

1. Introduction

Taupo District Council ("Council") undertakes borrowing (liability management) and investment activities, which in total are referred to as treasury activity. Council's treasury activities are carried out within the requirements of the Local Government Act 2002, its related amendments and other relevant local authority legislation.

This Treasury Management Policy provides the policy framework for all of Council's borrowing and investment activities and defines key responsibilities and the operating parameters within which borrowing, investment and related risk management activities are to be carried out.

Key borrowing and investment objectives form the basis of the policies. These objectives, while consistent with corporate best practice, are subject to overall Council objectives, as stated in the Annual Plan and Long Term Council Community Plans (LTCCP).

Because this policy can only be amended as an LTCCP amendment or as part of an LTCCP (per the LGA 2002 section 102), other than in exceptional circumstances, this policy will be reviewed and amended on a 3-yearly basis.

This policy covers:

- **Liability Management**
Council's borrowing activity is largely driven by its capital works programme, mainly related to its infrastructure assets. Council's liability management policy is discussed in Section 3 of this policy.
- **Investments**
Council manages a portfolio of investments comprising equity investments, airport, property, forestry and financial investments. Council's investment policy is discussed in Section 4 of this policy.

Council acknowledges that there are various financial risks such as interest rate risk, currency risk, liquidity risk and credit risk arising from its treasury activities.

Council is a risk adverse entity and does not wish to incur additional risk from its treasury activities.

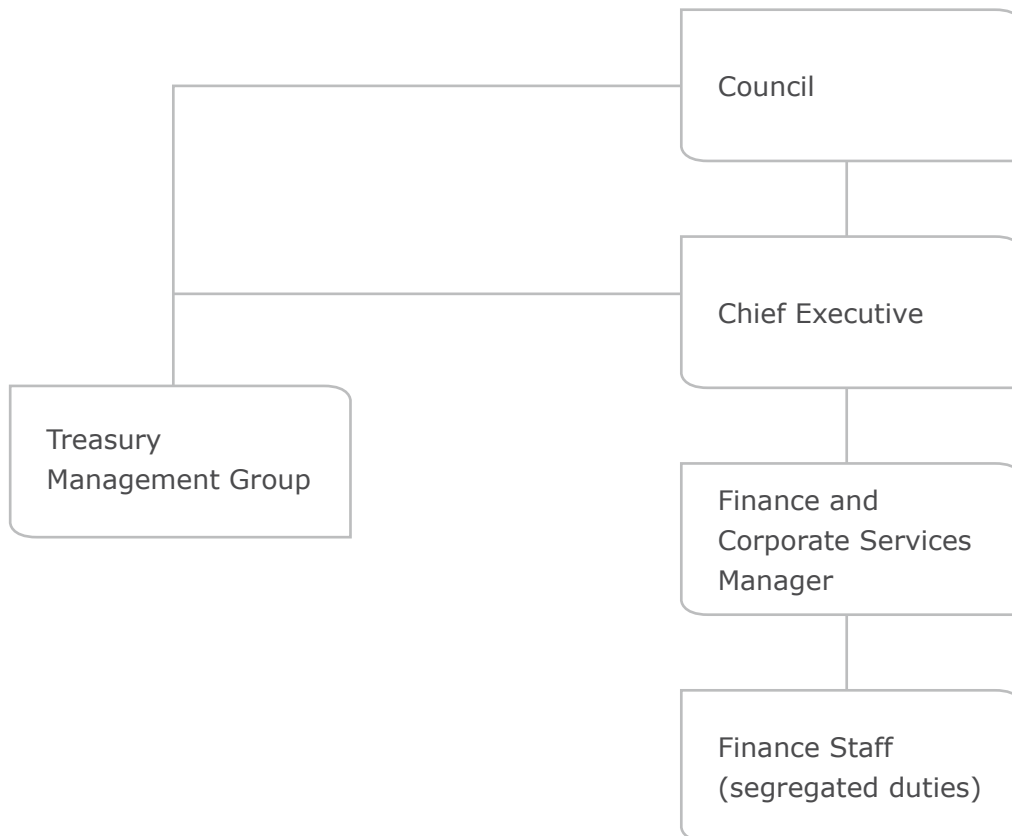
Council's accounting function in relation to its treasury activities is a risk management function focused on protecting Council's budgeted interest costs and revenues and stabilising Council's cash flows. Council does not undertake any treasury activity that is unrelated to its underlying cash flows or is purely speculative in nature.

Further detailed information and procedures supporting the Treasury Management Policy are contained in the relevant internal policy and procedure manuals.

2. Management Structure, Responsibilities and Delegated Authorities

2.1 Financial Services Organisational Structure

The organisation chart for treasury activity is as follows:



Detail of roles and responsibilities are set out below.

2.2 Delegated Authorities

Delegated authorities are summarised at the end of each section of the liability management and investment policy (sections 3 and 4).

2.3 Legislative Requirements

The Liability Management and Investment Policies of the Treasury Management Policy are in compliance with the requirements of the Local Government Act 2002 (LGA 2002).

3. Liability Management Policy

3.1 Purpose

Council borrows for the following primary purposes:

- General debt to fund Council's capital works primarily on infrastructure assets. The use of debt is seen as an appropriate and efficient mechanism for promoting intergenerational equity between current and future ratepayers in relation to Council's assets and investments.
- Short term debt to manage timing differences between cash inflows and outflows, and to maintain Council's liquidity.
- Specific debt associated with significant "one-off" projects and non-financial investments from time to time.
- Borrowing through hire purchase, credit, deferred payment or lease arrangements in the ordinary course of Council business.

3.2 Local Government Act 2002 Requirements

Section 104 of the LGA 2002 provides that the Liability Management Policy required to be adopted under section 102(4)(b) must state the local authority policies in respect of liability management, including:

- a) Interest rate exposure (section 3.5).
- b) Credit exposure (section 3.6).
- c) Liquidity (section 3.7).
- d) Debt repayment (section 3.8).
- e) Specific borrowing limits (section 3.9).
- f) The giving of security (section 3.10).

3.3 Objectives

The objectives of the Liability Management Policy are consistent with market best practice and will take into account Council's 10 year plans as set out in the LTCCP. The key Liability Management objectives in relation to borrowings are to:

- Prudently manage Council's borrowing activities to ensure the ongoing funding of Council.
- Borrow only under Council approved facilities and as permitted by this policy.
- Minimise borrowing costs within prudent risk management control limits.
- Manage exposure to adverse interest rate movements.
- Ensure operational controls and procedures to protect Council against financial loss, opportunity cost and other inefficiencies are maintained.

3.4 Borrowing Management And Internal Controls

Council approves policy parameters in relation to borrowing activities.

Council approves, by resolution, the borrowing requirement for each financial year in the annual plan or LTCCP or by later resolution during the year.

Council considers the impact on its borrowing limits (section 3.9) as well as the size and the economic life of the asset that is being funded and its consistency with Council's LTCCP.

A resolution of Council is not required for hire purchase, leased, credit or deferred purchase of goods if:

- the period of indebtedness is less than 365 days; or
- the goods or services are obtained in the ordinary course of operations on normal commercial terms for amounts not exceeding in aggregate \$50,000.

Council's Chief Executive has overall responsibility for the operations of Council.

The Treasury Management Group ("TMG") review regular treasury reports to ensure compliance with policies, procedures and risk limits and has overall responsibility for setting risk management strategies in relation to the implementation of this treasury policy. It also oversees the management of Council's relationship with financial institutions and the negotiation of borrowing facilities with bankers, the appointment of brokers/arrangers/managers.

The TMG meets at least quarterly to review the risk management strategies in place and other treasury related issues as appropriate. Members of the TMG are the Group Manager - Finance and Corporate Services, Financial Accounting Manager, Financial Accountant, Management Accountant, Assistant Accountant Treasury and representative(s) of the Council's Independent Treasury Advisors (if appointed) on an ex-officio basis.

The Group Manager - Finance and Corporate Services has overall responsibility for the formulation and implementation of specific borrowing and interest rate risk strategies consistent with the strategies developed by the TMG and the overall objectives of this policy. Implementation of borrowing and interest rate risk management strategies is controlled by the Liquidity, Credit and Interest Rate guidelines of this policy.

Council's borrowing activities are managed centrally through its accounting function. The accounting function is broadly charged with the following responsibilities:

- Manage Council's borrowing programme to ensure funds are readily available at margins and costs favourable to Council.
- Raise authorised and appropriate borrowing, in terms of both maturity and interest rate strategies.
- Manage the impact of market risks such as interest rate risk and liquidity on Council's borrowing by undertaking appropriate hedging activity in the financial markets.
- Minimise adverse interest rate related increases on ratepayer charges and maintain overall interest costs within budgeted parameters.
- Provide timely and accurate reporting of treasury activity and performance.

Council's systems of internal controls over borrowing activity include:

- Adequate segregation of duties among the core borrowing functions of deal execution, confirmation, settling and accounting/reporting.
- There are a small number of people involved in borrowing activity, however the risk from this will be further minimised by the following processes:
 - a documented discretionary approval process for borrowing activity.
 - regular management reporting and review.
 - regular operational risk control reviews by an independent audit function.
- Organisational, systems, procedural and reconciliation controls to ensure:
 - all borrowing activity is bona fide and properly authorised.
 - reviews in place to ensure Council's accounts and records are updated promptly, accurately and completely.

Council is prohibited from borrowing in a foreign currency by section 113 of the LGA 2002.

3.5 Interest Rate Exposure

Interest rate risk management refers to managing the impact that movements in interest rates can have on Council's cash flows. This impact can be both favourable and unfavourable. Council's ongoing borrowing requirement gives rise to direct exposure to interest rate movements.

3.5.1 Fixed/Floating Profile

Interest is incurred on any bank funding facility, issuance of local authority stock and other borrowing arrangements. This policy recognises that the longer the term of borrowing, the greater the interest rate risk. Longer term fixed rate borrowings may be of benefit if market interest rates rise, but equally may not allow the Council to take advantage of periods of low interest rates.

A balance is achieved through having variable terms with regard to interest rate resets.

The Council manages its interest rate exposures by defining minimum and maximum hedging percentages within various time buckets. These parameters are reviewed annually by the Treasury Management Group ("TMG"). Any changes recommended must be approved by the full Council before inception. The table below shows an example of how minimum and maximum hedged or fixed rate exposure requirements within various time buckets are detailed in operational procedure and reporting documentation.

Interest Rate Maturity Profile Limit		
	Minimum Fixed Rate	Maximum Fixed Rate
Less than 1 year	40%	100%
1 year to 3 years	20%	70%
3 years to 5 years	10%	50%
5 years to 10 years	0%	40%

Any hedging outside the determined parameters or for longer than 10 years must be approved by the Council, before initiation.

When managing the interest rate risk of the Council the hedging percentages relate to total core debt. Core debt cannot exceed borrowing projections as per the LTCCP or Annual Plan or as approved by the Council. The actual quantum used for policy parameters will be reviewed annually by the TMG.

The hedging parameters are cumulative. For example using the example parameters above, if total debt was \$50 million, \$10 million of hedging entered into for a period of five years would increase the hedging profile for all time buckets up to five years, by 20%.

The TMG sets the interest rate risk management strategy and hedging levels within the approved bands by monitoring the interest rate markets on a regular basis, evaluating the outlook for short term rates in comparison to the rates payable on fixed rate borrowing, Council borrowing requirements going forward, budgeted interest expense and other relevant factors.

3.5.2 Interest Rate Risk Management Contracts

Interest rate risk can be managed by using interest rate risk management contracts that allow the re-profiling of the portfolios including the:-

- Hedging of up to 100% of repricing risk on existing fixed rate debt and issue yield risk on planned new debt within the next twelve month period.
- Converting fixed rate borrowing into floating rate or hedged borrowing and floating rate borrowing into fixed or hedged borrowing within the overall parameters of this policy.

The following interest rate risk management instruments are approved by Council:

- Interest Rate Swaps
- Forward Rate Agreements
- Interest Rate Options on approved underlying instruments, e.g. on Interest Rate Swaps or bonds.
- Interest Rate Collar Strategy, but only where the ratio of the face value and interest rate exposure on bought to sold legs is 1:1.

3.6 Credit Exposure

Council hedging can only be undertaken with approved New Zealand Registered Banks, as per section 4.6.3.

3.7 Liquidity and Funding Risk

Liquidity management refers to the timely availability of funds to Council when needed, without incurring penalty costs. Funding risk management centres on the ability to re-finance or raise new debt at a future time at the same or more favourable pricing (fees and borrowing margins) and terms of existing facilities. A key factor of funding risk management is to reduce the concentration of risk at any one point in time so that if one-off internal or external negative credit events occur, the overall interest cost is not unnecessarily increased.

The following guidelines have been established to provide Council with appropriate levels of liquidity at all times, as follows:

- Cash flow forecasts will be produced to assist in the matching of operational and capital expenditure to revenue streams and borrowing requirements.
- Council will maintain its financial investments in liquid instruments.
- Council will ensure that, where sinking funds or Council created investments are maintained to repay borrowing, these investments are held for maturities not exceeding the relevant borrowing repayment date
- To minimise the impact of unexpected cash surpluses, the Council will take advantage of the efficiencies of any floating rate loan facility.

The following guidelines have been established to control funding risk:

- To avoid concentration of debt maturity dates no more than 50% or \$25 million (whichever is the highest) of total debt can be subject to refinancing on a rolling 12 month basis. Total debt is defined as total existing external debt.

3.8 Debt Repayment

Repayment of debt (interest and principal) is governed by:

- Affordability of debt servicing costs.
- Intergenerational equity principles (debt will be repaid over the life of the asset or 25 years whichever is the lesser).
- Maintenance of prudent debt levels and borrowing limits.
- Council repays borrowings from general, special funds or from the existing specific sinking fund allocated to that borrowing.
- Where a loan is raised for a specific purpose and the funds are no longer required the funds will be held in a special fund until the funds can be applied against a future borrowing.

3.9 Borrowing Limits

In managing its borrowings, Council determines appropriate control limits based on the following covenants:

- The gross interest expense¹ on gross external debt² will not exceed a specified percentage of total annual operating income.
- A control ratio of EBIT/Net Interest³ (EBIT has to be a multiple of net interest) will be determined.
- A ratio of net cash inflow from operating activities to gross annual interest expense on gross external debt is specified.
- A control ratio of gross external debt to equity.

The applicable control limits will be set by the full Council and reviewed on an annual basis.

1 Refers to gross external interest expense, excluding interest owing on internal loans (after interest rate risk management costs/benefits)

2 Gross external debt is borrowing from the banking sector or capital markets

3 EBIT is earning before interest and taxation and net interest is interest on external debt less interest received on investments

3.10 Security

All loans are secured over either the separate general and targeted rates of the district or Council assets

Formal security over either the separate general and targeted rates of the district or Council assets requires prior Council approval.

3.11 Borrowing Mechanisms

In developing strategies for new borrowing (in relation to source, term, size and pricing) Council takes into account the following:

- Available and Council approved sources, terms and types of borrowing.
- Council's overall debt maturity profile, to ensure concentration of debt is avoided at reissue/rollover time.
- Prevailing interest rates, margins and total cost relative to term and nature of the borrowing.
- The market's outlook on future interest rate movements as well as Council's own.
- Legal documentation and financial covenants.

3.12 Guarantees

Council provides guarantees to banks for loans between the bank and non-profit bodies advances where Council considers the guarantee to be beneficial to the community in accordance with Council's policies on loan guarantees. Clear parameters for maximum levels of exposure are set in the loan guarantees policy.

The non-profit bodies are to forward their financial statements to Council annually. Should the guarantee be called upon, Council takes immediate steps to recover the money.

Guarantees require the prior approval by way of Council resolution.

3.13 Internal Borrowing – TEL

Council can use its special reserves to fund its new capital expenditure projects. This creates operational efficiencies as savings are created by eliminating the 'lenders' margin' that would be owing through Council simultaneously investing and borrowing. Such internal loans are set up within the portfolio based on planned loan funded capital expenditure as approved by Council resolution as part of the Annual Plan or LTCCP.

Council uses the internal loan portfolio as an input into determining Council's external debt requirements. Where possible and within limits, Council's reserves are used to reduce external debt effectively reducing Council's net interest cost.

The following specific reserve is used for internal borrowing purposes:

- TEL investment portfolio

The following guidelines apply in relation to the management of Council's internal loan portfolio:

- All internal borrowing activities are consistent with the principles and parameters outlined throughout the Treasury Management Policy.
- One of the primary reasons for holding financial investments is to provide ready cash in the event of a natural disaster. The amount of internal debt is limited to the extent that at least \$3 million needs to be held in liquid financial investments to meet this objective.
- The interest rate charged on internal loans shall be no less than the weighted average interest rate of the Council's external debt and shall be reviewed at least annually.
- Internal borrowing will be limited to a maximum of 30% of the capital portion of the TEL fund.
- The project to be internally funded must require funding of at least \$1million.

3.14 Internal Borrowing – Use Of Depreciation Reserves

To ensure prudent cash flow management, depreciation reserve balances that are temporarily available may be used to fund the purchase of assets within the rating area funding the reserve. Interest, at no less than the weighted average interest on Council's external debt, shall be charged and depreciation funds arising from the new asset will repay the loan back to its internal funding source.

3.15 Leases

Council utilises finance leases (as opposed to an operational lease i.e. renting) as a means of financing some office equipment.

3.16 Delegations

The delegated authority in respect of the Liability Management policy is as follows:

Council:

- Approve liability management policy.
- Alter liability management policy.
- Approve borrowing strategy outside policy parameters.
- Approve borrowing programme for the year through the Annual Plan or LTCCP.
- Approve borrowings other than in accordance with the Annual Plan or LTCCP.
- Approve interest rate risk management instruments outside policy parameters.
- Approved seal register signatories - transfers of stock / register new debt issues.
- Approve charging assets as security over borrowing.
- Review Liability Management performance.

Treasury Management Group:

- Review risk management strategies in place and revise as appropriate.
- Recommend alterations to the liability management policy.
- Review Liability Management performance.
- Overviews management of Councils relationships with financial markets.

Group Manager - Finance and Corporate Services:

- Implement day-to day borrowing strategies in line with overall strategy developed by TMG.
- Raise new loans in accordance with Council approved borrowing programme, and carry out debt negotiations in accordance with strategy and policy.
- Authorise use of Council approved interest rate risk management instruments in line with strategy.

Financial staff

- Execute approved borrowing and borrowing interest rate risk management strategies.

3.17 Performance Measurement

The performance of the borrowing activity will be measured against pre-determined benchmarks:

- Adherence to policy and in particular the borrowing limits.
- Unplanned overdraft costs – specifically that daily bank balances are within limits taking into account unforeseen external activity.
- Comparison of actual monthly and year to date interest costs vs. budget borrowing costs.
- Comparison of actual monthly borrowings with budgeted borrowings.
- Comparison of actual financial ratios to budgeted financial ratios as per the Annual Plan and LTCCP.

3.18 Reporting

Reporting to Council

- 3-yearly review of Liability Management Policy
- Monthly Treasury Report including commentary where significant changes in borrowing strategy are being entered.
- Annual Report
- 3-yearly internal audit on borrowing activity (with findings and recommendations to Council)

3.19 Review

Liability Management Policy

- 3-yearly review

4. Investment Policy

4.1 Purpose

Council holds financial investments sufficient to match reserve accounts created by Council resolution and as a result of short term cash flow surpluses. Council also manages investments in equities, property, council controlled organisations, (e.g. Taupo Airport Authority) and forestry.

4.2 Local Government Act 2002 Requirements

Section 105 of the LGA 2002 provides that the Investment Policy required to be adopted under section 102(4)(c) must state the local authority policies in respect of investments, including:

- a) The objectives in terms of which financial and equity investments are to be managed (section 4.3)
- b) The mix of investments (section 4.5 - 4.11)
- c) The acquisition of new investments (section 4.6 - 4.11)
- d) An outline of the procedures by which investments are managed and reported on to the local authority (section 4.4, 4.6 - 4.11, 4.14 - 4.17)
- e) An outline of how risks associated with investments are assessed and managed (section 4.6 - 4.11)

4.3 Objectives

The objectives of this investment policy are consistent with market best practices and will take into account the requirements of Council's Annual Plan and LTCCP. The key investment policy objectives are to:

- Prudently manage Council's investment assets in the interests of the Council's district and its inhabitants and ratepayers, only for lawful purposes and so as to safeguard against loss.
- Manage investments in accordance with the Local Government Act 2002 and the Trustee Act 1956; administer, manage and account for its funds and exercise the care, diligence, and skill that a prudent person of business would exercise in the managing the affairs of others.
- Maximise investment income within a prudent level of investment risk. Council recognises that as a responsible public authority any investments that it does hold should be of relatively low risk. It also recognises that lower risk generally means lower returns.
- Invest only in approved securities and asset classes as permitted by this policy. Accordingly, only creditworthy counterparties are acceptable.
- Ensure investments are maintained at an appropriate level of liquidity to enable the provision of cash flow when required.
- Minimise potential risk due to adverse interest rate movements.
- Regularly review the performance and credit worthiness of all investments.
- Maintain operational controls and procedures to best protect Council against financial loss, opportunity cost and other inefficiencies.

4.4 Investment Management and Internal Controls

Council approves policy parameters in relation to borrowing and investment activities.

The Treasury Management Group ("TMG") review regular treasury reports to ensure compliance with policies, procedures and risk limits and has overall responsibility for setting strategies in relation to financial investment activity. The TMG meets at least quarterly. Members of the TMG are the Group Manager - Finance and Corporate Services, Financial Accounting Manager, Financial Accountant, Management Accountant, Assistant Accountant Treasury and representative(s) of the Council's Independent Treasury Advisors (if appointed) on an ex-officio basis.

In making any investment decisions the TMG considers:

- the desirability of diversifying investments;
- the nature of existing investments;
- the risk of capital loss or depreciation;
- the potential for capital appreciation;
- the likely income return;
- the length of the term of the proposed investment;
- the marketability of the proposed investment during, and on the determination of the term of the proposed investment;
- the effect of the proposed investment in relation to tax liability; and
- the likelihood of inflation affecting the value of the proposed investment.

Council's Chief Executive has overall responsibility for the operations of Council.

The Group Manager - Finance and Corporate Services has financial management responsibility over Councils' investments.

Operational management is detailed in sections 4.6 - 4.11.

Council's systems of internal controls over investment activity include:

- Adequate segregation of duties among the core investment functions of deal execution, confirmation, settling and accounting/reporting. There are a small number of people involved in investment activity, however the risk from this will be further minimised by the following processes:
 - a documented discretionary approval process for investment activity.
 - regular management reporting and review.
 - regular operational risk control reviews by an independent audit function.
- Organisational, systems, procedural and reconciliation controls to ensure:
 - all investment activity is bona fide and properly authorised.
 - reviews in place to ensure Council's accounts and records are updated promptly, accurately and completely.
- Overall assessment of performance of funds management [fund manager portfolio and internally managed portfolio] by investment advisors.

4.5 Investment Portfolio

An investment is an asset held by Council that provides service potential or future economic benefit to Council. Investments include property, ownership in council related trading entities and financial assets. A financial asset is any asset that is cash or the contractual right to receive cash including the financial investment instruments.

Council invests in the following assets:

- Financial investments (excluding day-to day cash management activity).(section 4.6)
- Equity investments (section 4.7)
- Council controlled organisations (CCOs) (section 4.8)
- Property investments (section 4.10)
- Forestry investments (section 4.11)
- Cash and working capital management) (section 4.12)

4.6 Financial Investments

Council maintains financial investments for the following primary reasons:

- Invest amounts allocated to special reserves and existing sinking funds
- Invest surplus cash and working capital funds
- Provide ready cash in the event of a natural disaster. This cash is intended to assist reinstatement and to finance short-term needs between the disaster and the reinstatement of normal income streams.
- Invest Taupo Electricity Limited (TEL) and Taupo Generation Limited (TGL) sale proceeds known as the TEL investment portfolio (additional detail is provided in section 4.6.4)

The following are approved financial investments:

- Government investments (treasury bills, government stock)
- New Zealand Registered bank investments (call and term deposits, registered certificates of deposit), subject to Counterparty Exposure Limits (section 4.6.3).
- Local authority investments subject to Counterparty Exposure Limits (section 4.6.3).
- SOE investments subject to Counterparty Exposure Limits (section 4.6.3).
- Corporate investments (corporate bonds, promissory notes) subject to Counterparty Exposure Limits (section 4.6.3).

4.6.1 Acquisition/Disposition and Revenue

Interest income from financial investments is credited to general funds or special reserves and is included in the Statement of Financial Performance.

Proceeds from the disposition of financial investments are used for operational and capital expenditure purposes or for the purpose for which they have been established, as approved in the Annual Plan or LTCCP.

4.6.2 Management Procedures

Financial investment strategy is set by the TMG and implemented by the Group Manager - Finance and Corporate Services with day to day management centrally through its accounting function.

The accounting function is broadly charged with the following responsibilities:

- Assist the TMG in developing its investment strategy by reviewing on a regular basis, cash flow forecasts incorporating plans for approved expenditure and strategic initiatives, evaluating the outlook for interest rates and the shape of the yield curve, and where applicable, seeking appropriate financial advice.
- Develop and maintain professional relationships with the financial markets in general and Council's main relationship bank in particular.
- Manage Council's investments within its strategic objectives and ensure that surplus cash is invested in liquid and creditworthy instruments.
- Manage the impact of market risks such as interest rate risk and liquidity on Council's investments and currency risk on investments by undertaking appropriate hedging activity in the financial markets.
- Minimise adverse interest rate related increases on ratepayer charges and maintain overall revenues within budgeted parameters.
- Manage the overall cash and liquidity position of Council's operations.
- Provide timely and accurate reporting of treasury activity and performance for management and the Council.

4.6.3 Investment Risk

Credit Risk - Counterparty Exposure Limits:

Council's primary objective when investing is the protection of its capital. Accordingly, only creditworthy counterparties are acceptable. Creditworthy counterparties are selected on the basis of their Standard and Poor's (S&P) rating except for unrated Local Authorities secured by charge over rates, which are governed by individual counterparty limits.

More specifically, Council minimises its credit exposure by:

- Ensuring all investment, cash management, interest rate risk management and any foreign exchange transactions are undertaken with entities (excluding Government) that have a Standard and Poor's (S&P) credit rating, of at least A2 for short term and A- for long term except for unrated Local Authorities secured by charge over rates, which are governed by individual counterparty limits and SOE's which must have minimum credit ratings of A2 and BBB respectively.
- Limiting total exposure to prescribed amounts and portfolio limits.
- Rigorous monitoring of compliance against set limits.

Council approval is required to add to or delete from the counterparty exposure limits. The following table summarises credit requirements and limits:

Institution	Minimum S&P Short Term Credit Rating⁴	Minimum S&P Long Term Credit Rating⁵	Total Exposure Limit for each counterparty	Portfolio Limit (% of Total Portfolio)
Government	n/a	n/a	Unlimited	100%
New Zealand Registered Banks				
• On balance sheet exposures	A2	A-	\$35 million	80%
• Off balance sheet exposures	A2	A-	\$10 million	N/A
Strongly Rated Corporates, SOEs (on balance sheet exposures only), Local Authorities with rates as security (on balance sheet exposures only)	A2 (n/a for Local Authorities)	A- (BBB for SOE's, n/a for Local Authorities)	\$5 million [Face Value]	50%

If any counterparty's credit rating falls below the minimum specified in the above table then all practical steps are taken to reduce the credit exposure to that counterparty to zero as soon as possible or in any case within three months of the downgrade being notified. Exposures to each counterparty are computed as follows:

On-Balance Sheet:

- Total principal invested with that counterparty.
- International Equities currency exposure on foreign currency hedging converted on the day at the spot rate.

Off-Balance Sheet:

Credit exposure on interest rate contracts computed by multiplying face value of outstanding transactions by an interest rate movement factor of 5%, per calendar year or part thereof of the life of the instrument.

Interest Rate Risk:

Interest rate risk refers to the impact that movements in interest rates can have on Council's cash flows. Council's financial investments give rise to direct exposure to interest rate movements. Interest rate risk is managed by Council as part of its overall investment strategy.

4 Short term refers to securities with a remaining maturity of 12 months or less

5 Long term refers to securities with a remaining maturity of more than 12 months

The following interest rate risk management instruments are approved by Council:

- Interest Rate Swaps
- Forward Rate Agreements
- Interest Rate Options on approved underlying instruments, e.g. on Interest Rate Swaps or bonds.
- Interest Rate Collar Strategy, but only where the ratio of the face value and interest rate exposure on bought to sold legs is 1:1.

Council does not enter into incidental arrangements within or outside New Zealand in currency other than New Zealand currency.

Liquidity Risk:

Liquidity risk management refers to the timely availability of funds to Council when needed, without incurring penalty costs.

Because of Council's credit rating criteria, all investments would be readily saleable in the secondary market, which addresses Council's liquidity requirements, even though there may be a pricing risk if there was a forced sale in adverse market conditions. Nevertheless, at least 25% of financial investments (excluding investments within the TEL investment portfolio) must mature within the ensuing twelve months.

The average duration⁶ of the total investment portfolio would normally be between 2 and 3 years.

4.6.4 TEL Investment Portfolio

The TEL Investment Portfolio is managed in line with a separate Investment Strategy Statement (ISS) for that Fund.

Key elements as set out in that ISS are:

Objective

The key objective in the management of the TEL Fund is to generate a stream of revenue that will be utilised to reduce the rating requirement in the TKMP rating areas while still maintaining the 30 June 2005 capital value of the fund on an inflation-protected basis. In regard to the inflation-proofing aspect of this objective it should be noted that the ability to achieve this is dependent on the level of rates subsidy demanded by Council and the level of investment risk that is to be accepted.

Performance Expectations

In general, the Council would like the Portfolio to earn at least a return of 9.5% (nominal and before fees) on average over 5 years. The targeted return ranges between 100 and 200 basis points higher than the 90 day bill rate. It is understood an average return of 9.5% will require targeted market risk exposure to: (1) retain principal value; and, (2) purchasing power; (3) adequately contribute to the annual cash flow distributions as required. Furthermore, the objective is to inflation proof the fund.

⁶ Duration is a mathematically calculated term representing the average of the time weighted cash flows of the investment, discounted at current yields

Mix of Investments

The Council has established a unique asset allocation strategy taking into account contemplated assets, operating expenses, expected returns, and future distributions.

This asset allocation is as set out below. The ISS allows the percentage allocation to each major asset class (that is Equities, Fixed Interest, Property and Cash) to vary as much as plus or minus 25% (or in the minus aspect such lesser amount as appropriate where the stated allocation is less than 25%) depending upon market conditions. Asset allocation is also subject to potential change in an annual review process.

Asset Classes	Strategic Allocation	
	%	%
International Equities	15	
Large		7.5
Value		3.75
Small		3.75
Australasian Equities	10	
Large		5
Value		2.5
Small		2.5
New Zealand Equities		-
Diversified Fixed Interest	50	
Property	15	
Cash	10	
	100%	

Acquisition of New Investments

Acquisition of investments will be carried out in line with the determined asset allocation and in accordance with Council delegations or specific requirements as set out elsewhere in this Investment Policy.

Management and Reporting of investments and assessment and management of risks

Performance Objectives

The Council acknowledges fluctuating rates of return characterise the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the Council intends to evaluate manager performance from a long-term perspective.

The Council is aware the ongoing review and analysis of the investment managers is just as important as the due diligence implemented during the manager selection process. The performance of the investment managers will be monitored on an ongoing basis and it is at the Council's discretion to take corrective action by replacing a manager if they deem it appropriate at any time.

On a timely basis, but not less than quarterly, the Council will meet to review whether each manager continues to conform to the search criteria outlined in the previous section; specifically:

- 1) The manager's adherence to the portfolio's investment guidelines;
- 2) Material changes in the manager's organization, investment philosophy and/or personnel; and,
- 3) Any legal or other regulatory agency proceedings affecting the manager.

The Council has determined it is in the best interest of the Portfolio's participants that performance objectives be established for each investment manager. Manager performance will be evaluated in terms of an appropriate asset class market index (e.g. the S&P 500 stock index for large-cap U.S. equity manager) and the relevant peer group (e.g. the large-cap growth mutual fund universe for a large-cap growth mutual fund).

A manager may be placed on a Watchlist and a thorough review and analysis of the investment manager may be conducted, when:

- 1) A manager performs below median for their peer group over a 1-, 3- and/or 5-year cumulative period.
- 2) A manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.
- 3) There is a change in the professionals managing the portfolio.
- 4) There is a significant decrease in the product's assets.
- 5) There is an indication the manager is deviating from his/her stated style and/or strategy.
- 6) There is an increase in the product's fees and expenses.
- 7) Any extraordinary event occurs that may interfere with the manager's ability to fulfil their role in the future.

A manager evaluation may include the following steps:

- 1) A letter to the manager asking for an analysis of their underperformance.
- 2) An analysis of recent transactions, holdings and portfolio characteristics to determine the cause for underperformance or to check for a change in style.
- 3) A meeting with the manager, which may be conducted on-site, to gain insight into organisational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager cannot be made by a formula. It is the Council's confidence in the manager's ability to perform in the future that ultimately determines the retention of a manager.

Measuring Costs

The Council will review at least annually all costs associated with the management of the Portfolio's investment program, including:

- 1) Expense ratios of each investment option against the appropriate peer group.
- 2) Custody fees: The holding of the assets, collection of the income and disbursement of payments.
- 3) Whether the manager is demonstrating attention to "best execution" in trading securities.
- 4) Investment Management Entity - cost of management.

Risk Tolerances

The Council recognises and acknowledges some risk must be assumed in order to achieve the long-term investment objectives, and there are uncertainties and complexities associated with contemporary investment markets.

In establishing the risk tolerances for this ISS, the Council's ability to withstand short- and intermediate-term variability were considered. The Council's prospects for the future, current financial condition, and level of funding suggest collectively some interim fluctuations in market value and rates of return may be tolerated in order to achieve confidence in longer-term objectives.

Investment Strategy Review

The Council will review the ISS at least annually to determine whether stated investment objectives are still relevant and the continued feasibility of achieving the same. It is not expected that the ISS will change frequently. In particular, short-term changes in the financial markets should not require adjustments to the ISS.

The current ISS is always available on request.

4.7 Equity Investments

International Equities and New Zealand Equities

Council maintains international equities for the following primary reasons:

- Invest (TEL) investment portfolio
- Diversify the TEL Investment portfolio to enable appropriate returns to be achieved over the long term

4.7.1 Acquisition/Disposition and Revenue

All income earned from international equities, including dividends is recognised in the Statement of Financial Performance and forms part of special funds [TEL]. Any change in the Fund Managers for the equity portion of the TEL portfolio requires Council approval.

Revenue earned from New Zealand equities outside the TEL fund is minimal. All income is recognised in the Statement of Financial Performance and forms part of general funds. Any sale of these investments as well as acquisition of new investments requires Council approval.

4.7.2 Management Reporting and Procedures

The international equities are managed by Fund Managers. Monitoring procedures are in place as set out in the TEL Fund Investment strategy statement.

Annual Reports for the New Zealand equity investments are received and reviewed by Council.

4.8 Council Controlled Organisations (CCO's)

Council has 50% ownership of the joint venture Taupo Airport Authority, with the other 50% owned by the Crown. Council has 100% ownership in Destination Lake Taupo Ltd and Data Capture Systems Ltd. Both of these companies are non-trading. Council may establish or be jointly involved in the establishment of other CCO's in the future.

Council retains ownership of the airport because it is essential for the economic development of the Taupo district and is consistent with Council's Annual Plan and LTCCP.

Council facilitates cost effective external borrowings for the Taupo Airport Authority by way of its standing in the marketplace and recognises that there is a financial benefit to the Airport Authority from this. Council can pass funding to the authority at cost or include a margin to reflect its support. If a margin was applied it would be set by the TMG as a basis point charge over and above the external cost of funds reflecting standalone financing charges and would be reviewed on a regular basis.

From time to time Council may provide direct financing to assist in cash flow management. Any funding in this form that totals over \$100,000 must be approved by Council.

4.8.1 Acquisition/Disposition and Revenue

The airport and any other CCO investment is consolidated into the Council's annual report in line with generally accepted accounting practice. Any surplus generated by the CCO will generally be utilised by the CCO, except in the case that a dividend requirement is set out in the CCO SOI or other such determination. Proceeds from the disposition of any CCO investment will form part of general or special funds.

Additions to or disposal of any CCO investment requires Council approval.

4.8.2 Management Reporting and Procedures

Council is responsible for the management of the airport through its appointment of the Airport Manager who reports to the manager designated by the Council CEO. The Airport Manager reports to the Taupo Airport Authority Committee as required. A half year report and an Annual Report are prepared by Council staff. The authority prepares an annual statement of intent for approval of the joint venture partners.

Similar management reporting and accountability practices are also in place for other CCO interests.

4.8.3 Investment Risk

The primary objective for risk management of the airport is to maintain operational efficiency and safety. This is managed by regular Civil Aviation Authority audits.

4.9 Build, Own, Operate and Transfer (“BOOT”) Arrangements

Council may from time to time enter into BOOT arrangements with external entities. The potential future funding requirements would be recognised in the annual council plan and LTCCP and any actual borrowings that eventuated would be managed within the parameters of this policy document.

4.10 Property Investments

Council’s property investments include:

- crown land vested in Council and Council owned reserve lands
- property owned by Council either for the development needs of the district or for investment purposes (land, buildings, ground leases and motor camps)

Council’s primary objective for crown owned land vested in Council and Council owned reserve land is for the social benefit of the Taupo district.

Council’s primary objective for property owned for development needs or for investment purposes is that it is important for the economic, physical and social development of the Taupo district and secondly, to achieve an acceptable rate of return. Council generally follows a similar assessment criteria in relation to the acquisition of new property investments.

4.10.1 Acquisition/Disposition and Revenue

Prior to acquisition of property for the development needs of the district or for investment purposes the property will be assessed as follows:

- Property for the development needs of the district - a financial and non financial assessment of economic, physical and social benefit to the district, the cost of owning the property and the cost of ownership and assessment.
- Investment property - a financial assessment including a calculation and assessment of the cost of ownership, and the likely returns to be generated from that ownership.
- Proceeds from the disposition of property investments are used for retirement of debt relating to such property, or allocated to general or special funds. All income from property investments is shown in the Statement of Financial Performance and forms part of general funds.

Any acquisition or disposition of property, other than investment property purchased within the asset allocation parameters of the TEL Investment Portfolio (as set out in section 4.6.4 of this policy), requires Council approval.

4.10.2 Management Reporting and Procedures

Council reviews the performance of its property investments on at least a six monthly basis, and ensures that the benefits of continued ownership are consistent with its stated objectives.

4.10.3 Investment Risk

Insurance cover is held for all property investments. A risk assessment is carried out prior to acquisition of a property investment.

4.11 Forestry Investments

Council has a holding of forestry assets which are held as long term investments on the basis of their net positive discounted cash flows. The discounted cash flows take into account projected market prices, annual maintenance and logging costs.

4.11.1 Acquisition/Disposition and Revenue

Proceeds from the disposition of forestry investments are applied firstly to the repayment of forestry encouragement loans raised to fund these assets. Surplus proceeds (after repayments of loans) from the disposition of forestry investments will be allocated to special funds of the rating areas in the proportion of Taupo/Kaingaroa 55.94%, Turangi/Tongariro 23.79% and Mangakino/Pouakani 20.27%.

Any disposition of these investments requires Council approval. Valuations are carried out in accordance with accepted accounting practice.

4.11.2 Management Reporting and Procedures

The forestry assets are managed under contract to Council and are overseen by the manager designated by the Council CEO. An annual Forest Health report is provided by the Forest Managers.

4.11.3 Investment Risk

Professional Forest Managers are engaged to oversee the forests. Insurance cover is held for all forest investments.

4.12 Cash and Working Capital Management

Cash management deals with the net balance in Council's main bank accounts. The accounting function is responsible for managing Council's cash surpluses and/or deficits.

Council maintains a Daily Balancing Report (bank reconciliation) and short term and long term cash flow projections which are updated monthly and which form the basis of its cash management activity. Generally cash management surpluses are available for periods less than 90 days.

Cash management instruments are limited to:

- Call deposits with New Zealand registered banks.
- Corporate Commercial Paper with a maturity less than three months.
- Term deposits (less than three months) with registered banks.
- A target average daily balance of \$0 to \$100,000 is aimed for in the main bank account, with surplus transferred to call deposits.
- The use of interest rate risk management instruments on cash management balances is not permitted.

Cash and the counterparties on cash management instruments may only be invested with approved counterparties within the limits detailed in section 4.6.3.

4.13 Sinking Funds

Council is not required to use specific funding mechanisms and accordingly Council does not establish sinking funds for new borrowing. Established sinking funds are wound down as loans mature or are used to repay existing borrowing at the earliest opportunity.

Remaining sinking funds are managed by the appointed commissioners in a manner consistent with Council's general investment policy. A statement of sinking funds is prepared annually by the Sinking Fund Commissioners.

4.14 Other Investments – Loans and Mortgage Advances

Council has other investments in the form of rural housing loans, Hillary Commission loans and water and wastewater lump sum loans. All existing loans will continue to be held on the same terms and conditions, unless there are obvious financial reasons suggesting a change.

A Council resolution is required to provide funding assistance in the form of water and wastewater loans. Hillary Commission loans are made under the criteria set by the Hillary Commission. Council has no intention of continuing with rural housing loans once existing loans are cleared.

On occasion Council may also approve loans to Trusts or other community based organisations where there is clear social or community benefit to be achieved from the lending. Often such lending might be made at significantly discounted or nil interest rates, again in recognition of the clear social and community benefit that is being provided.

4.15 Delegations

The delegated authority in respect of the Investment policy is as follows:

Council:

- Approve investment policy
- Alter investment policy
- Open/close bank accounts
- Approve interest rate risk management instruments and subsequent additions and deletions
- Approve acquisition and disposition of investments.
- Approve cheque signatories
- Review Investment performance and strategies

Treasury Management Group:

- Review strategies in place and revise as appropriate.
- Recommend alterations to the investment management policy.
- Review performance.
- Overviews management of Councils relationships with financial markets.

Group Manager - Finance and Corporate Services:

- Implement day-to day investment strategies in line with overall strategy developed by TMG.
- Authorise use of Council approved interest rate risk management instruments in line with strategy and treasury policy
- Financial staff
- Execute approved investment, investment interest rate risk management and daily cash management strategies.

4.16 Performance Measurement

The performance of the investing activity will be measured against pre-determined benchmarks:

Financial Investments

- Adherence to policy.
- Comparison of actual monthly and year to date accrued returns vs. investing the entire treasury portfolio at the combined average of the 90 day bill rate and the three year investor swap rate, over the last two years.
- A maturity profile showing the average yield in each maturity band compared against the current market yields.

Equity Investments

- Adherence to policy.
- Comparison of actual return with budgeted return as set out in the TEL Investment strategy statement

Property Investments

For investment property:

- Adherence to policy
- Comparison of actual gross and net income to budgeted gross and net income
- Comparison of actual return to budgeted (and/or market) return (with market return able to be established from such measures as the Property Council's Investment Performance Index)
- Comparison of actual property sales to budgeted property sales
- Comparison of actual property purchases to budgeted property purchases.

Forestry Investments

- Adherence to policy
- Comparison of actual annual cash flows to budgeted projected annual cash flows.

General

- Total return achieved by the TEL Fund compared to investment objectives and Annual Plan target.
- A quarterly review by Council's Investment Advisors of performance of the whole of Council's investment portfolio.
- Comparison of actual financial ratios to budgeted financial ratios as per the Annual Plan and LTCCP

4.17 Reporting

Reporting to Council

- 3-Yearly review of Investment Management Policy
- Annual Statement of Intent (for CCO's).
- Monthly Treasury Report including commentary where significant changes in investment strategy are being entered.
- Annual Audit on investing activity
- Annual Report (for Council and CCO's).

Reporting to the Group Manager - Finance and Corporate Services

- Monthly Fund managers report
- Daily balancing report (bank reconciliation)

4.18 Review

Investment Policy

- 3-Yearly review.
- Quarterly review by investment advisors of whole portfolio performance.

Investment Advisors

Annual review

Glossary

Approved Risk Management Instruments

- Forward rate agreements ("FRA").
- Interest rate swap ("IRS").
- Interest rate option, interest rate collar.

Examples of the use of Derivative Products

Forward Rate Agreement

An agreement between Council and counterparty (usually a bank) protecting Council against a future adverse interest rate movement. Council and the counterparty agree to a notional future principal amount, the future interest rate, the date and the benchmark rate, which is contained on the Reuters system.

Objective

To provide Council with certainty as to its interest rate cost on an agreed principal amount for an agreed period. A Forward Rate Agreement (FRA) typically applies to a 3-month period, starting at some point within the next 12 months.

Example

Council wishes to provide certainty on a portion of its floating rate borrowings over the event risk posed by an expected change in monetary policy at a point in the future. A borrower's FRA is purchased in say, March, at 6.00% for protection through the June to September period. It is described as a 3X6 FRA, i.e. the rate applies to a borrowing for 3 months starting in 3 months time.

Outcome

If on the rate set date in June, the 3-month interest rate has climbed to, say, 8.00%, Council receives the difference between this and the FRA rate of 6.00%. It then borrows at 8.00%; the payment received making the effective borrowing rate 6.00%, plus its margin.

Interest Rate Swap

An interest rate swap is an agreement between Council and a counterparty (usually a bank) protecting Council against a future adverse interest rate movement. Council pays (or receives) a fixed interest rate and receives (or pays) a floating interest rate. The parties agree to a notional principal amount, the future interest rate, the settlement dates and the benchmark floating rate, which is usually off the Reuters page containing the daily rate sets for BKBM (bank bill reference rates).

Objective

To provide Council with certainty as to its interest rate cost on an agreed principal amount for an agreed period. Floating rate sets are typically every 3 or 6 months over the life of the swap.

Example

Council fixes its interest rate for 3 years at 6.50%, on a quarterly basis on a portion of its planned borrowings by entering into a 3 year 6.50% fixed rate swap. The floating rate reference is 3 month BKBM.

Outcome

On a swap-reset date, the 3 month bank bill rate is at, say 4.75%. Council borrows from its bank the principal, for 3 months at 4.75% plus Council's margin. At the same time the bank pays Council 4.75% on the principal amount for a 3 month period. Council then pays the bank 6.50% on the principal amount for a 3 month period. This means that Council's effective interest rate is 6.50% plus its margin. In practice cashflows would be netted off if the swap and the underlying borrowing facility were with the same bank.

Interest Rate Collar

The combined purchase (or sale) of a cap or a floor with the sale (or purchase) of another floor or cap. Unlike an outright option purchase there is no premium payable but conversely participation in favourable movements is limited.

Objective

To provide Council with certainty as to its interest rate cost on an agreed principal amount for an agreed period, but at the same time avoid the need to pay an up front premium.

Example

Council wishes to secure a worst case borrowing rate of 7.50% for the next 5 years, but wishes to avoid paying a premium. In exchange for the worst case protection at 7.50%, Council accepts a best case outcome at 6.00%. In this structure Council has bought and sold options, with the respective option premiums offsetting each other. On each quarterly rate set date Council will have a rate between 6.00% and 7.50%, the parameters of the collar.

Outcome

If on each rate set date the 3-month interest rate is in excess of 7.50% Council exercises its option and pays 7.50%, for that 3-month period, its worst case rate. If on each rate set date the 3-month interest rate is below 6.00%, the bank exercises its option on Council and Council pays 6.00%, Council's best case rate. If on any rate set date the 3-month interest rate is between 6.00% and 7.50%, Council borrows at the market rate.

