Contents

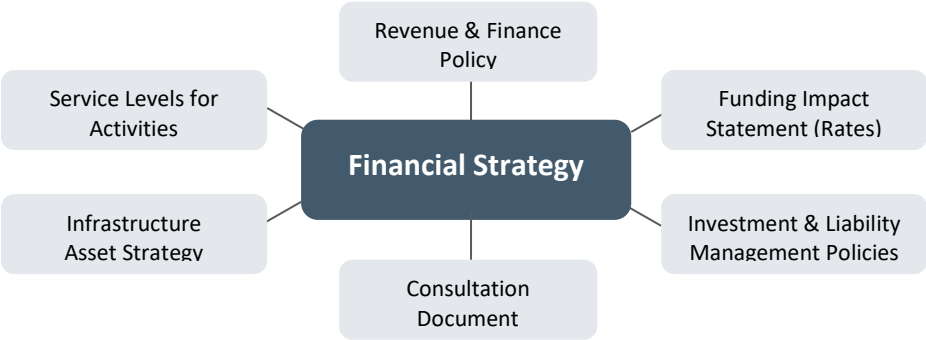
Section 1 - Introduction

1.1 Purpose

As required under section 101A of the Local Government Act, the purpose of this financial strategy is to facilitate prudent financial management by providing a guide for the council to consider proposals for funding and expenditure against. Furthermore, this strategy will endeavour to make transparent the overall effects of these strategies on HBRC's services, rates, debt and investments.

1.2 Context

The Financial Strategy informs and guides the assessment of funding and expenditure proposals outlined in the LTP. It brings together key aspects of other sections in the LTP to from a coherent strategy as illustrated below.



Section 2 - Key goals and outcomes

This Financial Strategy signals a step-change in Council activity, particularly in the areas of land and water to achieve real results on-the-ground at pace and at scale. This is in response to the challenge set by the Council's 2017-2021 Strategic Plan, which sets ambitious time-frames to achieve strategic goals in the following focus areas:

- Water quality, safety and certainty
- Smart, sustainable land use
- Healthy and functioning Biodiversity
- Sustainable Services and Infrastructure.

The Financial Strategy sets out the levers available to council to accelerate and scale-up activity and influence behavioural changes to achieve these goals. It is premised on front loading the current incremental activity to have a greater impact sooner.

Key levers include the council's funding mix (i.e. fees and charges, investment income, debt, external grant funding and rates), adjusting the balance of incentives and regulation, increasing internal capacity and its operating and capital expenditure.

This Financial Strategy includes an increase in debt for long term projects that provide intergenerational benefits. This includes new borrowing of $71M over ten years with a total outstanding loan balance of $38M by the end of the plan after repayments. This equates to 6.8% of equity which is still relatively conservative and well below the debt limit of 28%.

The investment strategy aims to main and grow investments for generating income to enable HBRC to help fund an aggressive programme of environmental enhancement projects. Keeping the dividend from Hawke's Bay Regional Investment Company Limited (HBRIC Ltd) which owns Napier Port allows for a new rating limit which shows how these funds help keep rates at 50% or less of annual revenue.

Section 3 – Key considerations

3.1 Changes in population

Providing for population change in Hawke's Bay is not expected to have a significant impact on HBRC's operating and capital costs over the 10 year life of the plan.

The latest available statistics shows Hawke's Bay usually resident population at 164,000. It increased 1.5% on the year before, and 0.7% per annum on average over the past 10 years. This compares to the national increase of 2.1%, and 1.3% respectively (source: Infometrics, for year ending March 2016). To account for this growth, council has applied an increase of 0.25% in rateable properties each year of the plan.

The most significant growth is projected in the Heretaunga Plains of Hawke's Bay. According to the Heretaunga Plains Development Strategy (HPUDS), the number of residents around the Heretaunga Plains is projected to increase by over 10,000 in the next 30 years. HBRC is working collaboratively with Hastings and Napier councils to accommodate housing and business land needs of those urban communities, plus the associated infrastructural servicing.

3.2 Change in land use

Hawke's Bay's economy is largely a rural economy dominated by export orientated primary production including value added processing and is therefore exposed to significant environmental (e.g. climatic) and international market fluctuations.

In general, changes to higher value land use is limited in Hawke's Bay due to the availability of water to irrigate. One area of anticipated land use change is from hill country pasture to afforestation. In this plan, council is investing in a significant tree planting programme targeting the worst eroding land in the region. This complements a central government initiative to plant 1 billion trees per year. This initiative will have positive impacts on water quality, carbon sequestration and soil health.

Council will continue to monitor land use change to make sure it can respond in a timely manner to any adverse effects as a result of a change in land use. Some of the negative impacts of changing land uses could include:

- urban and residential expansion can result in the loss of land available for primary production;
- increased demand for water for productive purposes;
- water quality problems as a result of agricultural intensification;
- impacts on soil health and erosion from increased productivity;
- impacts on social and economic structures in rural areas

3.3 Change in community values and expectations

There is increasing pressure on government (local and central) to deliver better environmental outcomes, faster. As a result central government has created new legal and rule-based instruments (such as the National Policy Statement for Freshwater, amongst others) that require HBRC to do more in certain areas. This plan proposes a range of land and water related initiatives to effect change at scale and pace to address increased community expectations. This package of initiatives is focussed on getting things done on-farm through a mix of incentives and regulatory backstops as needed. The package is designed to provide landowners with the knowledge, tools and resources to meet the required changes, ideally before nationally driven deadlines come into effect.

A recent ratepayer survey on willingness to pay indicated some ratepayers are prepared to spend more, particularly in the areas of waterways and aquifers, marine and native species and plants. This demand for additional work needs to be balanced against the community's ability to pay. The mean annual earnings in Hawkes' Bay in 2016 was $49,700, compared with $57,780 nationally (source: Infometrics, 2016). This balance is achieved through the prioritisation of work requirements, and the application of a robust Revenue and Financing Policy which effectively targets the costs of work to those who cause or benefit from the work undertaken.

3.4 Napier Port and the Capital Structure Review Panel

Council owns Napier Port through the Hawke's Bay Regional Investment Company Ltd. The Port is facing significant growth in cargo volumes and needs to develop its facilities to handle that growth on behalf of the region. Those developments, including a new container wharf and the replacement of the existing container wharf and supporting infrastructure, will likely cost around $250 million over the next 15 years.

Due to steady growth and the need for investment in recent years, Napier Port's debt for the 2017 financial year will be about $86 million. Even with the forecasted growth, Napier Port cannot fund future development on its own without capital investment or dividend relief from the Council. The Kaikoura and Christchurch earthquakes also highlight the risks to Council of having all its capital investment in one physical asset.

Both the increasing financial demands on Council and the risks of having 'all its eggs in one basket' have necessitated a re-think on how Council attracts external capital investment to fund its core responsibilities to the environment, economy and community.

A Capital Structure Review Panel was formed in March 2017 by the Council to review the balance sheets of HBRC, HBRIC Ltd and Napier Port individually and as a group. This panel has had the mandate to look at asset needs and the use of those assets, additional funding options, risks, investment and the long-term requirements of Napier Port.

Napier Port, through HBRIC Ltd, returns Council an annual dividend of around $10 million, which significantly subsidises rates for the region. This plan assumes this dividend will continue over the next ten years. We have assumed this because the options being considered by the Capital Structure Review panel, which meet all of Council's objectives, do not have a negative impact on the forecast dividend

The panel has yet to make formal recommendations to HBRC but some of the considerations have been used as guidance for the development of the LTP.

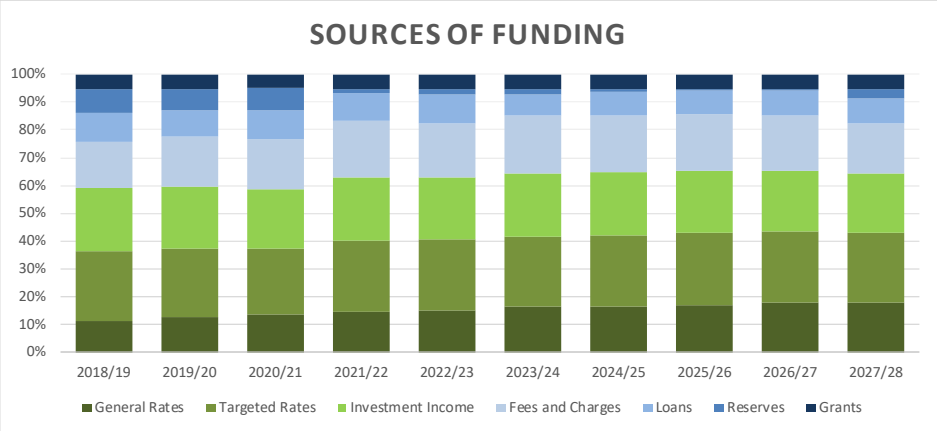
Section 4 – Funding

4.1 Funding Sources

HBRC activities are funded by a diverse mix of funding sources

- General Rates
- Targeted Rates
- Investment Income
- Fees and Charges
- Loans
- Reserves
- Grants

The funding mix over the period of the LTP is shown below.



The challenge for HBRC is to provide funding for its new strategic agenda, specifically in the areas of sustaining natural resources – e.g. water, land management and biodiversity whilst maintaining returns from HBRC's investment portfolio at a level which sustains a balanced operating budget.

4.1 Fees and charges

Fees and charges provide around 20% of the annual funding requirement of HBRC. The 2018-28 LTP includes a move towards charging more directly to those using our services. Both consents and compliance are now 80% chargeable to the consent holders up from the 60% and 70% respectively in previous years. Section 36 of the RMA allows regional councils to charge consent holders for their science activity. HBRC has continued with the 35% recoverable charges from consent holders in this area but has proposed to change the current zone based charging system to a more equitable split of 40% variable by consent type zone charging, 40% variable by consent type regional charges and 20% fixed charges.

4.2 Investments

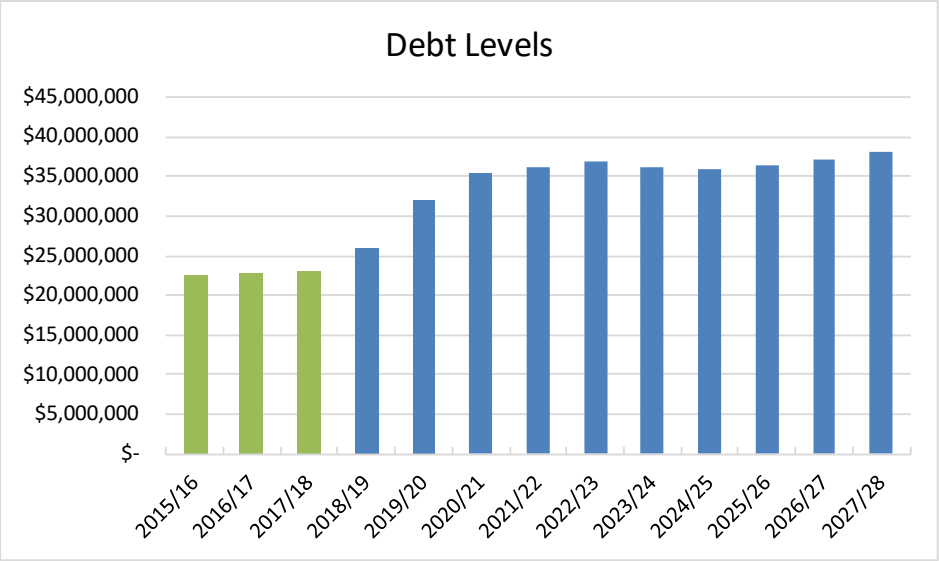
HBRC has historically been able to keep general rates at a minimum as they are subsidised by investment income effectively providing these returns back to the regional community.

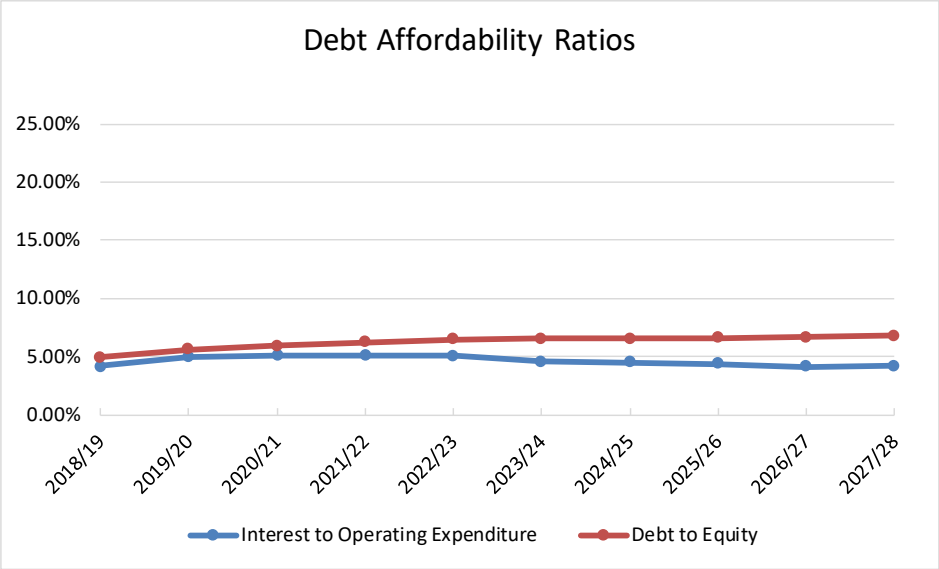
This investment income is derived from HBRC's investment in HBRIC Ltd, which owns Napier Port, leasehold income, forestry income, managed funds and cash on term deposit.

4.3 Debt

HBRC has historically had very low external debt. The 2018-28 LTP has focused on leveraging the balance sheet by borrowing more for larger long term projects that provide intergenerational benefits. These include new borrowing for integrated catchment management programmes for FEMPs, riparian planting and afforestation, sustainable homes, system integration software and capital expenditure.

HBRC has considered the timing of the programmes and the associated borrowing required to ensure that this best meets the needs of current and future generations. The debt levels stated below are set as such to enable HBRC to maintain the present levels of service and to meet the increased levels of service proposed in this Plan.





Limits on Debt

HBRC has two debt affordability limits which must be complied with:

- **Debt to Equity % must not exceed 28%**
- **Interest to Total Operating Expenditure must not exceed 25%**

The graph below shows the proposed limits on debt for the 2018-28 LTP

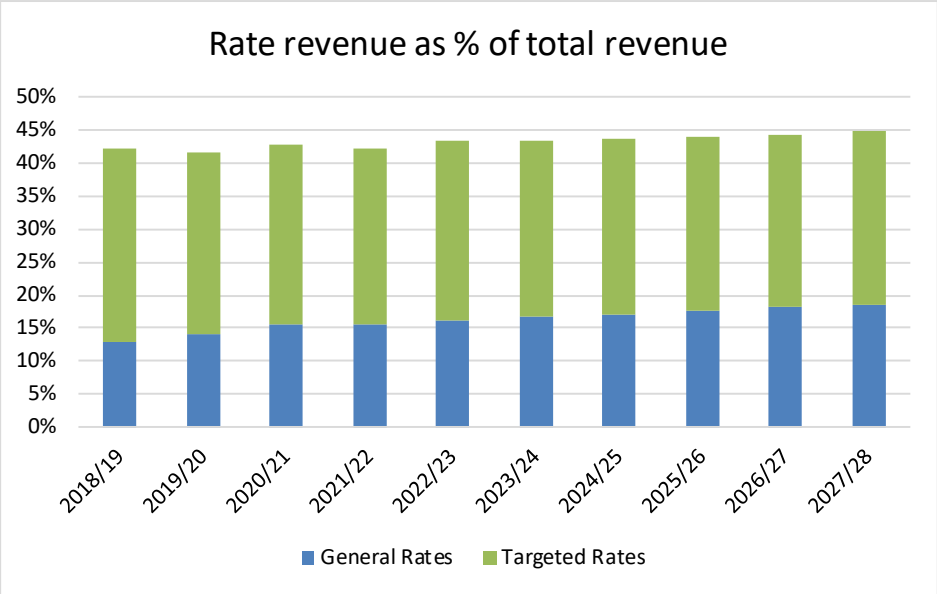
4.4 Rates

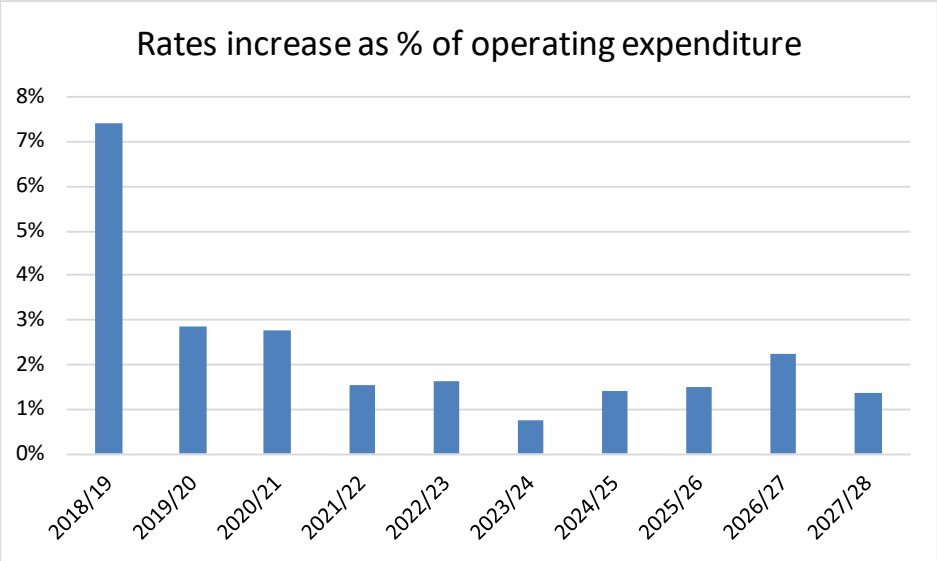
The balance of HBRCs funding requirements are provided by general rates. Rates are always the last alternative for funding operations due to the direct impact on the community.

Limits on Rates and Rate Increases

HBRC are has set the following limits in relation to its rate revenue:

- **Total rates revenue will not exceed 50% of the HBRCs annual revenue requirements**
- **Increases in the annual rate revenue requirement will not exceed 8% of HBRCs annual operating expenditure requirements**





4.5 Impact on Proposed HBRC Service Levels

HBRC is confident of its ability to provide and maintain existing levels of service and to meet additional demands for services included in the LTP within these limits.

4.6 Balanced Budget and Operating Surplus

HBRC have prepared the LTP budgets with a balanced budget with no in built surplus'. Any surplus shown in the statement of comprehensive revenue and expense is driven from none cash transaction such as revaluations or income derived for capital tranasctions.

Rate Increases/(Decreases)										
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Rate increase excl. CDEM regional rate	13.80%	6.4%	6.1%	3.2%	3.4%	1.5%	2.8%	3.0%	4.5%	2.7%
CDEM regional rate	5.2%	-	-	-	-	-	-	-	-	-
Total rates increase from previous year	↑ **19.0%**	↑ **6.4%**	↑ **6.1%**	↑ **3.2%**	↑ **3.4%**	↑ **1.5%**	↑ **2.8%**	↑ **3.0%**	↑ **4.5%**	↑ **2.7%**

Financial Measures: Rate Forecasts											
Rates ($000's)	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
General Rates	4,300	6,980	8,266	9,398	9,719	10,236	10,846	11,302	11,794	12,745	13,176
Total Targeted Rates	14,825	15,783	15,945	16,278	16,786	17,160	16,966	17,300	17,674	18,058	18,447
Total Rates	19,125	22,763	24,211	25,676	26,505	27,396	27,812	28,602	29,468	30,803	31,623

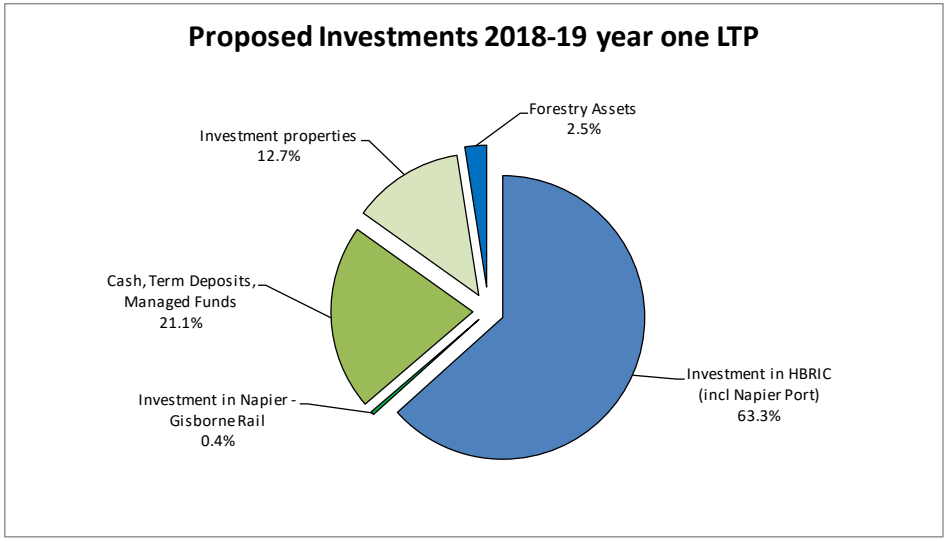
Projected Number of Rating Units										
	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28
Rating Units	71,408	71,586	71,765	71,944	72,124	72,304	72,485	72,666	72,848	73,030

Section 5 – Investment Strategy

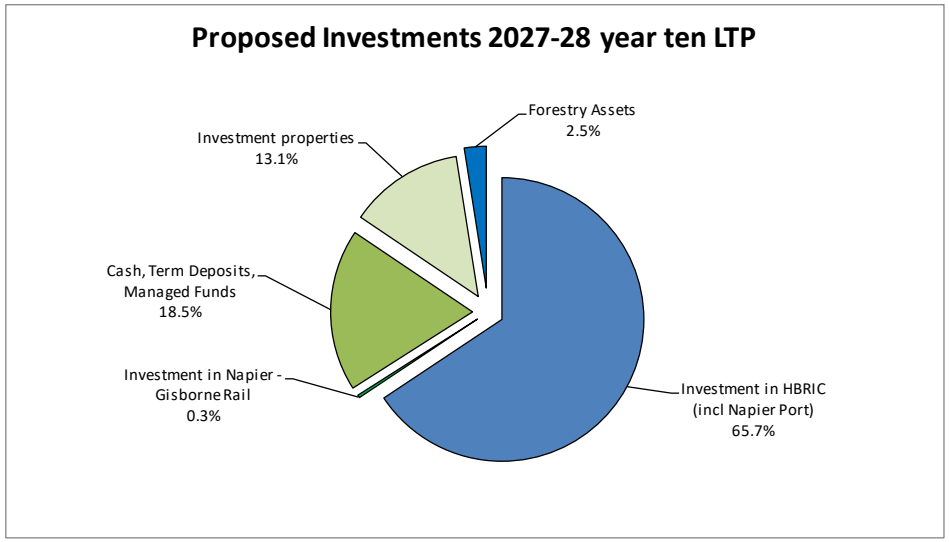
5.1 Financial Strategy for HBRC's Investment Portfolio

HBRC's strategic investment agenda for the 2018-28 LTP is to get the most out of the investments we do have and generate investment income to enable HBRC to help fund an aggressive programme of environmental enhancement projects.

The allocation of the current investment portfolio in year one of the LTP is shown below.



The allocation of the investment portfolio in year ten of the LTP is also shown to give a view that there is little movement proposed in the allocation of these investments over the term of the LTP



5.2 Investment Strategies/Economic Drivers/Value of Investment

HBRIC Ltd

HBRIC Ltd, the Council's investment company, commenced activities in February 2012. Its principal investment is 100% ownership of Port of Napier Limited (PONL), which owns and operates Napier Port

Dividends payable to HBRC will be 100% of HBRIC Ltd's Net Profit after Tax (NPAT) as stated in its Statement of Intent (SOI) for the year ending 30 June 2018.

The following table summarises the significant forecasting assumptions in respect of HBRIC Ltd dividends:

Year	$'000	Year	$'000
2018/19	10,000	**2023/24**	11,088
2019/20	10,209	**2024/25**	11,318
2020/21	10,422	**2025/26**	11,554
2021/22	10,640	**2026/27**	11,794
2022/23	10,861	**2027/28**	12,039

Leasehold Properties

Napier

HBRC owns leasehold endowment property within and around Napier City. Ground rents paid by lessors have been predominantly set at 5% of current land value, or "fair annual ground rental" and reviewed every 21 years.

From 1 July 2013, HBRC sold the annual rentals due from this portfolio over the next 50 years (i.e. until July 2063) to ACC for a lump sum of $37.8 million. As the annual rents have been sold this LTP assumes that the income received will be paid out as an expense with a small margin to be kept by HBRC as an administration fee.

The underlying properties continue to be owned by HBRC and sales to lessors have continued, and may continue in the future, in the same way as they have done in the past. HBRC has invested these funds in investments specified in HBRC investment policy, and will continue to do so in respect of net proceeds, (after disbursements to ACC), of sales of freehold interests to lessors.

Wellington

HBRC holds a portfolio of 12 leasehold properties in Wellington which were purchased from the historic proceeds of the sale of Napier leasehold properties. These leases provide a return of $840,814 per annum with leases renewed every 14 years.

Forestry

HBRC has an existing forestry portfolio consisting off:

Site Name	Area (ha)	Assumptions
CHB	168	No material investment, maintenance only, no harvesting in LTP period
Mahia	36	No material investment, maintenance only, no harvesting in LTP period
Waihapua	213	No material investment, maintenance only, no harvesting in LTP period
Tutira	114	Harvesting proposed over the period from 2018/19 to 2022/23. Replanting after Harvest
Tutira Manuka Honey	130	Maintenance continues with yearly honey income of $46,000 assumed
Tangoio	150	Harvesting proposed over the period from 2020/21 to 2021/22. Replanting after Harvest

Return on the forestry investments are determined by the harvest revenue received.

Tangoio forestry is treated differently from all the other forestry investment as HBRC does not own the land but does have responsibility for the management and control of the forest. Any income received from harvest is kept on reserve to fund the continuing maintenance programme and is not available for the funding of general HBRC operations.

New Investment

The previous LTP had proposed investment of up to $80 million into the RWSS project through HBRIC Limited. As at the end of June 2017 HBRC had advanced $15 million into the project. In the wake of a Supreme Court decision to rule against the land exchange needed to continue with the project, HBRC resolved to invest no further capital in the RWSS and write off the full value of the advance between HBRC to HBRIC Ltd.

The remaining $65 million was made up of $50 million cash funds and $15 million invested in Wellington Leasehold Property. It has been proposed to keep the Wellington Leasehold Property and the remaining $50 million which had been set aside for the project are now to be preserved and to provide investment income to help fund the increase to Council's operating activities.

Instead of keeping these funds on term deposit it is proposed to make these assets work harder and provide more returns. This LTP assumes a return of 4.5% on the funds for the first year of the LTP when term deposits are being transferred and then a 5% return for the rest of the LTP. Any income over those projections are to be transferred to reserve to cover market fluctuation risks.

These investments may include any of the investment classes included in the investment policy.

Start Up Investments

Water Augmentation

The LTP proposes a $5 million fund to be available for water augmentation, not fixed to any particular scheme but available as a grant fund for technical investigation and feasibility.

Although there may be potential for future investment returns from water augmentation investment these have not been factored into the LTP budgeting process as there needs to be more clarity in this area.

Napier – Gisborne Rail

The LTP proposes a commitment of $1.5 million in year one to support central Government's policy to reinstate the Napier-Wairoa rail line. No financial returns have been assumed over the next ten years as the final business case is not yet known.

Risks to Assumptions

The following tables outline the risks to significant forecasting assumptions. If these assumptions prove to be incorrect, there could be a significant effect on the level of rates that HBRC plans to collect from the community. In this situation, it will re-examine its work programmes and determine if it's appropriate to rate the community or change the scope of those programmes.

Council Investment Risks

Investments	Assumption	Risk to Assumption	Level of Uncertainty	Reasons and Financial Impact
HBRIC Ltd	Dividends will be paid to HBRC as scheduled	Napier Port financial performance falls short of its forecast or natural disaster reduces Napier Port capacity.	Low	A substantial part of HBRC's regional income comes from HBRIC as the majority of HBRC's investment assets are held by HBRIC. Any diminution of dividends paid by HBRIC to HBRC will have a direct negative effect on HBRC's operating position. HBRIC's ability to pay dividends relies in the first instance on the profitability and dividend payments of Napier Port.
Napier Port	The capital needs of the Napier Port will be meet through the recommendations of the Capital Structure Review Panel	Napier Port does not receive the capital injection needed and cannot build the new container wharf and the replacement of the existing container wharf and supporting infrastructure	Low	All entities involved with the Capital Structure Review Panel are confident that a solution to the Port Capital needs will be found and this will allow the Port to continue to grow. If a solution is not found then the Port would feel the need to try and develop the new infrastructure themselves which would require reduced dividends with large implications for the income of the Council.
Wellington leasehold properties	Lease payments will continue as scheduled	Lessees unable to pay or natural disaster leaves land unleaseable	Low	A good part of HBRC's regional income comes from Wellington Leasehold lease payments. Any diminution of payments will have a direct negative effect on HBRC's operating position
Forestry Harvesting	Log prices remain stable over the period of the LTP.	Price for logs at harvesting is lower than forecast.	Low	Like all commodity markets timber is cyclical, however this risk can be managed by bringing forward or deferring harvesting in the short term but if prices continue to be low in the long term there maybe less income than forecast.
Forestry - Manuka	Honey prices remain stable over the period of the LTP	Price for honey is lower than forecast.	Low	A small part of HBRC's regional income comes from honey sales.
Managed Funds	Revenue assumptions can be met each year	Investments and markets can fluctuate effecting income and capital value.	Medium	A diverse portfolio will be required to mitigate the risk of investment fluctuations as well as trying to build up a reserve to cover fluctuations. Managed funds held for investment are to be in the order of $50M at the start of this plan. Therefore a 0.5% movement either up or down from the

				assumed levels of returns in this plan would result in an annual exposure of plus or minus $250,000.
Water Augmentation	No returns assumed in the LTP period	No risk	Low	No downside financial impact. There may well be an upside if the investment can be turned into a commercial feasibly project.
NGR	No returns assumed in the LTP period	No risk	Low	No downside financial impact. There may well be an upside if the investment can be turned into a commercial feasibly project.

Other Risks

Investments	Assumption	Risk to Assumption	Level of Uncertainty	Reasons and Financial Impact
Inflation	Inflation rates have been developed from BERL economic forecasts	Inflation is higher or lower than forecast	Medium	Inflation is affected by external economic factors, most of which are outside of HBRC's control and influence. The estimate of the potential effects of the uncertainty is best illustrated by stating that for 2019-20 a move in the cost adjustors provided by BERL and used in this plan by plus or minus 0.5% would result in either an under or over provision for external expenditure of $107,000 and for employment costs of $90,000 .
Interest Rates on Borrowings	Interest rates increase slightly over the term of the plan	Interest rates are higher or lower than forecast	Medium	The majority of the borrowing programme proposed in this plan is to provide funding to cover loans to homeowners for Sustainable Homes and for the Integrated Catchment Activities. The effect of any interest rate movements on the borrowing programme can best be illustrated by stating that a 0.5% movement either up or down from the assumed levels of interest rates in this plan would result in an annual exposure of plus or minus $17,000 for 2018-19 $224,000 for 2027-28 the last year of the plan.
Occurrence of Natural Disaster	No natural disasters	A natural disaster/flood event occurs which damages Council's property, plant and equipment	Medium	Call on commercial insurance, Local Authority Protection Programme and Government funding through the National Civil Defence Recovery Plan. The use of reserves is also available to HBRC as required.

Section 6 –Infrastructure Assets

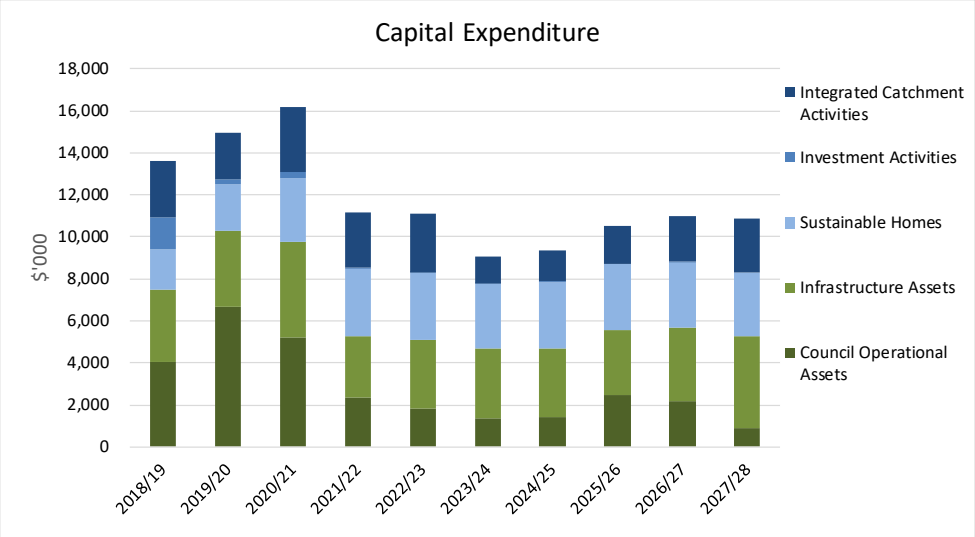
HBRC manages infrastructure assets through the 30 year Infrastructure Strategy (refer section XX). The financial budgets incorporate the key issues and responses from this document.

Overall HBRC is satisfied that it can respond to the infrastructure needs within the budget and rating parameters set within this financial strategy.

Section 7 – Summary of Capital and Borrowing

Capital Expenditure

HBRC proposed to embark on a significant capital programme across the 10 years of this Plan, mainly as a result of the proposed activity in Sustainable Homes, Integrated Catchment Activities and the continued Infrastructure programmes. The graph below sets out the proposed capital expenditure activity across each year of the LTP.



The increase in Council Operational capital expenditure in years 1 to 3 are driven by building renewals, accommodation requirements, science assets and computer system integration projects.

Infrastructure capital expenditure is relatively constant throughout the LTP and provides for the renewal of existing infrastructure as well as allowing for level of service increases for the Heretaunga Plains stop banks.

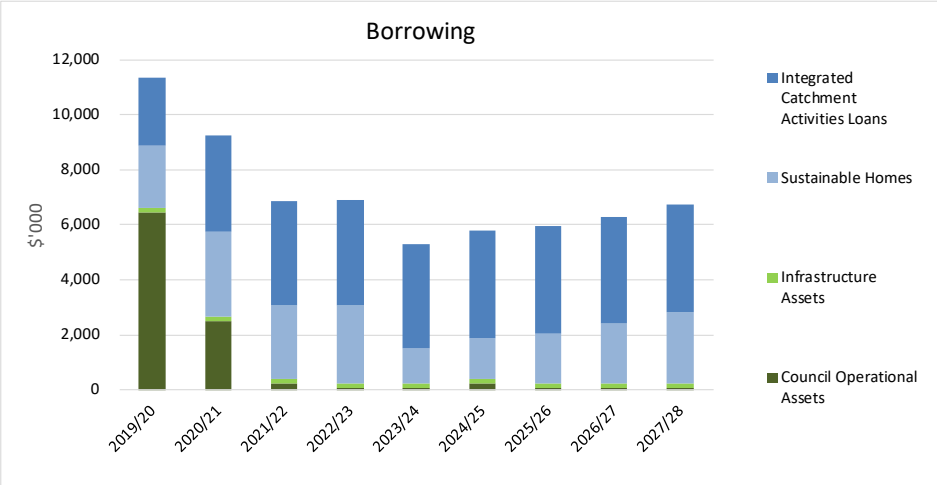
Community Loans include the Sustainable Homes programme and the Integrated Catchment Activities for Riparian planting and Afforestation

External Borrowings

This LTP has actively endorsed the use of increased borrowing in order to help achieve ambitious time bound strategic goals for water, land use, biodiversity and sustainable services and infrastructure.

HBRC proposes to borrow $71m over the 10 years of the Plan. Proposed budgets allow for the repayment of debt, so debt will grow from its current level of $23m to $38m over the life of the Plan.

The graph below analyses the years of the proposed new borrowings of $71 million and the programmes to be funded.



Debt Security

When HBRC undertakes external borrowing it does so under the Debenture Trust Deed which was established in October 2009.

Under the Debenture Trust Deed HBRC's borrowing is secured by a floating charge over all HBRC rates levied under the Rating Act, excluding any rates collected by HBRC on behalf of any other local authority. In such circumstances, the security offered by HBRC ranks 'Pari Passu' for all stock issues by HBRC including any security stock issued.

Under the Debenture Trust Deed HBRC offers deemed rates as security for general borrowing programmes. From time to time, with prior HBRC and Debenture Trustee approval, security may be offered by providing a charge over one or more of HBRC's assets.

Physical assets will be charged only where:

- There is a direct relationship between the debt and the purchase or construction of the asset which it funds (such as an operating lease or project finance);
- HBRC considers a charge over physical assets to be appropriate;
- Any pledging of physical assets must comply with the terms and conditions contained within the Debenture Trust Deed.

Section 8 - Financial Metrics

Set out in the table below are the financial metrics that assist in the evaluation of HBRC's financial performance over the years of the Plan.

	Year 1 2018/19	Year 2 2019/20	Year 3 2020/21	Year 4 2021/22	Year 5 2022/23	Year 6 2023/24	Year 7 2024/25	Year 8 2025/26	Year 9 2026/27	Year 10 2027/28
Net Surplus Margin (This metric shows the percentage of income retained by HBRC to fund capital expenditure, to meet repayments on debt and/or set aside to meet future contingencies)	9.47%	13.59%	12.98%	15.29%	14.47%	14.84%	15.42%	15.59%	16.06%	15.79%
Return on Investments (This metric shows the percentage of income retained by HBRC to fund capital expenditure, to meet repayments on debt and/or set aside to meet future contingencies)	3.44%	3.86%	3.34%	3.58%	3.43%	3.11%	3.12%	3.13%	2.85%	2.86%
Rates to Total Revenue (This metric shows the percentage of HBRC's total revenue that is collected through rates).	45.67%	44.83%	46.01%	45.55%	46.92%	46.83%	47.13%	47.43%	48.07%	48.65%
General Rates to Total Rates (This metric shows the percentage of HBRC's total rates revenue that is collected through general rates).	30.66%	34.14%	36.60%	36.67%	37.37%	39.00%	39.51%	40.02%	41.38%	41.67%
Capex to Total Cash Payments (This metric shows the proportion of total cash payments that has been spent on fixed assets).	10.22%	13.26%	12.20%	7.80%	7.04%	6.48%	6.46%	7.41%	7.42%	6.74%
Total Finance Expense to Operating Expenditure (Interest on Borrowings and payments to ACC for leasehold cashflows)	4.97%	5.60%	5.96%	6.25%	6.50%	6.55%	6.56%	6.60%	6.66%	6.80%
Interest Expense on Bank Loans to Operating Expenditure (Interest in Borrowings only)	2.70%	3.20%	3.55%	3.77%	3.95%	4.05%	4.11%	4.21%	4.28%	4.41%
Debt to Debt plus Equity	6.92%	7.47%	7.25%	7.10%	6.88%	6.18%	6.00%	5.77%	5.34%	5.32%