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Ratings

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Research Update:

Tauranga City Council Ratings Lowered To 'A+/A-1' On Weaker Financial Management; Outlook Stable

January 14, 2021

Overview

- Tauranga City Council's (Tauranga) financial management has weakened, in our view. Political and governance issues have beset the council recently and have resulted in the central government (the Crown) deciding to appoint commissioners in February 2021.
- Tauranga's large capital program and lower-than-previously budgeted rate increases will lead to very large deficits and rising debt levels. This partially reflects the council's response to the COVID-19 pandemic.
- We are lowering our issuer credit ratings on Tauranga to 'A+/A-1' from 'AA-/A-1+'.
- The outlook is stable. Though Tauranga's budgetary performance will remain weak, we expect the crown commissioners to stabilize the council's credit metrics.

PRIMARY CREDIT ANALYST

Anthony Walker
Melbourne
+ 61 3 9631 2019
anthony.walker
@spglobal.com

SECONDARY CONTACT

Jin Zhang
Melbourne
+ 61 3 9631 2041
jin.zhang
@spglobal.com

Rating Action

On Jan. 15, 2021, S&P Global Ratings lowered its long-term local and foreign currency issuer credit rating on Tauranga City Council to 'A+' from 'AA-'. At the same time, we lowered our short-term rating to 'A-1' from 'A-1+' on the New Zealand council. The outlook is stable.

Outlook

The stable outlook incorporates our expectations that commissioners will be appointed until at least October 2022, and that the council's budgetary performance will remain weak over the next few years given its large infrastructure requirements.

Downside scenario

We could lower our ratings if budgetary performance underperforms our expectations. This could occur if after-capital account deficits remain very large over a prolonged period resulting in debt rising more than in our forecasts.

Alternatively, we could lower the ratings if liquidity coverage weakens, as indicated by a lower debt service coverage ratio.

Upside scenario

We could raise the rating if financial management and governance issues improve or if after-capital account deficits and debt levels become structurally stronger than our forecasts.

Rationale

We have lowered our ratings on Tauranga based on our view that financial management is weaker than in the past due to political and governance issues. These issues recently resulted in the Crown decision to appoint commissioners in February 2021. Commissioners will perform and exercise the council's governance responsibilities, duties, and powers until at least the next local government elections in October 2022.

The council's large capital expenditure program and lower-than-previously budgeted rate increases are resulting in very large deficits and rising debt levels. This partially reflects the council's response to the COVID-19 pandemic.

Tauranga's strong economic profile and New Zealand's excellent institutional settings support our 'A+/A-1' ratings on the council.

Political and governance issues signal weaker financial management; New Zealand's supportive institutional framework and Tauranga's strong economic profile support its creditworthiness

On Dec. 18, 2020, the Crown announced its intention to appoint a commission to Tauranga. The commissioners will be announced in February 2021 and they would take over the governance role of the council's elected members to at least the next triennial local authority elections in October 2022.

This development highlights the political challenges the council was facing, and the financial challenges it continues to face. We believe the council was unable to implement unpopular, but necessary, policies and reforms in a timely manner to adequately address the city's infrastructure needs. We expect financial outcomes will stabilize, if not improve somewhat, under the direction of the commissioners.

The Crown's decision followed an independent review of the council by a review and observer team that identified significant governance problems among the council's elected members and the mayor's resignation on Nov. 20, 2020. This review was initiated in response to the Crown's Department of Internal Affairs request for evidence that the council was taking steps to "restore trust and confidence in its ability to meet the Crown's expectations of a high-performing council."

The institutional framework within which New Zealand councils operate is a key strength supporting Tauranga's credit profile. The framework provides for early intervention by the Crown before issues become detrimental to the long-term viability of a council. The New Zealand local government system promotes a strong management culture, fiscal discipline, and high levels of financial disclosure among local councils. In addition, the framework is supportive of councils' rate-collection abilities. This system allows Tauranga to support higher debt levels than some of its international peers can tolerate at the current rating.

In recent years, the council faced several financial settlements and cost overruns relating to building defects in projects such as the Bella Vista Homes development, Cayman Apartments, and the Harrington street transport hub carpark. These issues have negatively affected financial outcomes. More recently, the council has taken steps to improve its policies, procedures, training, enforcement, and other aspects of its operations, such as processes around consenting. These changes should prevent similar issues in the future, in our view.

Tauranga prepares a long-term plan every three years and an annual plan each year. This sets an important, but not always followed, baseline for the council's operating and capital expenditure requirements as well as its funding strategy. The council adopted its 2020-2021 annual plan in July 2020. After taking into account COIVD-19's effect on communities, the council agreed to a 4.7% average overall rates increase, which is lower than the 12.6% proposed in its draft 2020-2021 annual plan.

Like other New Zealand regions, the city's economic performance deteriorated due to COVID-19. Tauranga, however, is not highly exposed to international tourism and education, which are heavily affected by border closures.

Tauranga is New Zealand's fifth-largest city, with a population of 146,200. It was one of the country's fastest growing cities before the COVID-19 pandemic, supported by population growth, construction, and the region's horticulture sector. According to Ministry for Business, Innovation and Employment, GDP per capita in Tauranga for the year to March 2019 was NZ$62,217, slightly higher than the national average of NZ$61,712.

The growing population has been one of the key drivers of the city's strong economic growth in recent years, with an increasing number of retirees moving to the region. A total of 20.4% of Tauranga's population is older than 65, compared with a national average of 15.3%. While the Crown government is responsible for most costs associated with retirees, such as pension and health, Tauranga's aging population could negatively influence the council's rate-setting decisions and weaken its financial profile.

Substantial capital investment and slower revenue growth leading to weak budgetary performance and high debt levels; liquidity is adequate

Tauranga's budgetary performance is weaker than most domestic peers. We expect the council to incur very large after-capital-account deficits during 2019 to 2023, averaging about 25.5% of total revenue per year. If deficits remain close to these levels with little improvement, then downward pressure on the ratings would intensify.

We forecast deficits to narrow to less than 20% of total revenues after peaking at 40% of total revenue in 2021. Tauranga should benefit from central government capital grants for the Te Papa "shovel-ready" project, totaling NZ$45 million during 2021-2024, and for the Three Waters Reform Programme, totaling NZ$14.9 million during 2021-2022. In addition, the expected sale of Elder Housing in 2022 could generate NZ$24 million for the council, supporting its financial outcomes.

These higher than previously expected deficits reflect the council's decision to ramp up its capital spending and implement lower than previously budgeted rate increases, while revenues are being hit by the COVID-19 pandemic. We forecast revenues to be about NZ$42 million lower in 2021 than outlined in the 2018-2028 long-term plan. Larger deficits also reflect sizeable legal settlements related to multiple building defects that have occurred in recent years.

Higher capital expenditure will be allocated to roading projects, parks and recreation projects, three waters infrastructure such as the Waiari Water Treatment Plant and the Te Maunga

Wastewater Treatment Plant, as well as the shovel-ready Te Papa Spatial Plan and integrated landuse and multimodal movement strategy package.

The council's after-capital-account deficits averaged 24% of total revenue from 2018 to 2020 after a period of financial consolidation. The council had strong budgetary performance during 2013-2017, when it ran after-capital-account surpluses averaging 7% of total revenue a year. Capital expenditure during 2013-2017 averaged NZ$74 million a year, less than 40% of the roughly NZ$206 million that we expect to be spent per year over the next three years.

We expect the council's operating balance will remain strong, averaging 17% of operating revenue over 2019-2023. The ratio dropped to below 15% during 2019 and 2020 as operating expenditure growth outpaced operating revenue increase. This was mainly attributable to higher capital-project-related operating costs as the council delivered a larger capital program than in the past, as well as COVID-19's effect on the council's revenues in 2020. Receipts for fees and charges in 2020 were negatively affected by the pandemic and were about NZ$20 million lower than the council's 2018-2028 long-term plan. The council's decision to pull back its rates increase in 2020 to 3.9% from 7.5% as proposed in the long-term plan also contributed to the weaker operating balance in 2020.

The council's larger capital program and weaker revenue growth are driving debt-to-operating revenues much higher. We expect total tax-supported debt will reach 266% of operating revenues in 2023. Gross debt will reach about NZ$839 million in 2023, up from NZ$550 million in 2020. As of June 30, 2020, all of the council's debt is sourced from the New Zealand Local Government Funding Agency (LGFA) and the central government's Housing Infrastructure Fund.

With debt levels forecast to rise, we expect interest expenses to average about 8% of operating revenues between 2020 and 2022. Interest expenses relative to operating revenues should decline, reflecting a much lower interest-rate environment, but are likely to remain above 5%.

We view Tauranga's contingent liabilities to be limited, reflecting the likelihood of damage from natural disasters, its insurance policies, and litigation. The council is well insured for material damage for above ground assets, excluding roads and pipes, and 40% covered for underground assets, with the remainder covered by the Crown.

The council's liquidity position meanwhile is weaker than that of its peers. Debt service coverage ratio with bank lines stands at 71% over the next 12 months. The council does not currently have any commercial paper on issue. The council's prefunding debt maturities up to 12 months in advance benefits its liquidity coverage.

Supporting the council's liquidity is its access to the LGFA. This provides Tauranga, along with most of its New Zealand peers, with strong access to a well-established source of external liquidity. In our view, the LGFA benefits from an extremely high likelihood of extraordinary central government support, and has helped Tauranga to lengthen its maturity profile and reduce its interest expenses.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Governance factors

Key Statistics

Table 1

Key Statistics

	--Year ended June 30--				
(mil. NZ$)	**2019**	**2020**	**2021bc**	**2022bc**	**2023bc**
Selected Indicators					
Operating revenues	239	252	263	298	315
Operating expenditures	210	217	215	238	248
Operating balance	28	35	48	60	68
Operating balance (% of operating revenues)	11.9	14.0	18.4	20.2	21.5
Capital revenues	88	48	52	93	69
Capital expenditures	206	166	227	206	206
Balance after capital accounts	(90)	(83)	(126)	(53)	(70)
Balance after capital accounts (% of total revenues)	(27.7)	(27.8)	(40.0)	(13.6)	(18.2)
Debt repaid	61	10	54	64	54
Gross borrowings	148	92	197	129	134
Balance after borrowings	(3)	(1)	17	12	10
Tax-supported debt (outstanding at year-end)	469	550	693	759	839
Tax-supported debt (% of consolidated operating revenues)	196.5	218.4	263.4	254.3	266.0
Interest (% of operating revenues)	8.4	8.8	8.3	6.9	7.3
National GDP per capita (single units)	61,317	60,930	60,462	63,761	66,048

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Rating Score Snapshot

Key Rating Factors	
Institutional framework	1
Economy	2
Financial management	3
Budgetary performance	4
Liquidity	3
Debt Burden	5
Stand-alone credit profile	A+

Table 2

Rating Score Snapshot (cont.)

Issuer credit rating	A+

Note: S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

Sovereign Risk Indicators. An interactive version is available at http://www.spratings.com/sri.

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Oct. 29, 2020
- Institutional Framework Assessments For International Local And Regional Governments, Sept. 25, 2020
- COVID-19: Fiscal Response Will Lift Local And Regional Government Borrowing To Record High, June 9, 2020
- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, May 29, 2020
- COVID-19's Effects Will Pressure New Zealand Council Ratings, May 24, 2020
- New Zealand 'AA/A-1+' FC And 'AA+/A-1+' LC Ratings Affirmed; Outlook Positive, May 3, 2020
- COVID-19: Emerging Market Local Governments And Non-Profit Public-Sector Entities Face Rising Financial Strains, April 6, 2020
- Default, Transition, and Recovery: 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019

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

Downgraded

	To	From
Tauranga City Council		
Commercial Paper	A-1	A-1+

Downgraded; CreditWatch/Outlook Action

	To	From
Tauranga City Council		
Issuer Credit Rating	A+/Stable/A-1	AA-/Negative/A-1+