Auckland Economic Quarterly

Chief Economist Unit

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Funding Auckland's growth

- Rapid growth in Auckland has created demand for a lot more infrastructure.
- New bulk infrastructure worth billions of dollars is required to facilitate growth.
- Traditional options for funding infrastructure don't fit Auckland's situation, so more innovative solutions will need to be implemented to deliver the infrastructure we need.

Auckland is growing rapidly. In the year to June 2017, the city is expected to grow by around 45,000, the third consecutive year of this level of growth. That is equivalent to adding a Tauranga to Auckland in three years.

It is fantastic that our city is a place where people want to live, but it also creates challenges. Infrastructure – roads, stormwater, wastewater and fresh water supply for instance – is under pressure from the demand of this burgeoning population.

What new infrastructure costs

Infrastructure is expensive. Even using relatively modest growth projections, the cost of capacity and service upgrades needed to service additional dwellings in brownfields sites (i.e. in existing urban areas) will run into billions of dollars over the next 30 years. And council estimates that the bulk infrastructure needed for greenfields areas will cost around $19 billion, 90% of which has not yet been funded.

How do we fund this infrastructure? There are several ways to boost revenues or increase cash on hand, but the number of implementable options is not as large as many believe, and several options carry significant trade-offs.

Not an option: substantially increasing council debt

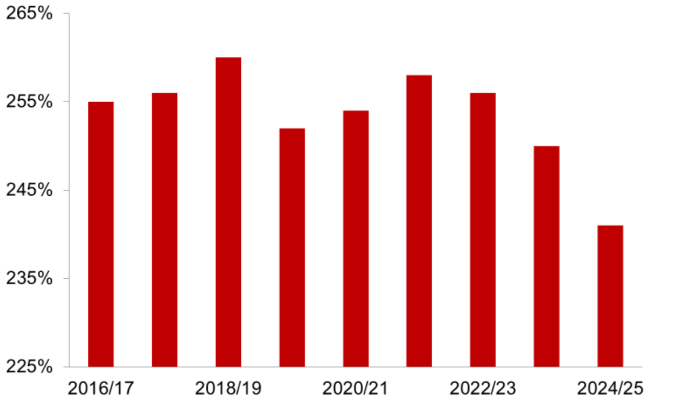
Some people ask: *why doesn't council just borrow more?*

Council forecasts that by 2019, net debt will reach around 260% of annual revenues. A ratio of 270% would likely trigger a review of council's AA credit rating and potentially a downgrade by credit ratings agencies.

This type of downgrade would result in higher borrowing rates, and could erode confidence among lenders, making them less willing to lend in future.

And if council were to be downgraded, it could trigger a credit downgrade for the Local Government Funding Agency (LGFA), and increase their borrowing costs and the borrowing costs for the whole local government sector because Auckland's borrowing via the LGFA is significant in relation to total LGFA borrowing.

Debt to revenue ratio* forecasts, Auckland Council Group



* According to Standard and Poors definition, estimated by Auckland Council

Other options suggested as solutions may have similar implications. Examples include public-private partnerships (PPPs) with local government and targeted infrastructure rates. Both these options result in a rise in council debt, as they result in an increase in future outgoings (annual management fees or upfront costs, respectively) that council will need to fund. That is simply not an option at the scale that would be needed to meet the infrastructure need.

Technically possible, but with big trade-offs

There are other options that are possible, but are unattractive. One of these is to increase general rates. Much bigger rate rises would be required to meet the infrastructure shortfall. But the mayor has committed to keeping overall rates increases lower after several years of sharp increases in Auckland.

The city could also sell non-strategic assets, particularly those that occupy substantial land that may be under-utilised. Selling this land for housing could achieve the double goal of increasing housing supply and providing funds for other infrastructure. Opinions on this are mixed.

In terms of strategic assets like the council's share of Auckland International Airport, if a change to ownership were ever to be proposed, it would require an amendment to the Long Term Plan and would therefore be subject to public consultation.

New ways to fund infrastructure

The limitations of the more traditional approaches to funding growth mean we're going to have to be more innovative in delivering infrastructure.

There are a couple of mechanisms to consider.

First, central government or the private sector could fund new development, including bulk infrastructure, through a special purpose vehicle (SPV). The current Urban Development Authority (UDA) proposal is one such example. Council has some reservations about the current form of the UDA proposal, but an SPV that accesses private and/or central government money for building local and connecting bulk infrastructure could overcome the current funding shortfall. The costs of that infrastructure could be recouped by the SPV through either development contributions, or though targeted rates on that developed land.

A second mechanism would be to be more sophisticated in capturing value uplift. Council policies and infrastructure investments can provide hundreds of thousands of dollars in value uplift for property owners, the recent Unitary Plan being one such example. Council is exploring ways in which it can access some of the windfall gains to property owners in future to pay for the infrastructure required. As soon as council or central government announces its intention to build a new transport link, or rezone an area, values are affected, so a mechanism needs to be in place before major announcements are made to ensure the benefits from the policy accrue to private individuals as well as the Council, which has to fund the infrastructure to deliver the levels of service residents expect.

Using infrastructure more efficiently

One way to delay or even eliminate the need for some new infrastructure is to manage demand rather than boost funding; it's more about optimising use of existing infrastructure (especially roading) so we don't need to build new infrastructure as quickly. One way to do this is to introduce demand pricing for road use, for example. Work is underway between central and local government to explore pricing of the road network to better manage demand and improve congestion outcomes.

Where does this leave us?

Growing council debt and massively increasing the burden on ratepayers are not realistic options. Instead, a number of innovative tools would likely need to be used in concert to achieve the best outcome, to maintain council's credit rating, and to minimise additional costs to ratepayers.

Auckland Economic Commentary

Auckland's population is continuing to grow strongly on the back of robust net migration – 35,800 for the year to March 2017 – almost exactly half the New Zealand figure of 71,900 over the same period.

As we said in the last Quarterly, population increases help fuel economic activity through demand for goods and services. Auckland's GDP grew at 4.4% for the year ended December 2016. Construction, tourism and the retail industry were the big drivers of economic growth.

The seasonally adjusted value of non-residential building work put in place was up 42% for the year ended December 2016. The corresponding number for residential work was 31% higher in December 2016 than a year ago. We expect commercial, accommodation and infrastructure building work to drive the construction sector in the coming months although NZIER's Quarterly Survey of Business Opinion (QSBO) reports an easing of the pipeline of Government building work.

The tourism sector has been a strong performer in terms of GDP growth, but the annual number of guest nights in March 2017 was lower than in December 2016. The figure was still 3.2% higher in the March year than a year ago. The growth was driven by international guests while domestic guest nights actually fell marginally over the last 12 months. Some have suggested that domestic tourists are being priced out of major tourist centres like Auckland and Queenstown.

Commercial vehicle registrations, a sign of business confidence looking forward, were 13% higher for the year ended December 2016, continuing a strong run. Retail sales continued to grow strongly, at 7.0% for the year to March, and we expect them to remain strong given the population increase that Auckland is likely to see in the near future.

Employment

Auckland's job market was almost unchanged this quarter, but it added 60,000 jobs for the year to March 2017. There was a slight reduction in the overall labour force participation rate this quarter, which meant that although the quarterly number of people in employment remained almost unchanged, the unemployment rate was slightly lower at 5%. We would caution, however, that regional level employment data does tend to bounce around a little from quarter to quarter.

The QSBO reported that it had become harder to find both skilled and unskilled workers in the March quarter compared to December.

This might now be reflected in the rate of wage growth, which is beginning to rise. As the unemployment rate falls or remains low, pressure tends to be placed on wage rates.

Housing and residential construction

The REINZ median Auckland house price rebounded strongly to reach its highest ever point at $905,000 in March 2017, 8.4% higher than a year earlier, and reversing the downward trend since reaching a peak in October 2016. But March is always a strong month, just as January is always weak, so it is worth looking at the seasonally-adjusted numbers. These show that prices in March were around the same as at the October peak.

However, annual house sales are 12% lower than a year ago, suggesting there is room for some price correction. Typically, a slow-down in sales is followed by sellers becoming more realistic on pricing. Still, as we pointed out in our recent Insights paper, with the RBNZ forecasting that it will keep the OCR at 1.75 percent until 2019, mortgage rates are likely to only increase on the back of bank funding costs over the next 12 months. With population growth remaining strong, and a shortfall of around 40,000 dwellings and growing, we would not expect a price correction of more than a few percentage points without a major shock to the economy, even if mortgage rates tick up a little.

The effect of the latest round of LVR restrictions on investors appears to have been to shift investor activity from those who need to borrow, to those who have the cash to buy. RBNZ data shows that new mortgage lending to investors in Auckland has fallen to 26% of total lending, steadily declining from 37% July 2016, when the LVR restrictions were implemented in spirit by banks. However, investors have been more active than ever. CoreLogic data shows that 44% of Auckland properties were purchased by investors over the first three months of the year.

New residential dwelling consents showed an encouraging increase in March after several lukewarm months. However, the annual consents figure gives us a better picture due to the lumpiness of multi-unit consenting and some seasonality in the data. Annual new dwelling consents were 10,200 for March 2017. Given that Auckland's population growth is likely to be around 45,000 on an annual basis, even assuming all of the consents are converted into dwellings, we are not keeping up with the growth in demand for housing.

The consent figures are displaying a shift away from detached houses towards apartments, townhouses and units. Attached dwellings made up half of all dwelling consents over the last six months compared to just a third of them over the corresponding six month period three years ago.

This could be an indication that as the city intensifies, higher land prices are making multi-unit development more profitable for developers. It will likely have the concurrent consequence of delivering more affordably priced multi-unit housing to the market.

Business confidence

Business confidence fell in the March quarter, with a net 4.5% of businesses feeling positive about general business conditions compared to 24% in the previous quarter according to the QSBO. Businesses still intend to increase headcount, but only a net 9% are looking to hire.

The survey indicated a lower overall level of confidence in economic conditions than last quarter. With construction activity elevated but appearing to plateau, and tourism growth slowing a little, this indicates that we may be in for a slightly slower pace of economic growth than the stellar rate we have seen in the recent past.

Indicator	Latest	Last quarter	12 months ago	5-year average	Rest of NZ latest
Employment indicators					
Annual employment growth (%pa)	7.3%	7.6%	2.9%	3.9%	4.9%
Unemployment rate (%)	5.0%	5.1%	6.1%	5.9%	5.3%
Unemployment rate among 20 to 24 year olds (%)	9.7%	9.0%	10.0%	10.6%	8.6%
Unemployment rate among 15 to 19 year olds (%)	25.6%	19.4%	23.8%	23.7%	18.8%
Earning and affordability indicators					
Annual nominal wage growth (%pa)	1.8%	0.7%	2.1%	2.2%	2.3%
Annual geometric mean rent growth (%pa)*	3.3%	5.1%	5.1%	4.4%	4.8%
Geometric mean rent to median household income ratio (%)*	29.1%	29.3%	29.6%	29.4%	26.1%
Annual median house price growth (%pa)*	8.4%	10.7%	14.4%	12.6%	9.6%
Mortgage serviceability ratio (relative to Dec-06)	-11.4%	-5.7%	-7.3%	3.6%	*NA*
Construction					
Annual new residential building consents growth (%pa)	6.6%	8.4%	20.5%	20.7%	12.1%
Annual m2 non-residential building consent growth (%pa)	36.2%	26.8%	18.9%	13.7%	8.3%
International connections					
Annual guest night growth (%pa)	3.2%	4.4%	1.7%	3.2%	3.2%
Annual net migration	35,772	33,916	31,230	22,381	36,160
Confidence					
Annual retail sales growth (%pa)	7.0%	8.0%	8.1%	6.3%	4.4%
Quarterly Survey of Business Opinion (net optimists)	4.5%	23.9%	10.1%	27.1%	23.1%
Westpac Consumer Confidence*	115.1	111.8	116.6	116.2	111.9

*Sources: Chief Economist Unit, Auckland Council; Statistics New Zealand; Ministry of Business Innovation and Employment; Real Estate Institute of New Zealand; New Zealand Institute of Economic Research; Westpac; Reserve Bank of New Zealand. * Rest of New Zealand figures are for all of New Zealand including Auckland. Data is not seasonally-adjusted.*

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