Three waters reforms: detailed financial information
Hutt City Council | March 2022

Section one: setting the local scene

Wellington Water Limited

Wellington Water Ltd (WWL) fully manages three waters assets for Hutt City Council. It provides high-quality, safe and environmentally sustainable services to Council with a focus on contracted service delivery for the operation, maintenance and ongoing development of drinking water, stormwater and wastewater assets and services, and asset management planning.

WWL operates on a non-profit basis. It represents an efficient and effective way to manage the three waters networks through a pool of expert staff and resources available to the region. Shareholding councils of WWL are Hutt City, Wellington, Porirua, Upper Hutt City Councils and South Wairarapa District Council. WWL also manages the bulk water supply assets for the Greater Wellington Regional Council.

Challenges we are facing

There is a need for significant additional investment in our water infrastructure as a result of a considerable period of underinvestment, combined with our growing population and climate change. Sixty per cent of our water infrastructure needs to be replaced over the next three decades.

As part of our 10-Year Plan we increased funding to enable a major programme of infrastructure investment to service existing and future residents.

Our financial context

The value of the three water assets held on our balance sheet as at 30 June 2021 was $0.5B. Total revenue across the three waters activities in 2021/22 is projected to be $61.7M. This is made up of $47.9M rates funding and $13.8M in other revenue, which includes user charges, government grants and development contributions. Total operating expenditure is projected to be $61M in 2021/22.

Hutt City’s three waters network is ageing. Sixty percent of the three waters assets need to be replaced over the next 30 years at an estimated cost of over $2B. Historically, investment in three water asset renewals has been relatively low and has resulted in a backlog of works estimated to be in the order of $250M.The increasing rate of water leaks over the past few years is one indication of the deterioration of the network.

Asset management

Infrastructure deteriotes as it ages, increasing the likelihood of failures and disrupting services to customers. These failures also increase maintenance, operations and customer service costs. We received advice as part of the preparation of our 10-Year Plan on our three waters assets based on the current information available from Wellington Water Ltd (WWL). This advice included the need for additional investment in understanding the condition of our underground assets.

The investment over the next 30 years included in the plan is expected to reduce the backlog of investment as well addressing future renewals needs.

Our three water assets

In the preparation of our Long Term Plan 2021-2031, we updated our 30 year Infrastructure Strategy. Table 1 (following page) summarises the three waters assets and includes information on their overall age and condition.

Infrastructure Category	Total Length	Estimated Value[1]	Key components	Levels of service	Condition and lifespan[2]
Water supply	711 km (pipes)	Depreciated Replacement Cost: $110M Replacement Cost: $275M	• reservoirs • water mains • pump stations	• safety of drinking water • maintenance of the network • fault response times • customer satisfaction • demand management	The average lifespan of our pipe network is 70–75 years. Based on age data, there is currently a backlog of life-expired pipes of approximately 27 per cent. This backlog of renewals would continue to increase without the investment agreed by Council.
Wastewater	680km (pipes)	Depreciated Replacement Cost: $231M [3] Replacement Cost: $532M Waste water treatment replacement cost: $81M	• treatment plant • sewage trunk mains • pump stations • storage tanks, and • outfall pipeline	• dry weather overflows • discharge compliance • fault response times • customer satisfaction	The average lifespan of our pipe network is 80 years. Based on age data, there is a current backlog of life expired pipes of approximately 14 per cent. This backlog of renewals would continue to increase without the investment agreed by Council.
Stormwater	454km (pipes)	Depreciated Replacement Cost: $190M Replacement Cost: $374M	• stormwater mains • pump stations	• system adequacy • discharge compliance • response times • customer satisfaction	The lifespan of stormwater assets varies between types of asset. For example, minor culverts have an estimated average life of 100 years, while major culverts generally last 80 years. The pipe renewals backlog is currently estimated at approximately 3 per cent, with nearly 30 per cent expected to need replacing (due to age) over the next 30 years. Replacement and upgrading of the network are mostly driven by the need to increase capacity to reduce the impacts of flooding etc, rather than purely because of age or condition, which drives the renewal of water supply and wastewater pipes, which tend to deliver the same levels of service.

[1] Estimated value include Depreciated Replacement Cost (which is the estimate of the current market value of assets as at May 2020, defined as the current cost of reproduction or replacement of an asset less deductions for physical deterioration and all relevant forms of obsolescence and optimization) and Replacement Cost (which is the insured value of the assets, except for roads and footpath, obtained in November 2020.) Wastewater includes approximately $40m owned by Upper Hutt City Council. The figures exclude value of land under roads.

[2] Details of assets' condition and lifespan are provided in Asset Management Plans.

[3] This figure excludes $1.8M for building assets at the Wastewater Treatment Plant

Capital investment included in the 10-Year Plan 2021-2031
The 10-Year Plan 2021-2031 confirmed a significant investment in three waters infrastructure of $587M over the ten year period of the plan. The investment is needed to avoid asset failures and disruption of services to customers, improve environmental outcomes, and plan for growth. This capital investment includes:

- Increased funding of $331M for asset renewals
- Sustainable water supply, capital expenditure funding of $36M and operational expenditure funding of $11M
- Healthy urban waterways, capital expenditure $29M and $8M operational expenditure
- Reducing carbon emissions, capital expenditure $53M and $3M operational expenditure.

Achieving this investment programme in a financial sustainable way
A challenge we face, particularly in relation to the condition of our three waters infrastructure, is this significant financial investment required over the long term. Council is acutely aware of the financial pressures on residents and businesses in the city, and particularly the impact of higher housing costs on some households, as well as the effects of COVID-19. We carefully considered affordability in preparing our 10-Year Plan 2021-2031.

Our financial strategy uses a combination of rates and borrowing to ensure that we are achieving a balanced approach to paying for services and developments in the city. Sharing the costs in a way that is fair and equitable to both current and future residents, as well as businesses, is important .

Due to affordability considerations, there are a range of three water investments which were restricted in the 10-Year Plan. This included investment in future growth, reducing carbon emissions, and heathy urban waterways.

Section two: Three Waters Reform impacts for Hutt City Council

Central government three waters reform funding
As part of the reform process central government has announced a $2.5B package to support and benefit Councils. This comprises $2B “better-off” funding and $500M “no worse-off” funding to be spread across local authorities.

<u>Better off funding</u>
The first $500M of the better-off funding will become available from 1 July 2022. Hutt City’s allocation of the total better-off funding is $33M. The better-off funding can be used to support the three waters service delivery reform objectives and other local wellbeing outcomes which align with priorities of central and local government.

Funding applications for the first tranche of this funding are expected to open from March 2022 to August 2022. Applications are likely to be invited for projects/initiatives which meet some or all of the following criteria:

- Supporting communities to transition to a sustainable and low-emission economy, including by building resilience to climate change and natural hazards;
- Delivery of infrastructure and/or services that:

  - Enable housing development and growth, with a focus on brownfield and infill development opportunities
  - Support local place-making and improvements in community wellbeing.

The information on the process for funding applications and the criteria were very recently confirmed by government, so we have not yet worked through which projects/initiatives will be submitted.

<u>No worse-off funding</u>

"No worse-off" funding is to ensure that no local authority is in a materially worse position financially to provide services to its community as a direct result of the reform. It is unclear at this stage the amount of funding that Hutt City Council would receive, as the government has not confirmed the approach and methodology to be applied. Based on modelling by DIA and advice we have received from PWC this is likely to be approximately $29M, however there is significant uncertainty in relation to this.

How will Council's financial direction look after three waters reform

As part of our 10-Year Plan we reviewed our financial strategy to ensure that it enabled our direction sustainably in the long term. The strategy is based on important principles that provide the foundation for prudent sustainable financial management:

- Affordability of rates
- Achieving intergenerational equity by spreading the costs between both present and future ratepayers
- Maintaining prudent borrowing levels
- Achieving a balanced budget and ensuring that everyday costs are paid for by everyday income
- Delivering services effectively and efficiently
- Strengthening council's financial position

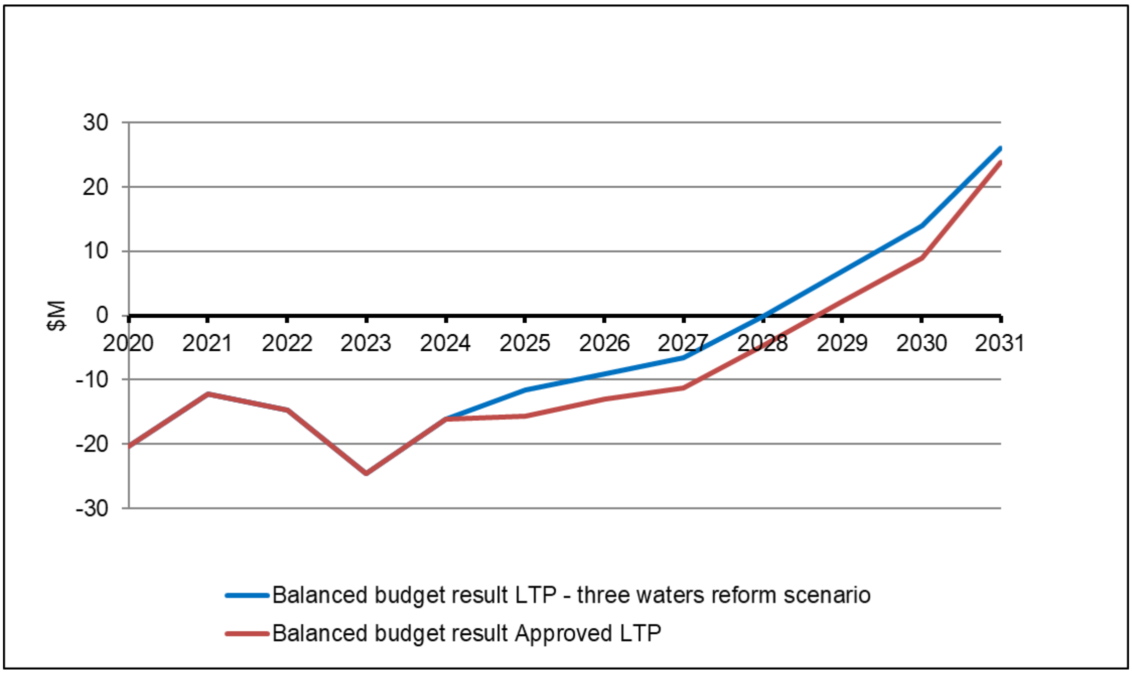
These underlying principles are enduring and would not be affected by the reform proposals.

We have undertaken an initial assessment against the key metrics in our financial strategy to understand how proposed reforms will affect financial planning in the long term. There is still a lot to work through as the reform process progresses. The information below is a high-level assessment based on information known at the point in time of this engagement.

<u>Balanced Budget</u>

Everyday costs of running the city should be paid for from everyday revenue. Legislation requires council to budget each year for operating revenue at a level sufficient to meeting the operating expenses budgeted for that year. This is known as the "balanced budget" requirement.

The graph below shows an updated projection of achieving a balanced budget following reform compared to the 10-Year Plan. This shows that there will be minimal change to our balanced budget position resulting from the reform.



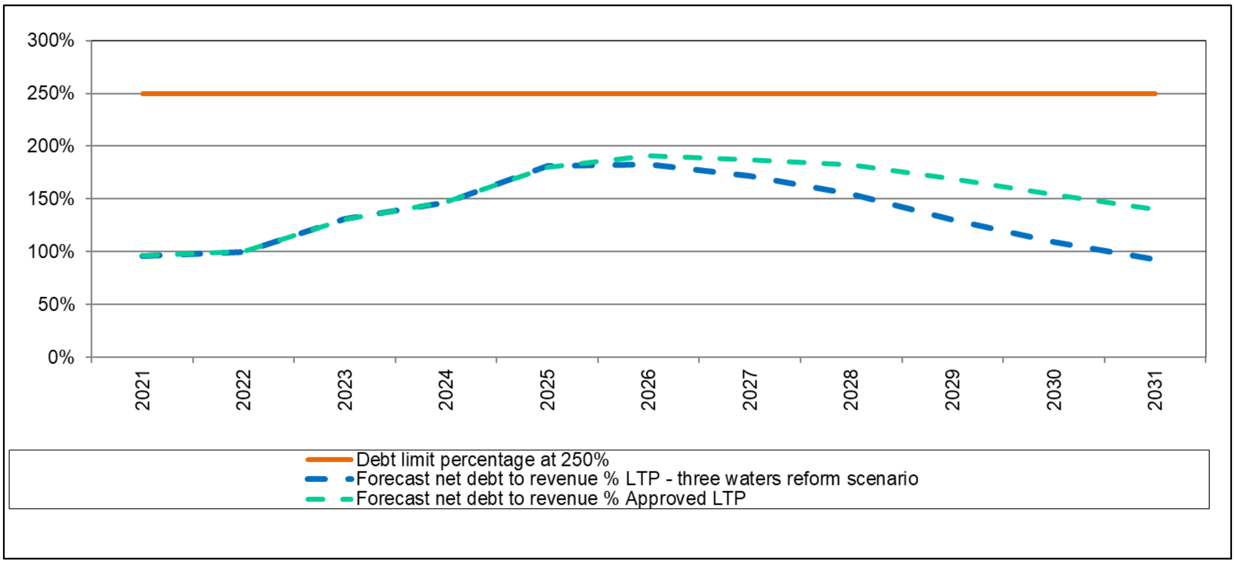
The Hutt City Council balanced budget target is defined as the Local Government (Financial Reporting and Prudence) Regulations 2014 definition, modified to exclude from the definition of revenue Waka Kotahi NZ Transport Agency's Capital improvement subsidies, Infrastructure Acceleration Fund grants and central government COVID-19 Response and Recovery co-funding for Naenae Pool and Tupua Horo Nuku.

Council debt

The key metric we use to assess our debt is through a metric of our debt compared to revenue. Our financial strategy sets a debt limit of no more than 250% of revenue.

As part of the reform programme, it is expected that the portion of debt that relates to three waters will transfer to the new entity when they are first created. This will ensure that council's financial position is not adversely impacted by the change. This has been factored into the forecasting below in the form of a reduction in our net debt of approximately $101M. This is an initial conservative estimate of the portion of council debt that relates to our three waters activities. We are awaiting further information from the Government to confirm the methodology to be applied in the transfer of debt.

The graph below shows the impact the reform is projected to have on our debt levels when compared to the 10-Year Plan. This shows proportionally lower levels of debt in the long term as a result of the reforms.



<u>Standard and Poors Credit rating</u>
We currently have a strong AA credit rating through Standards and Poors (S&P). A strong credit rating helps us keep our costs of borrowing down.

The governments "no worse-off" funding is intended to mitigate any negative impacts that may arise from three waters reform.

DIA engaged S&P to complete an assessment of the credit implications of the proposed three waters reforms on the local government sector. S&P noted the following:

We assessed that the impact on ratings and outlooks of the local councils would depend on several key issues. These include the amount of support the sovereign provides, the degree of influence each council has over the water services entities, and their individual credit characteristics, such as the effect the reforms have on their financial outcomes… In our view, under the scenarios presented, the impact on a local council's credit rating is likely to be increasingly negative where there is a greater level of local council influence and control over water service entities.

The summary report from Standard and Poors can be found here, and a more detailed report can be found here.

There is a large degree of uncertainty about the final decisions of the Government and what the impact will be on our credit rating. Given the intent of the "no worse-off" funding of the Government, it is anticipated that there would be no significant change to our credit rating in the short-term following transition.

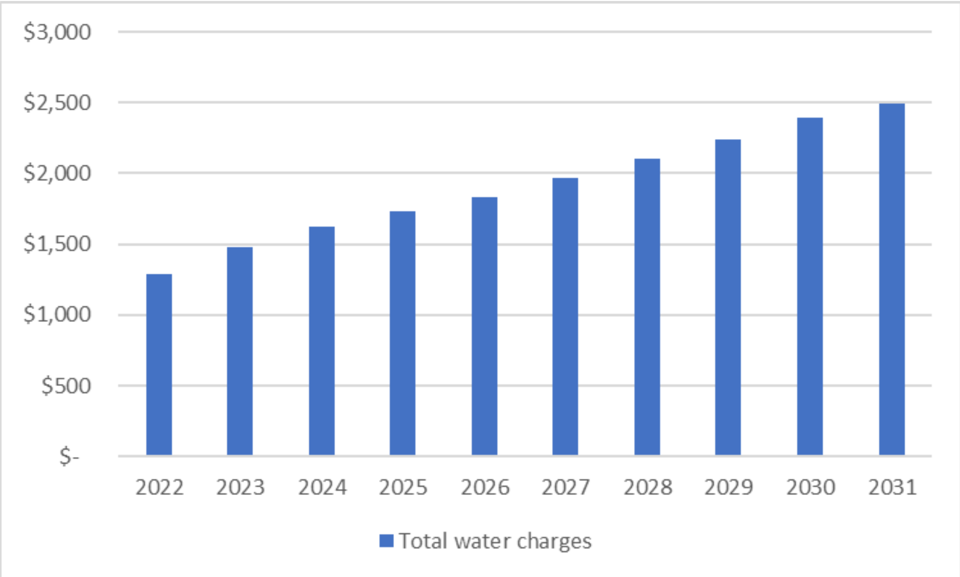
What will happen to the three waters assets if the reform proceeds?
Three waters assets would remain publicly owned and are not being sold. Our three waters assets would be transferred to a new water service entity. This water service entity would be collectively owned by Councils across the new entity's catchment.

An independent, competency-based board would govern the new water service entity. The water service entity would be required to meaningfully engage with the community on their strategic direction, investment priorities, prices, and charges.

How will the proposed changes affect the rates and service charges that I will pay?
The reforms will mean that Council will no longer charge rates for the three waters services. It's possible that Council will collect water charges on behalf of the new water entity in the first year, just as we currently collect rates on behalf of Greater Wellington Regional Council. In future years, the new water entity will likely send the bill directly to customers.

Our 10-Year Plan includes projected annual increases in our charges to enable the funding of the investment programme. This is shown in graph 1.

Graph 1: 10-Year Plan projection - Combined three water rates charges



Note: The combined charges include charges for Water Supply, Wastewater and Stormwater. Charges are based off our 10-Year Plan 2021-2031 and include the impacts of inflation.

Modelling undertaken by the Water Industry Commission of Scotland (WICS) for DIA has shown that the efficiencies provided by the reforms will significantly reduce the costs incurred by households in the long term. For information on this modelling, including inputs that were peer reviewed, refer to the DIA website.

Council charges for commercial metered water and trade waste are expected to be transferred over to the new water services entity. In our LTP we projected that these costs would increase for inflationary cost adjustments each year going forward.

Financial advice we have received
We engaged PWC in mid-2021 to provide advice on the financial impact of the reforms on Council. This was based on the information available from the Government at the time. Included in this advice was information about water assets, revenue, capital investment and debt. It included a range of scenarios on how debt related to three waters activities could potentially be calculated,

together with a projected debt-to-revenue ratio following reform. A report was presented to our Policy, Finance and Strategy Committee 16 November 2021 – read the extract here.

We also sought advice reviewing the WICS modelling undertaken, assessing the funding impact information released by DIA and identifying gaps for further investigation. This advice was presented at the Council meeting 8 September 2021 – read the extract here.

Our key financial assumptions

There is still a lot to work through as the reform process progresses. We have made a range of assumptions in our financial modelling undertaken to date:

- Our modelling is based on the projections in our 10-Year Plan 2021-2031
- "Better-off" or "no worse-off" Government funding has not been included in financial modelling at this time. Models have been prepared to show the council's position without this additional funding. The additional funding will improve the council position shown.
- Debt transfer of $101M has been included to reflect our estimate of the portion of council debt that will relate to three waters at the time of transition in July 2024. This is subject to work programme completion and due diligence as part of the transition process. It is also dependent on Government decisions.
- The portion of general rates related to stormwater has been estimated as the relative proportion of expenses.