable reduction in sectorwide debt. This could occur if proposed local government reforms or upcoming budget planning markedly improves councils' financial positions.

Predictability Of The Framework: Uncertainty Elevated In Areas Of Key Reforms

Major reforms are rare, but may be vital to the sector The New Zealand local government system is mature, governed by legislation that is predictable and supportive of local councils across the country. It is also reflective of the historically stable policy environment in New Zealand. Reforms and policy changes usually evolve over long timeframes and undergo rigorous consultation and development processes to ensure their suitability.

However, the recent change in central government has created uncertainty with delays in key water reforms. The new government has pledged to repeal these reforms by Feb. 23, 2024, and to restore control of water assets to councils before implementing its own version, Local Water Done Well, at some point in the future.

Between 2020 and 2023, the former government passed a suite of bills to enact major water reforms. The legislation created a new water regulatory framework and new water service entities (aggregated utilities), which were due to take control and operation of councils' water assets between July 1, 2024 and July 1, 2026.

The former government's water reforms were flagged well in advance and involved substantial consultation and development. In 2016, the Crown evaluated making local governments more flexible by allowing them to share services and costs across jurisdictions. The following year, the Crown established the Three Waters Review to develop recommendations for systemwide performance improvements for water services. The review recommended the establishment of aggregated water utilities, separate from local government, that would take some of the funding pressure off local government.

The RMA, a national strategy governing how land and natural resources are used, had undergone several changes under the former government following an independent review. The new central government, however, recently repealed these changes.

In June 2023, the former government handed down the Future for Local Government report. The report, which was in development for two years, examined the suitability of the local government system to emerging challenges, especially given that no major reforms have taken place since 1989. The new government did not address the recommendations prior to the October 2023 elections, and it is unclear if any of the suggested changes will be implemented.

The Crown has launched several rounds of minor reforms since 2012. The objectives of these reforms, such as improving financial accountability and long-term planning, and the way they were introduced have reinforced our view of New Zealand's extremely predictable and supportive institutional framework.

New Zealand local councils have limited ability to influence Crown policy New Zealand local governments are established under the Crown's Local Government Act, and not the constitution, like some of its international peers. This means the sector has less ability to withstand unwanted changes than many of its peers.

Local governments have some power to soften the negative consequences of reform but can't prevent them. Councils can individually and through Local Government New Zealand, an advocacy group, impact the debate surrounding changes. The Crown regularly consults with the association and individual local governments, but local governments have no power to reject reforms or demand additional funding to cover new mandates.

The water reform process demonstrated local councils' ability to influence Crown policy. Key principles of the new government's Local Water Done Well model appear to be driven by suggestions from many local authorities, including criticisms raised by many councils around the former government's legislation. These include issues such as water quality and regulation, ownership and control of water assets, co-governance of water services, and the implementation timeline. The Local Water Done Well model could restore more control to local governments, potentially allowing councils and ratepayers to adopt their own model to manage water assets.

In contrast, the former government pushed ahead with controversial elements of its water reforms such as co-governance despite strong council opposition. Most of the opposition to Affordable Waters reform related to ideological differences, rather than to the significant debt relief that the reforms could have provided.

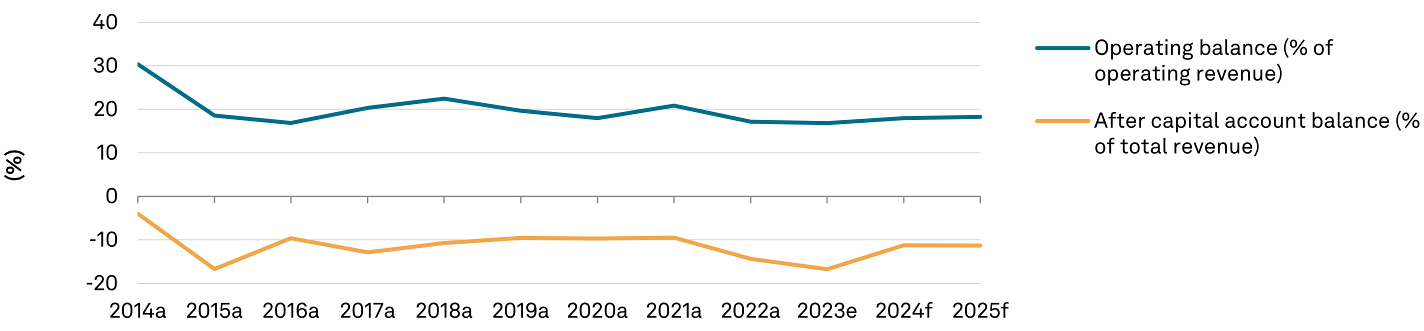
Revenue/Expenditure Balance: Revenue Growth May Not Adequately Fund Rising Infrastructure Spending

Strong revenue growth but not enough to cover rising expenditure needs The New Zealand central and local government appears to be a unwilling to address the growing imbalance between revenue growth and rising expenditure for the local government sector. Despite local governments having strong revenue and expenditure autonomy, they have much larger deficits and higher debt than we forecast.

Many councils are reluctant to substantially raise general property rates more than inflation to fund rising expenditure. This is despite rates being set by individual local governments and not being limited by Crown policies. Large rate increases in recent years have been cannibalized by high inflation, and rising interest expenses and infrastructure spending. Because of this, deficits have widened across the sector. We estimate the after-capital account deficit across the sector grew to be 16% of total revenues in 2023, and total debt rose to 184% of operating revenues.

Chart 1

Operating balance remains strong, after-capital account very weak



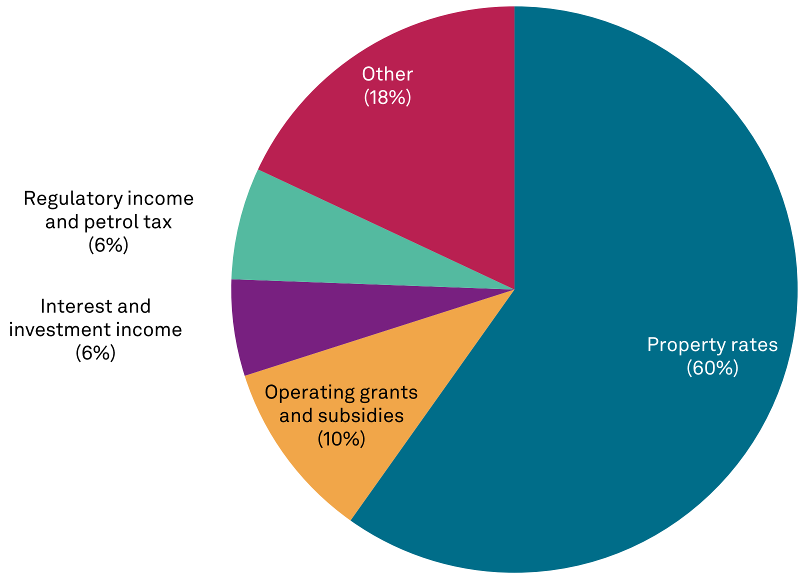
New Zealand fiscal year ends June 30. a--Actual. e--Estimate. f--Forecast. Source: S&P Global Ratings.

The New Zealand Productivity Commission estimates that local government property rates are roughly the same proportion of GDP today as they were more than 100 years ago. In contrast, the Crown's taxation has more than tripled over this period. Many councils prefer to accumulate debt to fund most of their infrastructure rather than fund it via cash flows, and they have limited ability to raise revenues outside of property rates.

Chart 2

Property rates make up the majority of revenue

Operating revenue breakdown of New Zealand councils for fiscal year 2022

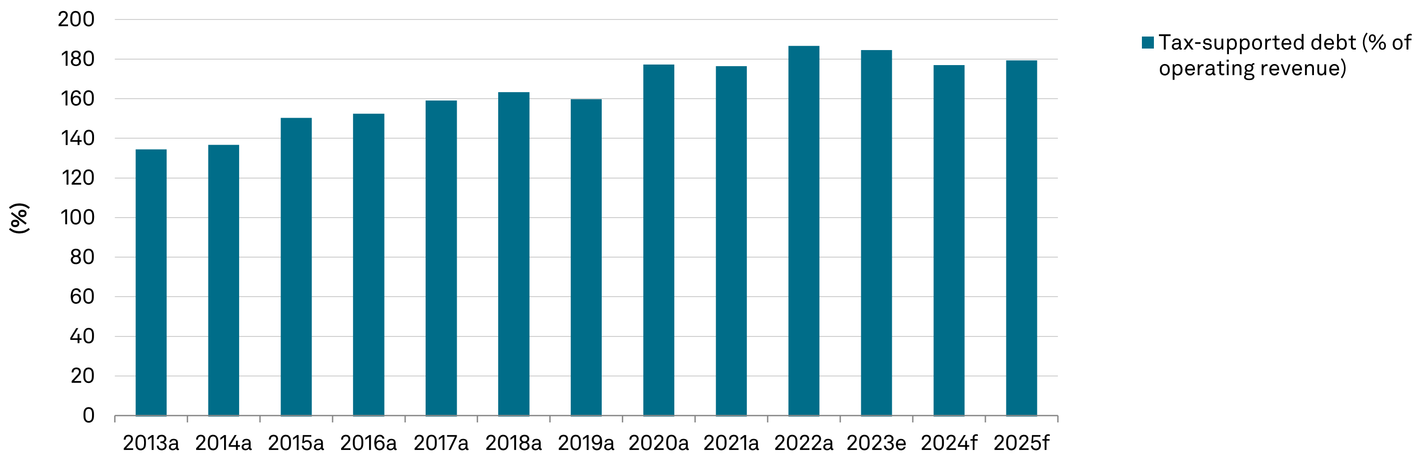


New Zealand fiscal year ends June 30. Sources: Stats NZ local authority financial statistics, fiscal 2022.

The debt of New Zealand councils is very high on a global scale and is rising more than our previous expectations. The size of the debt stock reflects the large infrastructure component of the responsibilities of these governments and the timing of capital expenditure, rather than an operating revenue and expenditure mismatch.

Chart 3

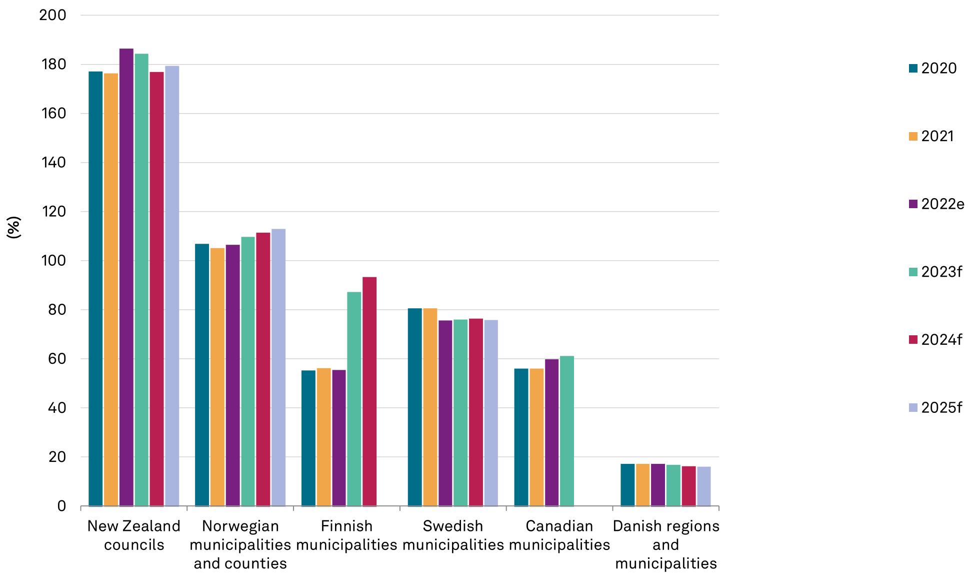
Sectorwide debt is very high



New Zealand fiscal year ends June 30. a--Actual. e--Estimate. f--Forecast. Source: S&P Global Ratings.

Chart 4

Debt of New Zealand councils is very high
Ratio of gross debt to operating revenue, selected jurisdictions



Figures based on our most recent reviews of institutional framework assessments over 2021-2023. f--Forecast. Source: S&P Global Ratings.

The Crown has steadily withdrawn financial assistance to local councils while increasing the sector's responsibilities. Local governments are responsible for a substantial proportion of infrastructure in New Zealand, such as road development and transportation and water infrastructure. Increased investment in water assets by local councils is a result of higher water standards imposed by the Crown, as well as emerging evidence of a nationwide infrastructure deficit due to historic underinvestment in renewals.

In addition, changes to national standards around earthquake strengthening and environmental protection have lifted investment too. These higher standards typically do not come with any new transfers or funding tools, which forces councils to rely even more on unpopular rate hikes to generate revenue. Other drivers of infrastructure spending growth include increasing community expectations, strong population growth, and reconstruction costs following recent natural disasters in areas such as Nelson, Marlborough, and Hawke's Bay. We also see some evidence of questionable project selection, with some councils prioritizing new sports and community facilities ahead of renewing less visible but critical underground water infrastructure.

The Crown provides partial capital funding for large infrastructure projects and ongoing grants for road renewal and maintenance. This amounts to about 5% of total revenues for the council sector, while general financial assistance, including for road maintenance, accounts for about 15-18% of the sector's operating revenue.

Local governments have extraordinarily strong rate-collection abilities because they can recover unpaid rates ahead of residents' mortgages (i.e., local governments outrank banks and finance companies) and can seek court approval to sell properties to claim unpaid rates. These are key strengths underpinning New Zealand local councils' creditworthiness.

There is no system of fiscal equalization in New Zealand.

Fiscal policy framework focuses on operating outcomes The fiscal policy framework in New Zealand supports the sector's operating revenue and expenditure match by requiring local governments to balance their budgets on an accrual basis and ensure that debt is not used to fund operating expenditure or financial investments (termed the "golden rule" of fiscal policy). The framework limits debt to capital investments and requires depreciation of capital to be expensed in the accrual financial statements. However, the system, doesn't limit overall deficits or indebtedness of the sector.

The Crown requires a local government to provide a sound rationale if the council is forecasting an accrual operating deficit. Despite this, some local governments have signaled that they will run small accrual operating deficits. We expect almost all rated local governments to deliver strong operating surpluses on a cash basis.

Debt limits and liquidity covenants apply to local governments borrowing from the New Zealand Local Government Funding Agency (LGFA). The debt covenants are relatively relaxed, in our view, and were loosened in 2020 to give councils even more debt headroom to respond to the pandemic. As of December 2023, LGFA membership totals 77 of the sector's 78 local governments and the funding agency accounts for 90% of New Zealand local government sector debt. Auckland Council--the largest and most sophisticated local government--is the only council allowed to borrow in foreign currency. This limits the sector's exposure to foreign currency risks. No local government can use derivatives for speculative purposes. Further, councils must disclose liquidity targets and their interest rate exposure.

Local governments' financial policies and targets are outlined in their long-term plans. All local governments have internal debt limits that are published in the long-term plans, annual plans, and annual reports that are audited by Audit New Zealand to ensure financial sustainability.

We expect the Crown to intervene before situations become critical In our view, Crown support would be forthcoming to a local council long before a default scenario materializes. This is as a result of the Crown's close oversight of local governments, the system's transparency, and the mechanisms available to the Crown to intervene in a local council's operations.

There is no explicit guarantee for New Zealand's local governments and no history of extraordinary support provided to a local government in distress. There has been no known local government default in New Zealand. The Crown has set out several ways that it could intervene in the operation of local governments to prevent them from being close to default. It has the power to call an election and dismiss a local government based on the local government's inability to properly govern, poor financial management, or corruption. Other measures include requesting information from a local government, as well as appointing a Crown review team, a Crown observer, a Crown manager, or a commission.

The Crown has shown that it is willing to use these powers when needed. It has intervened in several local councils in recent years, such as:

- Appointing a commission to act in place of elected representatives at Tauranga City Council in February 2021. This followed an independent review which identified significant governance problems and infrastructure and funding challenges. Crown commissioners will oversee the development of the council's 2024-2034 long term plan before the return of elected officials.

Local government elections are scheduled in Tauranga for July 2024.

- Appointing a Crown observer to Christchurch City Council in January 2012 to assist the council after several major earthquakes. It also appointed a Crown manager in July 2013 to ensure the council regained its building consent accreditation, which was withdrawn by International Accreditation New Zealand (the council regained accreditation in 2015).
- Appointing commissioners to Kaipara District Council in August 2012 to replace elected councilors and appointing a Crown manager in 2016 and 2017 after a range of legal issues.
- Replacing councilors from Environment Canterbury, a regional council, with commissioners in May 2010.

Another example is the Crown's cost-sharing arrangements for natural disasters, such as the repair and replacement of Christchurch City Council's essential infrastructure after several severe earthquakes. The Crown pledged to fund 60% of the rebuild cost. The Crown offered a NZ$275 million emergency financial support package to councils affected by Cyclone Gabrielle in May 2023, covering a considerable proportion of emergency costs for affected councils. In addition, longer-term cost sharing deals will need to be negotiated with the hardest-hit councils to fund restoration costs. For example, Marlborough District Council secured funding from the Crown for 95% to help repair its storm-damaged roads after two heavy rain events in July 2021 and August 2022.

The Crown and individual councils each fund 25% of the repair cost of properties that suffer from "weathertightness" issues or building moisture damage. We also expect that the Crown could provide support to the LGFA, which raises debt on behalf of local councils, through, for example, its NZ$1.5 billion committed liquidity facility with the New Zealand Debt Management office.

Transparency And Accountability: Strong Oversight And Disclosure Requirements

The New Zealand local government system is highly transparent when compared with international peers Governing laws set out in the Local Government Act 2002 impose comprehensive requirements for public consultation and financial planning and reporting. There is also a clear separation between the responsibilities and roles of elected officials and their administration.

Strict financial and nonfinancial reporting requirements enhance the transparency and accountability of New Zealand local governments. The requirements include public reporting of audited consolidated accounts, in accrual and cash terms, within specified time limits. Crown reforms have increased disclosure and transparency by introducing funding impact statements and disclosure of risk-management strategies.

The Local Government Act requires local governments to develop long-term plans that span 10 years and are updated every three years. Long-term plans supplement the annual planning process with which they are integrated and reflect longer-term asset-management intentions. The system also requires local governments to consult the public on these documents and annual plans. All local governments also must develop and publish 30-year infrastructure strategies to identify future infrastructure needs and identify options, including asset management plans, to address them. These extensive plans, even for the smallest local governments, are an indication of the sector's long-term capital planning and budgeting capabilities.

Policy uncertainty has caused reporting delays. The Crown government has announced an extension to the June 30, 2024, statutory deadline for the adoption of upcoming long-term plans. This followed a direction for all councils to include water activities in all future budgets. However, current legislation requires local governments to remove all water-related activities from financial statements starting from the 2026 fiscal year. We expect the Crown to repeal this legislation by Feb. 23, 2024. Nevertheless, this has caused a period of heightened uncertainty for councils.

The ongoing shortage of auditors has affected many organizations' ability to prepare audited financial statements. Consequently, legislation was passed in 2020 extending statutory reporting timeframes by two months for Crown entities, local authorities, and council-controlled organizations with June 30 balance dates. Auditor shortages, challenging immigration settings, staff turnover, and higher sick leave (in audit firms and in public organizations related to COVID-19) led to 35 councils adopting 2022 annual reports more than four months after of the end of fiscal year, breaching the statutory deadline. We anticipate the timing of reporting will improve as councils are increasingly permitted to access the private sector for audit opinions and as staff shortages ease.

As part of the amended Local Government Act, local governments are required to prepare pre-election reports. The reports, which provide information about the issues a local government faces, promote public discussion and help voters make more informed choices. The reports provide details on a local government's financial performance for the three years before the election; financial plans and projects for the next three years; and statements comparing rates, rate increases, borrowing, and returns on investments, with the limits and targets set in the financial strategy.

Local governments also publish financial prudence benchmarking in their annual reports. This shows a local government's financial performance in relation to various benchmarks to assess whether it is prudently managing its revenues, expenses, assets, liabilities, and general financial dealings. The benchmarks compare actual performance to budgets, including a local government's performance against self-imposed financial ratios that are flagged in long-term plans and annual plans.

High level of disclosure, with councils adhering to international accounting standards The minimum level of disclosure in the New Zealand local government sector is high by international comparison. Local governments' financial statements, on accrual and cash formats; long-term plans, including treasury and liability management policies; 30-year infrastructure plans; and annual plans are all publicly disclosed and must meet detailed requirements as set out in legislation. Monthly or quarterly reports are also available via local government websites, as are the agenda and minutes of most local government meetings.

Standardized audit procedures provide for reliable information. Long-term plans are audited by Audit New Zealand, a business unit of the Crown, or its appointed agents. Annual plans are published before the start of the fiscal year, and any changes to annual plans are also reviewed by Audit New Zealand and publicly disclosed. Audits are done according to the Auditor General's Auditing Standards, which incorporate New Zealand's public benefit entity accounting standards.

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019

Related Research

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., Dec. 16, 2023
- New Zealand Local Government Outlook 2024: Bridge Over Troubled Waters, Nov. 20, 2023
- New Zealand 'AA+/A-1+' Foreign Currency Ratings Affirmed; Outlook Stable, Sept. 08, 2023
- New Zealand Local Government Funding Agency, March 2, 2023
- New Zealand Local Government Funding Agency Ltd. Ratings Can Tolerate Higher Council Leverage Limits, May 6, 2020