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Credit FAQ:

New Zealand's Policy Shift To Weaken The Institutional Setting On Local Councils

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This report does not constitute a rating action.

Credit risk for New Zealand's local councils is rising. On Feb. 19, 2024, S&P Global Ratings revised the trend of our New Zealand local council institutional framework to weakening from stable. Sector debt has risen rapidly since the start of the pandemic as councils grapple with large infrastructure needs and persistent inflation in operating and capital budgets.

On Feb. 19, 2024, we revised the outlooks on our long-term ratings on 15 New Zealand local councils and two council-controlled organizations to negative from stable to reflect this risk (see "New Zealand Councils' Extremely Predictable And Supportive Institutional Settings Are At Risk," Feb. 18, 2024.

Frequently Asked Questions

Why did we take this action and what's changed this year?

Rising infrastructure budgets and responsibilities are exerting pressure on the finances of New Zealand's local governments. Revenues and central government (Crown) grants are not rising enough to cover this additional spending. This is leading to widening revenue and expenditure mismatches, as seen in large deficits and rising debt compared with similar systems. If the trend continues, we could assess that the institutional framework for local councils in New Zealand has weakened.

We now forecast much higher sector deficits and debt than we previously expected. This weighs on our assessment of New Zealand's revenue and expenditure balance. The local government sector's after capital account deficit reached 16% of total revenues in fiscal 2023. The deficit may remain at more than 10% over the next two years, versus our previous estimation that it could narrow to half the amount.

Meanwhile, gross total tax-supported debt was 184% of operating revenues in 2023, up from less than 160% in 2019. Gross debt was steady at 150%-160% from 2015 to 2019.

Furthermore, the final timing and structure of Crown water reforms and the impact on local government finances remain uncertain after more than five years. A new National Party-led government, elected in October 2023, promised to repeal existing legislation by Feb. 23, 2024. It also plans to legislate its version of reforms--Local Water Done Well--by mid-2025. The former Labour government passed its final water reform legislation prior to the election. Labour's reforms, if implemented, could have alleviated a significant portion of sector debt.

The final design of Local Water Done Well will be vital for addressing the rising revenue and expenditure mismatches in the sector. Reforms may also be important for curtailing sector debt as a proportion of operating revenues.

Were all local councils affected by the change in the institutional framework trend?

No. We revised the outlooks on our long-term ratings on 15 councils to negative from stable. We affirmed our ratings on another four councils with stable outlooks. Our ratings on the remaining six councils in our rated portfolio were already under pressure and retain negative outlooks.

Why did we revise the rating outlooks on some councils to negative?

The outlook revisions suggest we are likely lower the ratings on these entities if we were to form a view that the institutional framework has weakened. These 15 councils have limited headroom within the current ratings to accommodate a weakening of the institutional settings or other credit metrics.

Why did we keep the rating outlooks on some councils stable while revising others to negative?

We decided that four councils still have enough headroom within the current ratings to accommodate a potential weakening in the institutional framework. This could be, for example:

- If the councils' individual credit profiles are at the stronger end of the current rating categories; and
- If there are other countervailing improvements that potentially offset the weakening institutional framework, such as improving economic prospects and diversification, or improving fiscal outcomes with smaller deficits and declining debt and interest costs.

Our rating on Auckland Council, for example, is unaffected by today's announcement. Auckland's individual credit profile is at the stronger end of an 'AA' rating. We forecast its after capital account deficit will narrow and be smaller than the sector average over the next two years.

Furthermore, Auckland's total tax-supported debt could continue to drop compared with operating revenues. The council's interest expenses also sit just above a key threshold in our methodology. If interest expenses relative to operating expenses decline slightly, our view on the council's debt burden could improve. Because of these factors, we believe the council has sufficient headroom at the current rating.

Did we consider last week's Local Water Done Well announcement in our latest rating decision?

The rating actions are not the result of the Crown's Feb. 12, 2024 announcement. The Crown outlined its plan to repeal the water reform legislation of the former government and introduce its own reforms. Pressure has been building on local governments for a few years and we believed the previous Affordable Water reforms may have addressed the sector's growing revenue and expenditure mismatches. In saying this, policy uncertainty is elevated until there is a clear way forward.

Would successful implementation of Local Water Done Well support the sector and institutional framework?

The new Crown government will repeal the previous government's Affordable Water reforms by Feb. 23, 2024. It will eventually replace these with Local Water Done Well. At the time of writing, the repeal bill had already passed New Zealand’s parliament and will soon be signed into law.

There is little information on how Local Water Done Well will operate or the timeline for its implementation. We only know that the Crown expects to pass relevant legislation by mid-2025. Implementation could drag the process on for another couple of years, given the complexity of the issue and the public consultation processes. During this period, fiscal conditions for the local councils could continue to deteriorate, and policy uncertainty may continue. This would increase credit risks.

Recent announcements on Local Water Done Well signal that councils may have to devise plans to meet the new, stricter, water standards, under the supervision of a new water infrastructure regulator. The councils would also have the option to form regional council-controlled organizations (CCOs) for water delivery. These CCOs would presumably differ from Labour's proposed water services entities. They could be voluntary and more tightly controlled by councils because of the removal of the co-governance requirement with local mana whenua.

As we previously highlighted, we would likely view a CCO (with either a high degree of political control or concentrated ownership, alongside a high level of indebtedness) as part of its parent council's tax-supported debt or at least a contingent liability of the council (see "New Zealand Local Government Outlook 2024: Bridge Over Troubled Waters," published Nov. 19, 2023).

Additionally, we see heightened policy uncertainty for the local councils. For instance, the Crown has extended the statutory deadlines for 2024-2034 long-term plans, given the upcoming repeal of water legislation. If policy uncertainty continues, even if Local Water Done Well is implemented, the institutional framework may face downward pressure. Unlike some peers, central government legislation and not a constitution governs New Zealand's local councils. This means the sector is less able than peers to influence structural changes.

What would cause us to revise downward our institutional framework assessment (IFA)?

We could revise downward our IFA for New Zealand's local councils if there is no material improvement in the revenue and expenditure balance of the sector, such as a substantial reduction in after capital account deficits and a structural lowering of tax-supported debt to operating revenues.

Additionally, we could revise downward our IFA if policy uncertainty continues, particularly in areas with large effects on the sector's financial outcomes, such as water reforms.

What would cause us to revise the IFA trend assessment to stable and how would this affect the ratings on local councils?

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

Revising the trend of the institutional framework back to stable could result in our revision of the outlooks on the affected councils to stable, all else being constant. This is if there is no underlying weakening of the individual credit profiles of the councils.

Does this mean New Zealand's local councils won't be highly rated anymore?

New Zealand's local councils remain highly rated. We have not lowered the ratings on any local council today. We have flagged a potential weakening in ratings and revised several outlooks to negative. Even if we revised downward the institutional framework and lowered the ratings, New Zealand councils remain highly rated in a global context at between "AA" and "A" categories.

What is the effect of today's actions on the sovereign rating on New Zealand and the rating on the New Zealand Local Government Funding Agency Ltd. (LGFA)?

There is no direct bearing on either rating.

Our assessment of the sovereign's fiscal performance and debt burden looks at the general government sector (i.e., it consolidates the central and local governments). In theory, a further widening of local government deficits and debt could weigh on this assessment.

However, the local government sector in New Zealand is a small component of the general government. It accounts for just 11% of gross general government debt on our measures. As such, activity at the central government level will continue to drive sovereign fiscal metrics.

We also assess that a slight weakening in the average credit quality of the local councils--say, a one-notch drop--would be unlikely to affect the rating on LGFA. There are at least two avenues through which local government credit quality affects the LGFA:

- It affects the quality of LGFA's loan book. However, generally improving loan book quality over the past decade counterbalances the negative rating actions announced today. The councils still have very strong capacity to service their debt obligations to LGFA, in our view.
- It affects the average credit quality of the councils that are parties to the joint and several guarantee over the LGFA's obligations. This guarantee has expanded to 72 guarantors and remains a key rating strength for the LGFA.

If the ratings on local councils fall, those councils may pay higher credit margins to the LGFA under current arrangements. This could slightly boost the profitability of the LGFA.

Related Research

- New Zealand Councils' Extremely Predictable And Supportive Institutional Settings Are At Risk, Feb. 18, 2024
- Various Rating Actions Taken On New Zealand Local Councils On Weakening Institutional Framework Trend, Feb. 18, 2024
- New Zealand Local Government Outlook 2024: Bridge Over Troubled Waters, Nov. 19, 2023

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