Research Update

L-T Rating On New Zealand's Christchurch City Council Lowered To 'AA-', S-T Rating Affirmed, Outlook Negative

- We have lowered the long-term ratings on Christchurch City Council and the council's subsidiary Christchurch City Holdings by one notch to 'AA-', from 'AA'. The outlook remains negative. The short-term ratings were affirmed at 'A-1+'.
- The ratings on Christchurch City Council reflect the strong institutional framework supporting the New Zealand local government sector along with the council's good liquidity position.
- However, the council's financial management--while still positive--is increasingly being affected by a difficult environment stemming from a prolonged recovery period.
- In addition, the council has significant capital expenditure responsibilities from earthquake repairs and infrastructure reconstruction, which is affecting budgetary flexibility and performance, and increasing the debt burden. Contingent liabilities continue to weigh on the rating.
- The negative outlook reflects ongoing uncertainty regarding the cost of the city's reconstruction to the council, which could result in debt peaking above our expectations.

Overview

On Dec. 19, 2012, Standard & Poor's Ratings Services lowered its long-term credit ratings on New Zealand's Christchurch City Council (CCC) and the council's wholly owned subsidiary Christchurch City Holdings to 'AA-' from 'AA'. The short-term ratings on both entities were affirmed at 'A-1+' and the outlooks remain negative.

Rationale

The downgrade reflects our view that the council's financial management--while still positive--is facing significant challenges and is increasingly being affected by a difficult environment stemming from a prolonged recovery period following the earthquakes in 2010 and 2011. Although we consider that CCC's financial strategy is prudent, the degree of control over the reconstruction held by the Crown, rather than by CCC, in our view reduces the council's political and managerial strength.

Significant repair and reconstruction costs have affected the council financially. We consider CCC's budgetary flexibility and performance to be weak, with capital expenditure expected to rise to about 40% of total expenditure as the reconstruction gains pace, and will remain elevated in the medium term. CCC's modifiable revenues are around 35% of total consolidated revenues.

Budgetary performance is also weak, with revenues dampened by the earthquake-related impacts reducing the rateable base while increasing expenses, as well as significantly increasing CCC's capital-expenditure program. CCC's operating balance was weak in fiscal years ended June 30, 2011 and 2012, but performance is expected to improve as elevated earthquake-related operating expenditure eases. We expect CCC's operating balance to average in excess of 5% for 2011-2015. Primarily funded through debt and deferrals, CCC's large capital program and its currently weak operating performance result in a large deficit after capital expenditure, of about 15%. We anticipate that CCC's operating performance will improve as revenues increase and recovery costs ease. However, we forecast that CCC's deficit after capital expenditure will remain high over the medium term given the duration of the reconstruction program, which is anticipated to take more than five years.

CCC has implemented some special rates levies to raise council revenues and fund the reconstruction over time; in the interim, a significant amount of capital expenditure is being debt-funded, increasing CCC's debt burden to more than 180% of revenues. We anticipate that debt will remain below this level, however. Our base case anticipates that CCC will not fully achieve its capital-expenditure program as scheduled--given its large size--of around NZ$1 billion per year over the coming four years. We expect that interest costs will rise to be in excess of 5% of revenues as CCC's debt levels rise, but that interest will remain less than 9% in the medium term.

Contingent liabilities continue to weigh on the CCC rating. Insurance cover remains difficult to source, and further damaging seismic activity could have a significant financial impact on CCC. Litigation risk has also heightened, although we do not currently consider it likely that litigation will result in significant financial impact on CCC within the rating horizon.

The ratings on CCC reflect our view of the strong institutional framework supporting local government creditworthiness in New Zealand, combined with the provision of support specific to CCC as the city rebuilds. The ratings are also supported by the strong institutional settings in New Zealand, and its good liquidity position.

We consider the institutional framework supporting the local government sector in New Zealand to be stable and predictable, and regard it to be one of the strongest in the world. The system also promotes a strong management culture and fiscal discipline among New Zealand councils. CCC is receiving significant financial support from the New Zealand Crown to rebuild the city following the earthquake events. After insurance recoveries and Crown support, CCC anticipates it will fund around one-third of its reconstruction costs.

Christchurch is New Zealand's second-largest city, with a population of about 375,000, and is considered the gateway to the South Island. The region accounts for about 10% of national GDP, and it is estimated that the earthquakes negatively affected national GDP by 1.5 percentage points. Recent strong growth in the local economy--estimated to be 1%-3% per month--as the reconstruction gains traction, has resulted in the economy expanding more quickly than the national economy. In addition, the area's economic growth has recently recovered to be about the same level as that at September 2010. The population is estimated to have declined by around 8%, with some indicators showing that the pace of the fall has stabilized. In our opinion, Christchurch's longer term economic prospects are currently constrained by the significant work still needed to repair its infrastructure.

Liquidity

We consider CCC's liquidity position as a positive and supports the rating. CCC retains a good stock of cash and high-quality liquid assets on its balance sheet, as well as a large number of committed bank facilities. CCC's liquidity coverage ratio--cash, haircut liquid assets, and committed bank facilities as a percentage of 12-months' debt maturities and debt service--was 284% at June 30, 2012.

Outlook

The negative outlook reflects our view that there is at least a one-in-three chance of a further downgrade for CCC in the coming two years. We consider that the most likely rating driver for negative rating action is from a rising debt burden--such as if total tax-supported debt was expected to exceed 180% of revenues and/or interest to exceed 9% of revenues. CCC's debt levels could increase more than anticipated due to an escalation in CCC's share of reconstruction costs above our expectations. This could occur from a shortfall in insurance recoveries, project cost escalation that CCC was required to fund, or further earthquake activity causing greater damage to council infrastructure.

The outlook could be revised to stable when we consider there is greater certainty concerning the likely peak of CCC's debt levels. This would likely stem from greater clarity on the anticipated total cost of the reconstruction to CCC. Greater confidence that seismic risk had eased would also provide certainty on potential costs.

Due to the strength of the institutional framework, we do not currently consider that there is a high probability of the long-term rating falling to lower than 'A+'.

Related Criteria And Research

- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010
- Rating Government-Related Entities: Methodology And Assumptions, Dec 9, 2010