Three Waters Reform

Hutt City Council
February 2021

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Attention: Wendy Walker, Chief Executive Officer

22 February 2021

Three Waters Reform

We refer to our engagement letter dated 28 January 2021 (the Engagement Letter), and provide our draft report to you.

This report has been prepared to provide you with some high level analysis on the potential impact on Hutt City Council (HCC) of the Three Waters Reform. All information in this report is based on the 2018-2028 Long Term Plans (2018 LTP) provided by Councils throughout New Zealand. The numbers in relation to water investment in the 2021 LTPs are likely to have materially increased.

This is a draft report. Our work is not complete and the comments in this draft report are therefore subject to amendment or withdrawal. Our definitive findings and conclusions will be those set out in the final report.

We draw your attention to the important notice and restrictions set out in our engagement letter.

We understand that this report will be shared with Hutt City Council (HCC) on a hold harmless basis following receipt of a signed hold harmless letter.

Save as described in the agreement or as expressly agreed by us in writing, we accept no liability (including for negligence) to anyone else or for any other purpose in connection with this report, and it may not be provided to anyone else.

If you have any questions, please do not hesitate to contact either of us.

We look forward to discussing this report with you.

Ngā mihi nui

Carl Blanchard

Partner

Introduction

Background

The Government's Three Waters Reform Programme envisages the creation of multi-regional water service delivery entities. The scale of these entities and the scope of any asset and liability transfers is yet to be determined. It is likely that asset transfers will be in exchange for shareholding in a new entity and that, along with assets, some adjustment to liabilities (i.e. debt) will be made.

The Department of Internal Affairs is currently undertaking significant commercial and policy work to consider a range of options and outcomes and has issued a Request for Information (RFI) that seeks information to support this analysis. Engagement with the sector is expected in March 2021 to enable councils to consider and provide input into an initial set of options for reform.

In order to ensure the enduring success of the reform, both new entities and the residual councils need to be sustainable in the long-term.

We have been working with Porirua City Council to start to understand the potential impacts of the proposed reforms on councils in the Wellington region, including Hutt City Council (HCC). This paper sets out some high level analysis and findings to enable you to start to get a feel for the key areas of focus as you progress through the design phase and engage with Central Government.

Approach and scope

The work presented in this paper is based on **three waters** data (drinking, wastewater and stormwater) as included in the **2018-2028 LTPs**.

This paper summarises the following areas:

- The relative 'importance' of water for HCC from a revenue, asset and interest perspective, and how this compares to other council 'groupings';
- An indicative range of debt that could be transferred to the new water entity on day 1;
- The potential size and scale of the new water entity under different groupings (assets, revenue, debt);
- HCC's potential shareholding in the new entity; and
- The indicative debt to revenue profile and debt capacity of the new entity.

In performing this analysis we have considered the following groupings:

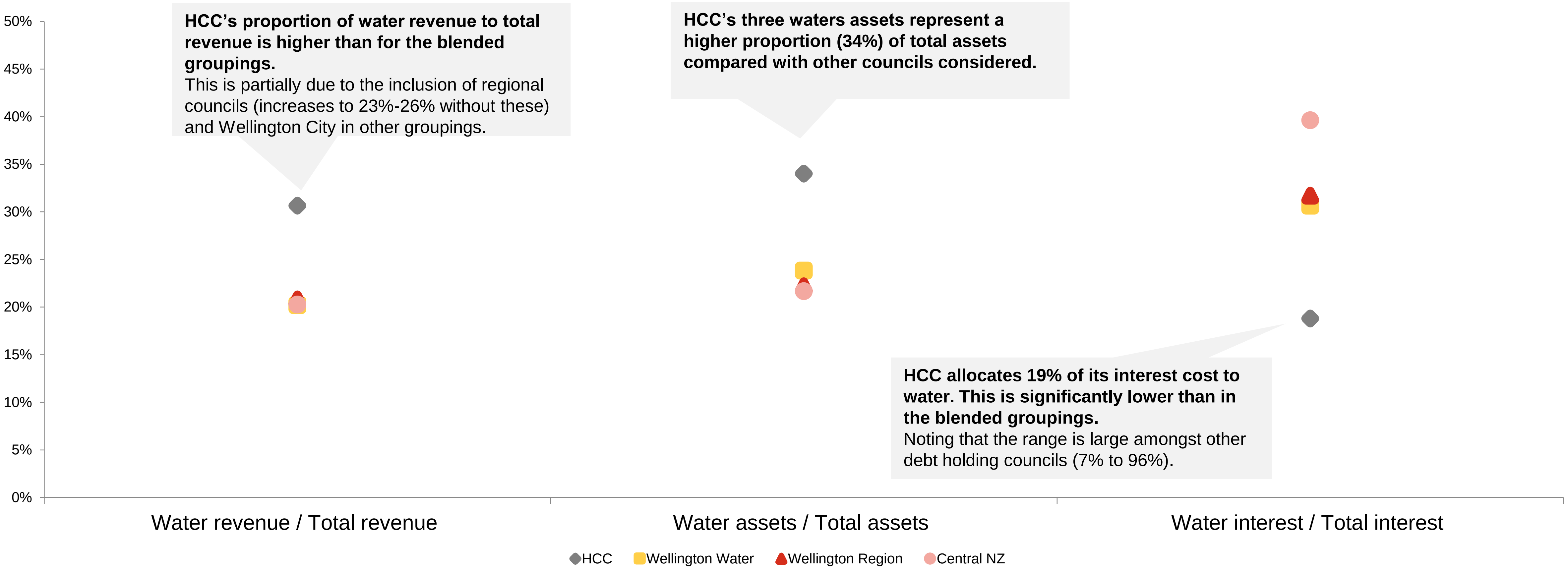
Groups	Councils Included in Group
Wellington Water	Wellington Water Limited councils (Porirua City Council, Wellington City Council, Hutt City Council, Upper Hutt City Council, South Wairarapa District Council and Greater Wellington Regional Council). This would largely simulate the existing arrangement noting that assets and debt would be transferred to the entity which would act as the revenue collector.
Wellington Region	Wellington Water councils (noted above) and other councils within the Wellington region, specifically Carterton District, Kāpiti Coast District and Masterton District councils.
Central NZ	Wellington Region councils (noted above) as well as other councils located in the following regions: Hawke's Bay, Gisborne, Manawatu-Wanganui, Taranaki, Nelson, Tasman and Marlborough.

The groupings have been provided for illustrative purposes to compare how the water entity might look under different scenarios, they are not an indication of likely groupings.

Overview of relative "importance" of water

HCC has a greater proportion of its revenue allocated to three waters than councils in the groupings considered. However, HCC's level of water related interest is disproportionately lower than the relative value attributed to water assets or water revenue. This may impact on debt apportionment and / or shareholding.

Relative value of water to total council revenues, assets, interest (FY20)



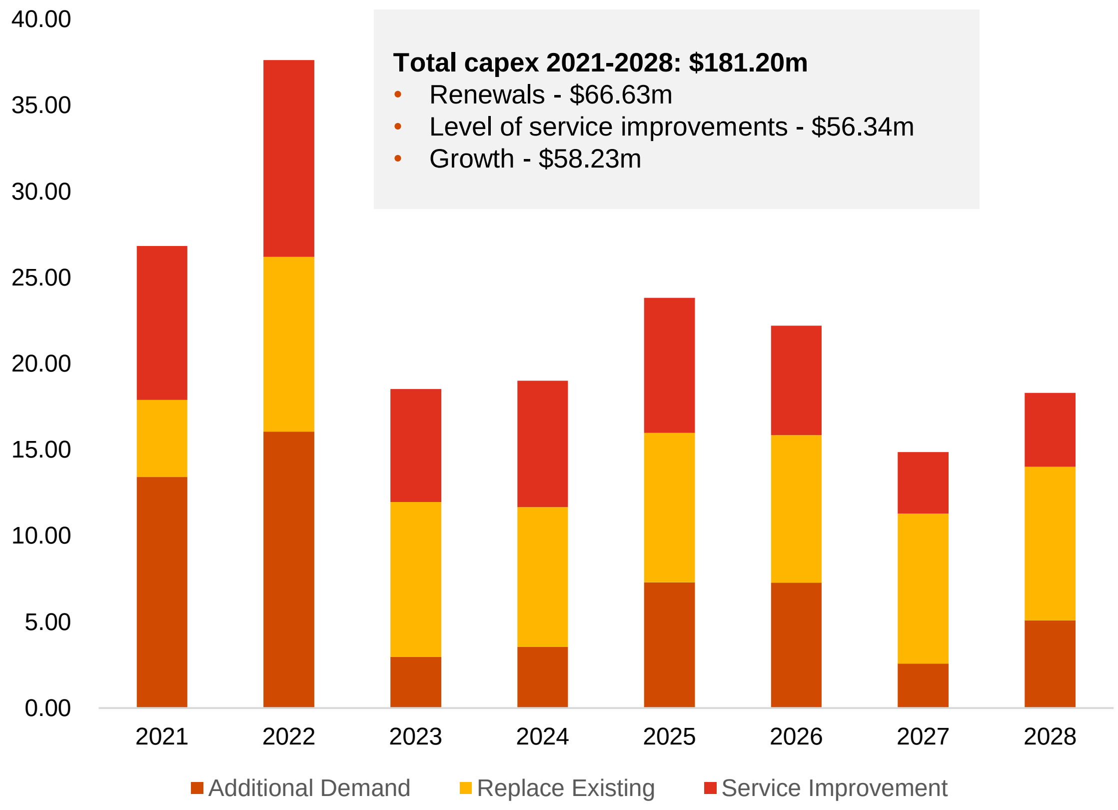
Forecast "cost" of water

HCC has a significant capital expenditure programme for Three Waters. It represents a higher proportion of total capital expenditure to other council activities, compared to the groupings considered. These figures will may materially increase in the 2021 LTP.

Forecast Capital Expenditure for Three Waters 2021 – 2028

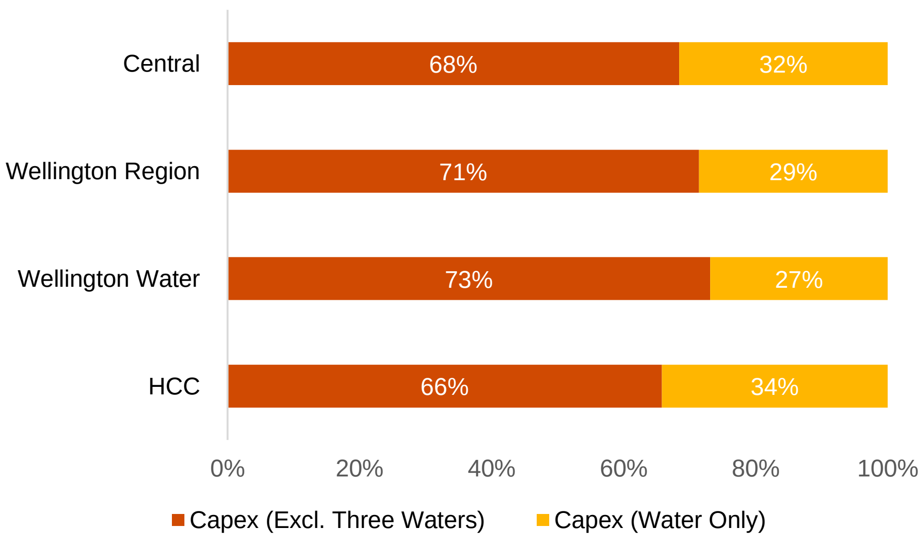
Total capex 2021-2028: $181.20m

- Renewals - $66.63m
- Level of service improvements - $56.34m
- Growth - $58.23m



Percentage of Capital Expenditure relating to Three Waters 2021 - 2028

HCC's forecast three waters capex represents a higher proportion of total capex than for the groupings considered.
This may reflect the fact that water assets represent 25% of HCC's total asset base (vs c.20% across the groupings).

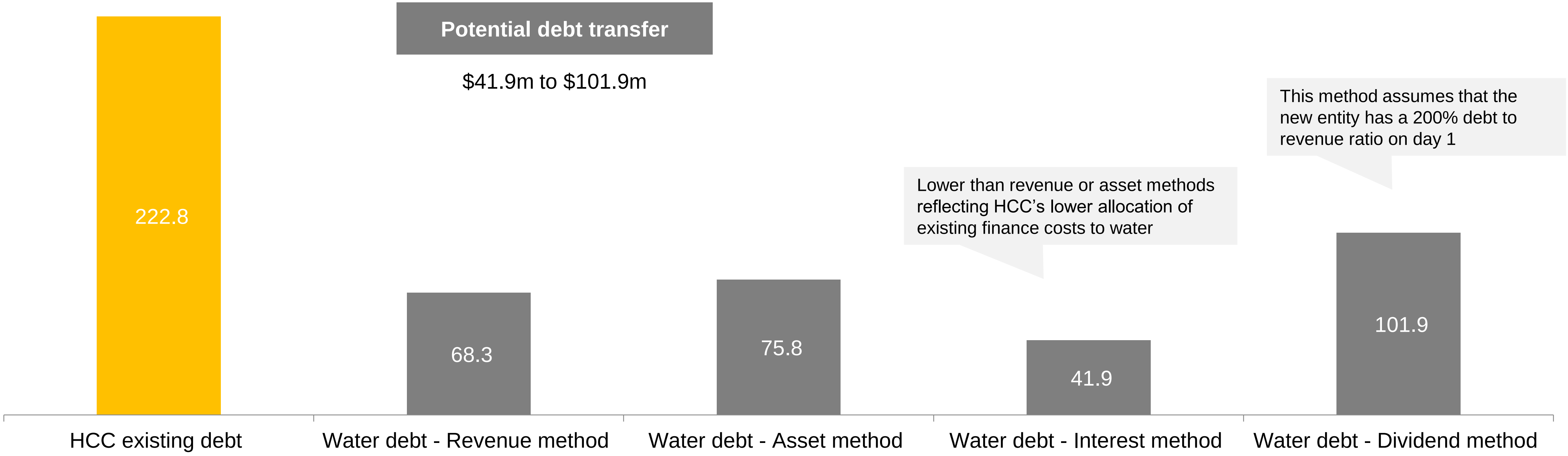


Indicative Impact: HCC debt transfer to the new water entity

As part of the Three Waters reform process, it is likely that a portion of HCC debt will be transferred to the new water entity. Depending on the method agreed there could be a material variance in the amount transferred and the resulting debt in HCC. Debt transferred could range from $41.9m-$101.9m.

In addtion to debt transfers, consideration needs to be given to the unwinding of any swaps, associated costs and how this is managed

Potential debt transfer amounts in $m (FY20)



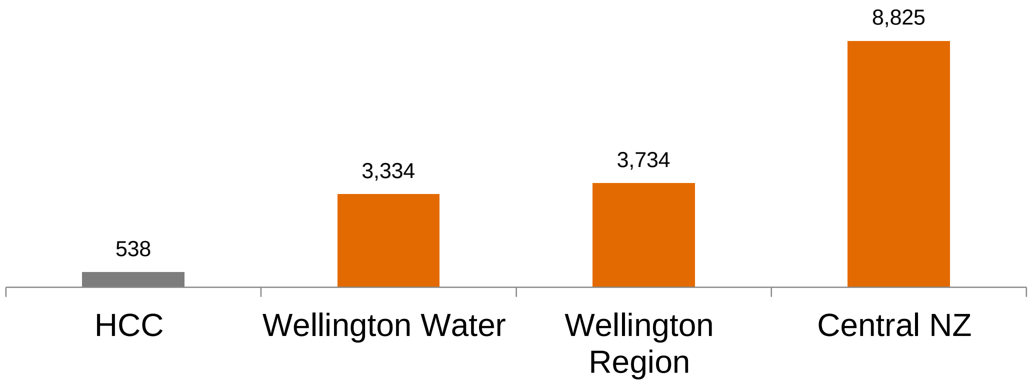
- **Revenue method** = (revenue attributed to 3 waters activity / total revenue) x total council debt
- **Asset method** = (assets attributed to 3 waters activity / total assets) x total council debt
- **Interest method** = (finance charges attributed to 3 waters activity / total finance charges) x total council debt
- **Dividend method** = (water assets / total water assets) x new entity debt (assuming 200% debt to revenue on day 1)

Note the above method depends on the combined assets in the groupings and relative proportion of these held by each council. The above simplistically assumes 200% of HCC's debt to revenue transfers to the water entity.

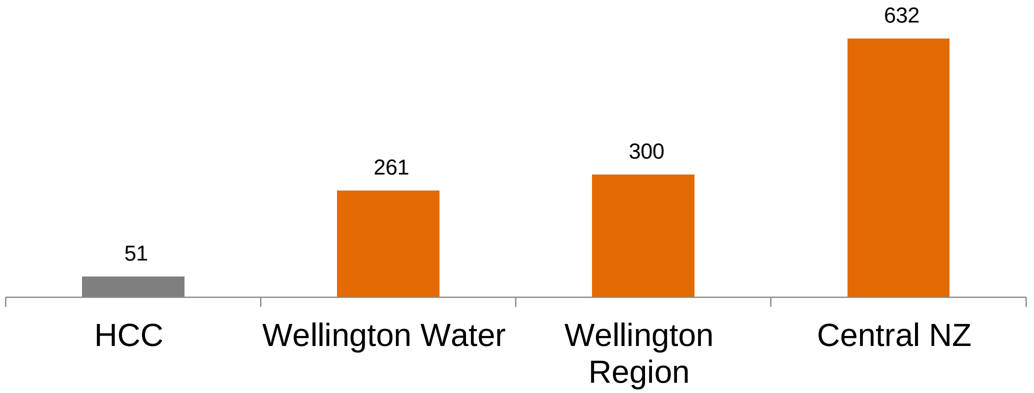
Indicative Impact: Key metrics of the new water entity

The scale of the water entities under different groupings is summarised below. Under the Central NZ scenario, the amount of debt trasferred to the entity varies significantly. This will need to be considered in light of the sustainability of the new entity, as well as the proportion of debt remaining in the councils relative to revenue, assets and other council operations.

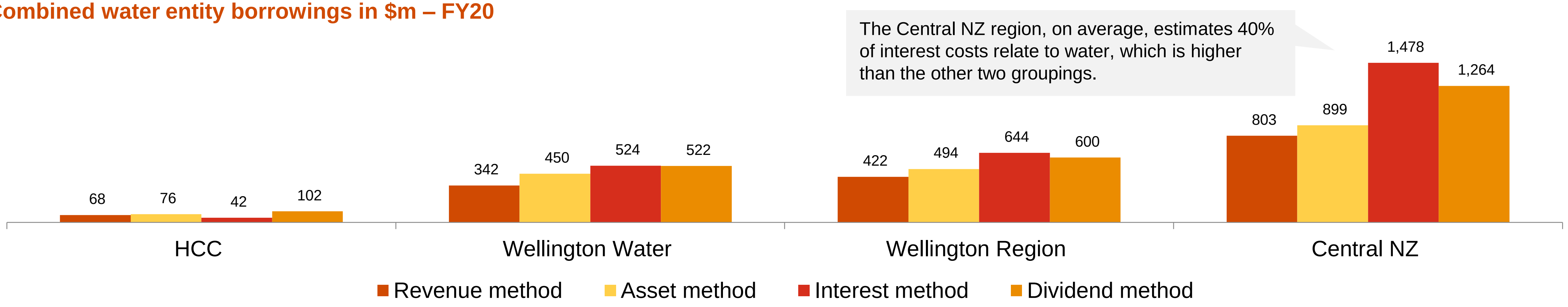
Combined water entity assets in $m – FY20



Combined water entity revenue in $m – FY20



Combined water entity borrowings in $m – FY20

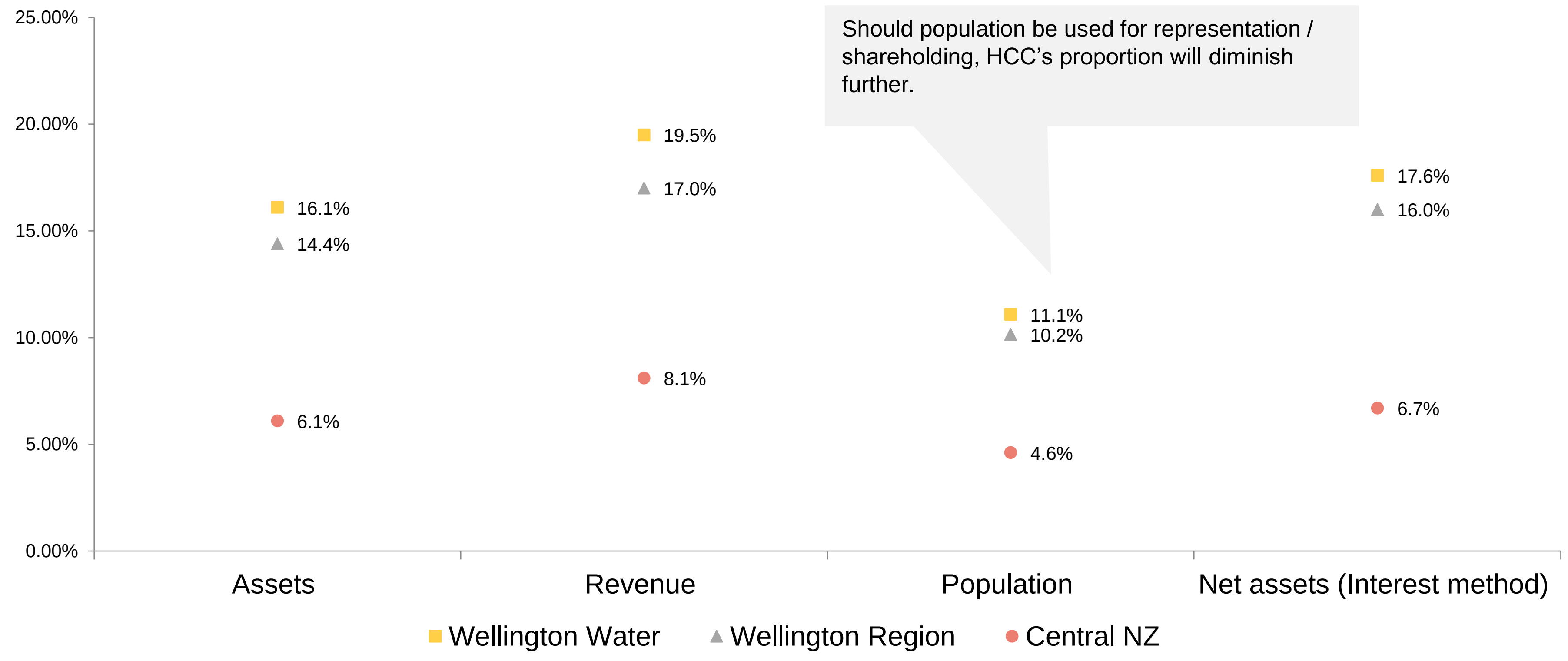


Indicative impact: HCC shareholding in the new entity

It is currently unclear whether the Crown is still considering collective council ownership for the new water entities, and if so, what the basis for shareholding might be. HCC's potential shareholding in the new entity would vary under different scenarios and in all cases likely to be a minority, unless equal shareholding from all participating councils is adopted.

Another key consideration is what shareholding will represent in terms of rights or financial interests. Given credit rating control considerations, councils are unlikely to retain any control rights. It is unlikely that dividends will be paid, at least in the first 10-20 years given the level of investment required. While public ownership is envisaged, the level of shareholding will become more relevant if this changes at some point in the future.

HCC indicative shareholding in the new water entity



Wellington Water

11.1% to 19.5%

Wellington Region

10.2% to 17.0%

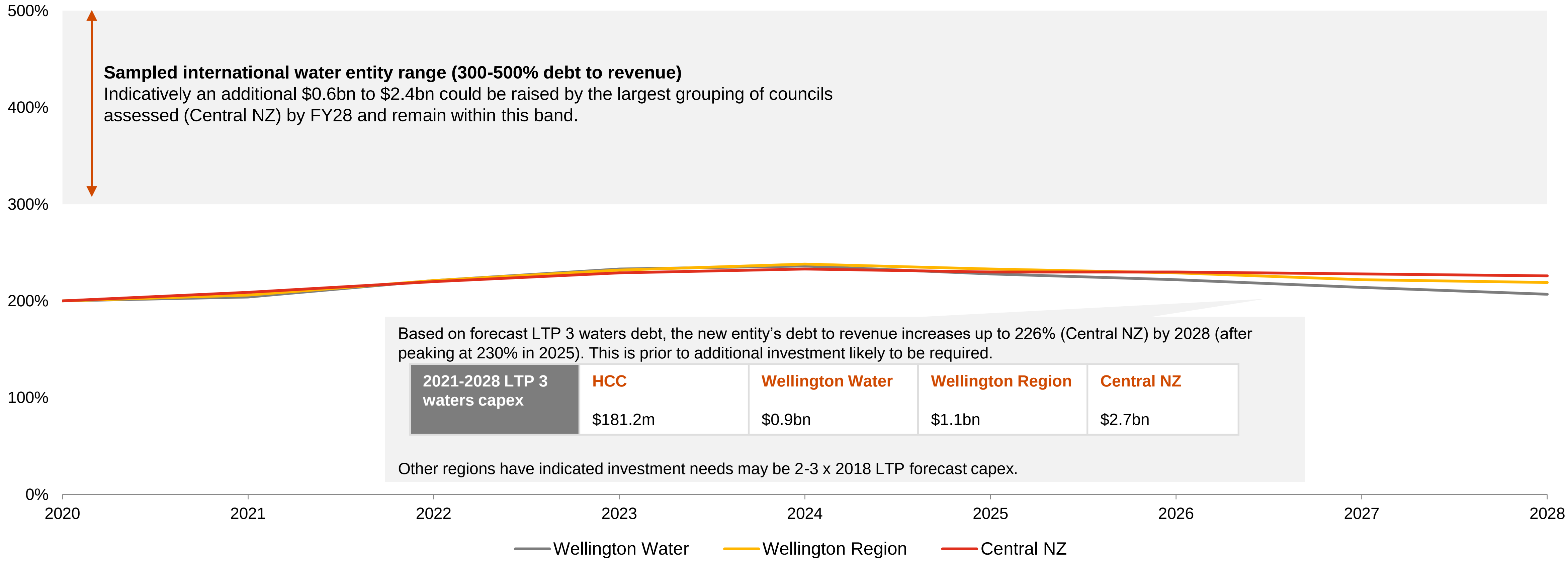
Central NZ

4.6% to 8.1%

Indicative Impact: Debt to revenue ratio of the new entity

The debt to revenue under each grouping increases over the forecast period and is highest in the Central NZ grouping. A number of international water entities borrow at higher debt to revenue levels (300-500% is not uncommon). Based on forecast water revenue, increasing debt levels to this range could provide an additional $0.6bn to $2.4bn debt to fund investment required.

New water entity debt profile



2021-2028 LTP 3 waters capex	HCC	Wellington Water	Wellington Region	Central NZ
	$181.2m	$0.9bn	$1.1bn	$2.7bn

Indicative Impact: Revenue and debt in HCC

HCC is showing slower water revenue growth rates over the LTP period than the groupings considered. For HCC this was forecast to grow at a higher level than overall revenue, suggesting lower rate rises for remaining activities. Given uncertainty around debt transfer methods, removal of water debt could increase or decrease debt headroom left in HCC, depending on the method applied.

Revenue

Based on the 2018 LTP forecasts, water revenue across the groupings is expected to increase at 4-5% cumulative annual growth rate (CAGR) which is higher than the level forecast by HCC. The actual impact on charges to ratepayers will need to be considered in light of current per capita differences and the level of investment required.

Grouping	Implied water revenue (2020)	Implied water revenue (2028)	CAGR
Wellington Water	260	357	4.0%
Wellington Region	300	411	4.1%
Central NZ	630	867	4.0%

3.2%

HCC water revenue CAGR

2.9%

HCC total revenue CAGR

HCC water revenue is forecast to grow at a greater rate than overall revenue, suggesting removal of water will result in lower rate rises. Albeit, water charges going forward will be payable to the new entity directly by ratepayers.

Debt

Prior to water separation, HCC was forecasting debt to revenue of 127% in 2028 (from 134% in 2020). Following water separation HCC's 2028 debt to revenue ratio could be between 111% and 153% depending on the water debt allocation method adopted.

This large range reflects uncertainty around the debt transfer method the Crown may choose to apply. It highlights the importance of understanding the different methods and estimating what you believe to be the true level of water related debt in HCC. The debt level inferred by the dividend method, transfers the greatest amount of debt to the new entity, with HCC residual debt lower in comparison to other methodologies (111% debt to equity).

At the 280% covenant, an additional c.$30m - $47m could be available.

127%

HCC 2028 debt to revenue ratio incl. water (134% in 2020)

111% - 153%

HCC 2028 debt to revenue ratio excl. water (105% - 157% in 2020)

Numbers presented in the analysis above and throughout this paper are based on 2018 LTP information, the numbers for water investment in the 2021 LTP are likely to increase materially across New Zealand.

Key Considerations

There is significant uncertainty in the outcome of the Three Waters Reform and its impact on HCC. There are a number of key considerations for HCC as it enters into dicussions with the Crown.

- The methodology adopted for debt allocation to the new water entity could result in different outcomes for HCC and the amount of debt headroom to service the balance of council activities.
- HCC has a higher proportion of revenue associated with water services than other councils in the region and groupings considered. As a result, removal of water related revenue will impact debt capacity for remaining council activities proportionately more than for other councils.
- Given the high proportion of water revenue, and that this is funded through general (stormwater only) and targeted rates, consideration should be given to the revenue relating to and cost of delivering the balance of council activities in the absence of water.
- Control over any new entity (including in terms of balance sheet consolidation, decision making influence and future funding commitments) is an important consideration for all councils. Different approaches to allocating shareholding (whether on an asset, revenue, population or equal shareholding basis) may have a material effect on service provision, investment and cost for HCC ratepayers. HCC may wish to consider local and community preferences and investment prioritisation when considering shareholding options.

Thank you

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Appendix A) Water debt methods

Summarised below are four methods to allocate council debt as water debt to be transferred to the new water entity, noting that the methods are purely illustrative

Method 1) Revenue apportionment

= water revenue / total revenue x council debt

A percentage of existing council debt apportioned, based on water revenue. Debt to revenue ratio is maintained.

Rationale:
Equitable approach: this method looks to maintain each council's current debt to revenue ratio post separation.

Method 2) Asset apportionment

= water assets / total assets x council debt

A percentage of existing council debt apportioned, based on water assets.

Rationale:
Combined approach: this method considers the relationship between investment in assets and debt.

Method 3) Finance cost apportionment

= water finance cost / total finance cost x council debt

A percentage of existing council debt apportioned, based on water finance costs.

Rationale:
Council allocation: this method uses finance costs to estimate the allocation of its total debt portfolio each council makes to water activities.

Method 4) Dividend method

= water assets / total water assets x new entity debt

New entity debt assumed to be 200% of revenue. Entity debt apportioned to council based on water assets.

Rationale:
Equal approach: this method applies the same treatment to each council, based on asset value and is independent of actual borrowings.