

Research Update:

# Upper Hutt City Council Outlook Revised To Stable On Improving Liquidity; 'A+/A-1' Ratings Affirmed

October 27, 2022

## Overview

- Upper Hutt's internal liquidity has strengthened thanks to a higher balance of cash and cash equivalents. While its debt-service coverage ratio is likely to be volatile, by our measures, we expect the council to manage liquidity prudently.
- Upper Hutt will record very large after-capital-account deficits over the next three years as it ramps up investment in new community facilities and other infrastructure. This will cause its debt burden to rise rapidly.
- The council has reprofiled some capital projects and its infrastructure spending, while elevated compared with peers, will likely be tempered by market capacity constraints.
- We therefore revised our outlook on the long-term ratings on Upper Hutt to stable from negative and affirmed our 'A+/A-1' ratings on the council.

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## Rating Action

On Oct. 28, 2022, S&P Global Ratings revised its outlook on the long-term issuer credit ratings on Upper Hutt City Council, a New Zealand local government, to stable from negative. At the same time, we affirmed our 'A+/A-1' ratings on the council.

## Outlook

The stable outlook reflects our expectation that Upper Hutt will prudently manage its liquidity and debt as it delivers a very large capital expenditure program. Debt will rise sharply but remain within the thresholds for the 'A+' long-term rating.

## Downside scenario

We could lower our ratings on Upper Hutt if its financial management weakens. This might be evidenced by liquidity coverage declining on a structural basis, or a deteriorating operating

balance. We could also lower our ratings if the Crown government's proposed "three waters" reforms adversely affect the council's credit profile.

## **Upside scenario**

We could raise our ratings on Upper Hutt if its budgetary performance turns out materially better than we presently expect. This could ease downward pressure on its liquidity metrics and lower its debt trajectory. This might occur either through changes to the council's own financial strategy or in conjunction with the Crown government's proposed "three waters" reforms.

## **Rationale**

The outlook revision reflects our assessment that Upper Hutt's internal liquidity has strengthened. This is primarily because of a higher balance of cash and cash equivalents and prefunding, though the council's debt-service coverage ratio will be volatile due to a lumpy spending and debt maturity profile.

We expect Upper Hutt to embark on a historically large capital expenditure (capex) program over the next few years to cater for its growing population. Its after-capital-account deficits will consequently be higher than those of most domestic and international peers, and generally exceed 25% of total revenues on average, and its debt burden will rise sharply.

Upper Hutt's strong economy, which benefits from proximity to the nation's wealthy capital city, Wellington, underpins the ratings on the council. Upper Hutt's robust financial management and New Zealand's excellent institutional settings are also supportive factors. We have updated our forecasts through fiscal 2025 (ending June 30, 2025) following the release of the council's fiscal 2023 annual plan and pre-election report.

Our base case excludes potential effects of the Crown government's (New Zealand central government) proposed "three waters" reforms. The reform program, as currently envisaged, could take away responsibility for drinking water, wastewater, and stormwater assets from councils and amalgamate delivery under four new regional water service entities from mid-2024. We expect legislation later in 2022 to provide further clarity on the reforms and implementation.

## **Improving liquidity partly offsets risks associated with spike in capital spending, widening deficits, and escalating debt**

We expect Upper Hutt to post very large after-capital-account deficits, averaging about 40% of total revenues, during the next three years as it embarks on ambitious capital spending. The two largest projects are the NZ\$32 million Maidstone Community Sports Hub redevelopment (of which NZ\$15 million is funded by a "shovel ready" grant from Crown Infrastructure Partners), due for completion by the end of 2023, and the NZ\$51 million H2O Xtream aquatic center upgrade, for which enabling construction works commenced in October 2022. These projects come on top of renewals of core water and other infrastructure.

Industry capacity constraints and shortages of labor and materials mean many New Zealand councils will struggle to deliver on their budgeted capex programs. Our base-case forecasts assume Upper Hutt will execute about 60% of its capital budget in fiscal 2023, with sizable "carryforwards" to be reprofiled into future years.

Delays in the start of the H2O Xtream upgrade and other projects meant the estimated outturn for

fiscal 2022 was considerably stronger than we previously forecast, with a moderate after-capital-account deficit of about 8% of revenue. The council delivered only 32% of its NZ\$85 million capex budget. Meanwhile, a planned NZ\$29 million upgrade of the Civic Centre has been postponed to 2027-2029.

Cash operating surpluses will average around 9% of operating revenues over fiscals 2021-2025. While high in global context, these operating surpluses are at the lower end among rated New Zealand councils. Average property rates are budgeted to increase by a slightly larger-than-usual 5%-6% through fiscal 2027, excluding the effect of growth in the ratepayer base. Like many of its domestic peers, the direct financial effect of COVID-19 restrictions has been marginal for Upper Hutt.

We project the council's debt burden to rise sharply. Tax-supported debt will climb to about 260% of operating revenues by fiscal 2025, roughly double the 126% ratio at the end of fiscal 2021. Interest expenses should remain manageable, averaging about 4.8% of operating revenues over fiscals 2022-2024. Like most of its rated domestic peers, Upper Hutt sources its debt through the New Zealand Local Government Funding Agency (LGFA). Overall, New Zealand's council sector is more highly leveraged than international peers (see "Institutional Framework Assessment: New Zealand Local Governments," published April 28, 2022.)

Contingent liabilities are minimal. Upper Hutt has some exposure to natural disaster risk, with adequate insurance coverage in place. It also has a 12.2% stake in Wellington Water Ltd., a jointly owned company that delivers water services across the Wellington region, which carries no debt.

Upper Hutt's internal liquidity has strengthened, by our measures. This is partly because capex under-delivery results in the council holding a higher level of cash and cash equivalents. Upper Hutt's total free cash position--inclusive of term deposits, and after accounting for budget needs--is sufficient to cover about 121% of debt service during the next 12 months. Debt-servicing needs comprise NZ\$6 million of term debt maturing in April 2023 and around NZ\$3 million of annual interest expenses. The debt-service coverage ratio will be volatile as capex ramps up over the coming years. Upper Hutt also has access to NZ\$11 million in undrawn standby facilities.

LGFA provides Upper Hutt, and most of its domestic peers, with strong access to a well-established source of external liquidity. In our view, LGFA benefits from an extremely high likelihood of extraordinary Crown government support (see "New Zealand Local Government Funding Agency Ltd.," published March 2, 2022). It has helped councils to both lengthen their maturity profiles and reduce borrowing costs.

Our base case excludes the potential effects of New Zealand's proposed three waters reforms. Preliminary modeling by the Department of Internal Affairs suggests the reforms could result in lower debt-to-revenue ratios for many councils. Details of the transition are likely to be included in legislation due to be introduced in parliament in the coming months (see "Credit FAQ: Lifting The Lid On New Zealand's "Three Waters" Reforms," published Oct. 12, 2022).

## **Local economy carrying good momentum; financial management and institutional settings support creditworthiness**

The New Zealand economy has recovered strongly from a COVID-19-induced downturn in 2020, although there are rising economic headwinds. We recently revised downward our real GDP growth projection for the country to 2.3% for calendar 2022 (see "Economic Research: Economic Outlook Asia-Pacific Q4 2022: Dealing With Higher Rates," published Sept. 26, 2022).

New Zealand is phasing out its remaining public health restrictions. The country has achieved high vaccination rates, which suggests future lockdowns are unlikely. The Reserve Bank of New Zealand began a sharp tightening of monetary policy in October 2021 in response to rising inflation. This should have a manageable impact on local government sector finances because revenues are generally not very sensitive to economic activity.

Upper Hutt's economy has performed well over the past year. Local GDP grew 4.1% in the year to June 2022, compared to a national average of 0.9%, according to Infometrics provisional estimates. Approximately 52% of the district's population commutes to work in Wellington. This partly explains why local GDP per capita stood at about NZ\$43,100 in 2021 (according to Infometrics data), about two-thirds of the New Zealand average. The city's population is around 47,700, and the council expects population growth to pick up to about 2% per year, resulting in additional infrastructure demands.

Fiscal processes are credible and well established. The council prepares 10-year plans every three years, annual plans in the intervening years, and audited annual reports. This is in line with statutory requirements. Upper Hutt borrows only in local currency and mitigates interest-rate risk through hedging. A mayor (who was re-elected in October 2022) and elected group of councilors govern the council. Day-to-day management falls on a full-time chief executive.

The institutional framework within which New Zealand local governments operate is a key factor supporting Upper Hutt's credit profile. We believe this framework to be one of the strongest and most predictable globally. It promotes a robust management culture, fiscal discipline, and high levels of disclosure. Due to a shortage of auditors, the Crown has temporarily extended councils' statutory reporting deadlines to six months from year-end, instead of four months.

## Key Statistics

### Upper Hutt City Council - Selected Indicators

(mil. NZ\$)	2021	2022e	2023bc	2024bc	2025bc
Operating revenues	53	57	55	65	71
Operating expenditures	47	51	53	60	62
Operating balance	6	6	2	5	8
Operating balance (% of operating revenues)	10.7	10.2	3.1	7.1	11.9
Capital revenues	7	16	15	9	13
Capital expenditures	30	27	43	50	51
Balance after capital accounts	(17)	(6)	(26)	(36)	(30)
Balance after capital accounts (% of total revenues)	(28.8)	(8.2)	(36.1)	(49.2)	(35.9)
Debt repaid	4	5	6	11	4
Gross borrowings	21	33	32	47	34
Balance after borrowings	0	19	0	0	0
Tax-supported debt (outstanding at year-end)	67	92	117	153	183
Tax-supported debt (% of consolidated operating revenues)	126.4	160.9	212.6	236.9	259.6
Interest (% of operating revenues)	3.1	3.6	5.0	5.8	6.6

## Upper Hutt City Council - Selected Indicators (cont.)

(mil. NZ\$)	2021	2022e	2023bc	2024bc	2025bc
National GDP per capita (single units)	67,000	70,196	75,468	78,785	82,214

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. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

## Ratings Score Snapshot

### Ratings Score Snapshot

#### Key rating factors

Institutional framework	1
Economy	2
Financial management	2
Budgetary performance	4
Liquidity	2
Debt burden	5
Standalone credit profile	a+
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

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- Credit FAQ: Lifting The Lid On New Zealand's "Three Waters" Reforms, Oct. 12, 2022
- Default, Transition, and Recovery: 2021 Annual International Public Finance Default And Rating Transition Study, Oct. 4, 2022
- Economic Research: Economic Outlook Asia-Pacific Q4 2022: Dealing With Higher Rates, Sept. 25, 2022
- Comparative Statistics: Local And Regional Government Risk Indicators: Asia-Pacific LRGs' Post-Pandemic Appetite For Capital Spending Is Strong, Sept. 22, 2022
- Local And Regional Governments Outlook 2022: Life Without Central Government Crutches, July 13, 2022
- Global Ratings List: International Public Finance Entities 2022, June 3, 2022
- Institutional Framework Assessment: New Zealand Local Governments, April 28, 2022
- Local Government Debt 2022: Rising Risks Keep Global Borrowing High, April 12, 2022
- New Zealand Local Government Funding Agency Ltd., March 2, 2022
- 25 Ratings In 25 Years: New Zealand Councils Prove Their Staying Power, Feb. 1, 2022
- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, May 29, 2020

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

**Ratings Affirmed; CreditWatch/Outlook Action**

	To	From
<b>Upper Hutt City Council</b>		
Issuer Credit Rating	A+/Stable/A-1	A+/Negative/A-1

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