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Report to the Policy and Finance Committee
from Greg Schollum, Chief Financial Officer

WRC Debt Buy Back

1. Purpose

To advise the Committee of the Port Company's decision in relation to convertible notes and to seek approval to buy back a parcel of WRC debt.

2. Exclusion of the Public

Grounds for the exclusion of the public under Section 48(1) of the Local Government Official Information Act 1987 are:

That the public conduct of the whole or relevant part of the meeting would be likely to result in a disclosure of information for which good reasons for withholding exists, ie to carry on commercial activities.

3. Background

At the Policy and Finance Committee Meeting on 18 May 1999, the Committee considered Report PE99.233 in relation to Port Wellington Convertible Notes.

I indicated in that report that a good outcome for the Council would be one which saw:

- The $10m worth of convertible notes convert into additional share capital in Port Wellington (WRC's $77% share approximately $7.7m).
- The Port Company pay out to shareholders a special dividend, fully imputed, of not less than $7.5m (WRC's 77% share approximately $5.8m).

- The Port Company increase its dividend payout percentage from 50% to 60% of net profit after tax.

I indicated in report PE99.233 that receipt of a special dividend of $5.8m within the WRC Holdings group would enable the Council to repay external debt (as is Council policy for such receipts).

4. Port Wellington's Decision in respect of Convertible Notes

The Directors of Port Wellington have responded positively to our preferred outcome and have agreed to convert the convertible notes into additional share capital and pay a fully imputed dividend totalling $7.5m on 28 June 1999 to shareholders (WRC's share $5.8m approximately).

In respect of the ongoing dividend percentage, I understand that the Directors of Port Wellington have agreed to increase the dividend payout percentage from 50% to 60% in respect of 1999/2000, but wish to revisit the percentage as part of the annual SCI process in future.

This is satisfactory from our point of view but does mean that it may not be prudent to budget beyond 1 year on the basis of 60%. It nevertheless provides an increased projected dividend flow for the 1999/2000 year into the WRC Holdings Group, which should offset the impact of the loss of interest income from convertible notes.

The impact on Council's rate line of the conversion of convertible notes and payment of a special dividend, and the increased Port Wellington dividend percentage from 50% to 60% is discussed further in Report 99.328.

5. Use of the Proceeds of the Special Dividend to be Received by Port Investments Limited

From a Treasury management perspective the Council manages its cashflows and borrowing requirements with the outside world on a group basis (ie Council and its 100% owned subsidiaries).

As a result, the Council's Treasury function intends to utilise the proceeds of the $5.8m special dividend due to be received by Port Investments Limited (PIL) to repay Council debt. This is irrespective of whether or not PIL itself declares a special dividend up the chain, as is the intention (ie the $5.8m proceeds will either be passed on by way of special dividend from Port Investments Limited to Council, or on lent to Council. Either way the cash will be transferred to Council to be utilised by Treasury in the most effective manner). As noted in Report 99.328 on the Finalisation of the 1999/2000 Annual Plan, the payment of the special dividend up the chain is subject to meeting the solvency test. This is likely to delay the payment of the special dividend from PIL to WRC Holdings and onto Council until the 1999/2000 financial year.

The Council's policy with respect to unbudgeted receipts such as capital repayments and asset sales is to use the proceeds to repay Council debt. Normally this is achieved by Council's Treasury investing the unbudgeted proceeds until the next maturity of Council debt (and then simply not replacing the debt when it matures).

However, in this case I am proposing that the Council use approximately $3m of the $5.8m to buy back (before normal maturity date) some high yielding Council debt as follows:

Face Value	Current Holder	Maturity Date	Interest Rate	Approximate Buy Back Price(1)
$2,000,000	National Mutual Funds Management	2004	16% pa	$2,930,000

(1)

- Will vary depending on interest rates on the day that the transaction is finalised.
- Includes approximately $130,000 of accrued interest which would have been payable irrespective of the buy back (ie effective premium to buy back debt early = $800,000 approximately).

The buy back price therefore comprises:

Face value of debt	$2,000,000
Accrued interest	$ 130,000
Premium	$ 800,000(1)
	$2,930,000

(1) The majority of the premium ($770,000) relates to a net present value calculation with the remaining $30,000 representing the incentive for National Mutual to sell.

6. What are the Costs/Benefits of the Buy Back?

The costs and benefits of Council using some of the cash from the Port special dividend to buy back debt are as follows:

Benefits:

- Using the proceeds in this way is entirely consistent with Council's policy, but also reduces the investment risk normally associated with waiting until the next maturity (avoids the negative margin between the borrowing rate and investing rate) to reduce debt

- Allows the Council to unwind approximately \$1.2m of sinking funds which up until now have been unable to be unwound (requires creditor approval which has not been forthcoming in relation to this parcel of debt). This will produce a positive net benefit to the Council over the remaining life of this debt.
- Contributes to a reduced weighted average cost of debt in future years (by removing debt from the portfolio on which Council is currently paying 16% interest brings the weighted average down)

Costs

- Council incurs an accounting "loss" in the year of the buy back. Based on current interest rates, this loss approximates \$800,000. This would reduce Council's operating surplus in 1998/99 if the transaction was undertaken before 30 June 1999.

7. Is it a Good Deal?

The repurchase of debt is not uncommon in the financial markets. As such, the markets have a widely accepted method of calculating the price. Essentially, this is based on the net present value of future cashflows foregone by the party selling back the debt. In this case, National Mutual are proposing to charge us an additional \$30,000 approximately over the net present value to reflect the fact that they are not an over-willing seller.

It is important to keep this in perspective, in that some premium is inevitable in such transactions. Also as noted earlier, the Council will be able to unwind sinking funds of approximately \$1.2m and therefore will benefit from removal of the negative margin on sinking funds by approximately \$36,000 pa (\$1.2m x 3%), for each of the next 5 years.

Therefore in purely financial terms, it is a good deal, but in addition it allows the Council to reduce its weighted average cost of debt in future years (by taking a loss in 1998/99) by approximately 0.20% per annum.

8. How will the Costs/Benefits be Accounted for?

8.1 Council Level

Assuming the transaction is completed before 30 June 1999, the Council would need to recognise the loss of approximately \$800,000 in its 1998/99 financial statements. As \$3m of the \$5.8m special dividend proceeds would be needed to buy back this debt, \$2.8m would be left to invest short-term until further debt matures.

8.2 Department Level

Theoretically all departments with internal debt should receive a charge from Treasury for their share of the $800,000 loss (given they will share in the benefit of lower interest rates in future years) and all departments should also receive a lower interest cost from Treasury with effect from the 1999/2000 year.

However for largely pragmatic reasons, I propose that apart from the water area which is levy funded, all other areas of Council with internal debt should be sheltered from their share of the cost of the buy back and should not receive the benefits of a lower weighted average cost of debt from that budgeted until the 2000/2001 year (ie the first year of the Council's next LTFS). This is on the basis that all other areas are funded through regional rates, which the Treasury activity also contributes towards, and it is preferable, where possible, to provide certainty to departments.

In terms of water, the water area will be charged for its share of the buy back cost and will receive reductions in interest rates with effect from the 1999/2000 year.

With effect from the 2000/2001 year, the impact of the debt buy back on the weighted average cost of debt should be built into all budgets (ie all other things being equal, departments will be able to budget on a lower level of interest charge than 8.75% pa; hopefully closer to 8.5% pa). This revised rate will be set as part of the development of next year's Annual Plan (as part of the LTFS process).

The Divisional Managers with significant internal debt concur that they will not be disadvantaged by what is proposed.

9. Communications

Other than inclusion of the loss in Council's 1999 Annual Report, I do not propose any specific communication initiatives.

10. Recommendations

(1) That the report be received and the contents noted.

(2) That the Committee recommend to Council that it:

(a) authorise the buy back of WRC debt from National Mutual Funds Management with a face value of $2,000,000, a maturity of 2004 and an interest rate of 16%

(b) authorise the Chief Financial Officer to negotiate, approve and agree precise terms and conditions of the debt buy back on the basis that such terms and conditions are not materially different from what is outlined in this report, and to authorise the execution of all documentation giving effect to the debt buy back on behalf of the Council, or to cause such documentation to be executed by the Council under its common seal.

GREG SCHOLLUM
Chief Financial Officer