CROWN INFRASTRUCTURE PARTNERS | HANGA NGĀTAHI

Te Tari Taiwhenua Internal Affairs

Local Water Done Well

Water services delivery models | October 2024

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New approach to water services

- Provides councils with flexibility to determine the **optimal structure and delivery method** for water services.
- **Water Services Delivery Plans** are a way for councils to provide more transparency about the costs and financing of water services and require councils to set out their proposed delivery model.
- This includes setting out how their **delivery models** will ensure water services comply with regulatory requirements, including ringfencing and financial sustainability requirements
- **Plans are a decision-support tool** that enables councils to make decisions that ensure future service delivery arrangements are sustainable.
- **Greater transparency** over water services revenue, investment and costs

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Fit for purpose delivery models

- Several structural options are available, including multi-council asset-owning water services organisations
- New LGFA financing arrangements will be available for wholly or partly-owned water organisations
- Water services organisations can benefit from:
  - Greater access to borrowing enabling higher rates of investment with less impact on water charges today
  - More efficient capital structures, with infrastructure costs spread over the life of the asset
  - Relatively favourable finance rates – up to 10 basis points higher than council borrowing
- Credit rating implications for councils differ depending on the option

Challenges with existing structures

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Council

Councils operate multiple activities within a single commercial structure:

- Transport
- Community services
- Urban development
- Facilities
- Waste management
- Water services

Existing CCO structures and financing arrangements lead to inefficient capital structures.

- Credit rating agencies and LGFA will assess councils and water organisations differently:
  - S&P rates councils under government-related methodology and water companies under a corporate utility methodology
  - LGFA limits council debt to <3 times revenue but will lend to water organisations at (roughly) 5 times revenue
  - Most councils operate water activities with higher levels of gearing than their non-water activities
  - Increasing water infrastructure investment will drive up rates faster than they would need to under a different capital structure
- Owning a water organisation will impact on councils' credit rating, but in a different way to currently

Financial treatment of different models

Existing Wellington Water model

Councils

Water services delivered through **asset managing CCO**. Councils continue to own assets and fund and hold water debt.

Ring-fencing and financial sustainability requirements will drive upward pressure on rates as infrastructure investment increases, relative to alternative models.

Expected LGFA / S&P Treatment:

LGFA lending to be capped at 285%, meaning more investment needs to be funded from current rates.

S&P credit rating downgrade likely if council operating near LGFA limit.

Alternative Single Council CCO

Council

Appoint representatives of committee or can appoint direct to the board

Appointments and Accountability Committee

Water Organisation Board

Management appointed by the Board

Water organisation

Council transfers assets and staff to new company

Council *provides joint and proportionate guarantee to support water organisation borrowing from LGFA*

Lacks scale required to deliver services effectively.

High establishment costs given no existing staff, systems etc.

Expected LGFA / S&P Treatment:

LGFA council lending cap of 285% will only apply to non-water debt/revenue only. LGFA lending to water organisation capped at 500% (subject to council guarantee) – not counted toward council LGFA limit

S&P will consolidate water CCO debt and revenue for rating purposes. Credit rating impact (~1-2 notch downgrade) if water company lifts borrowing to maximum allowed under LGFA covenants

Financial treatment of different models

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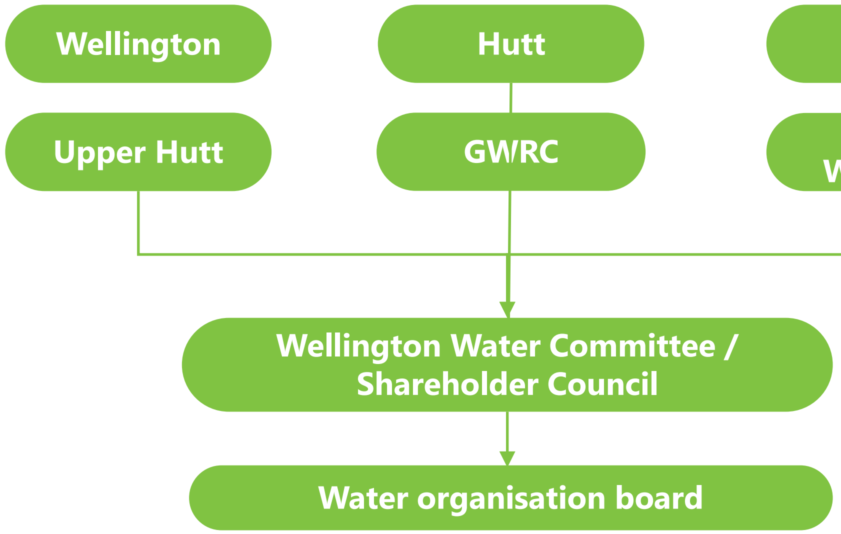
Multi-council owned water organisation



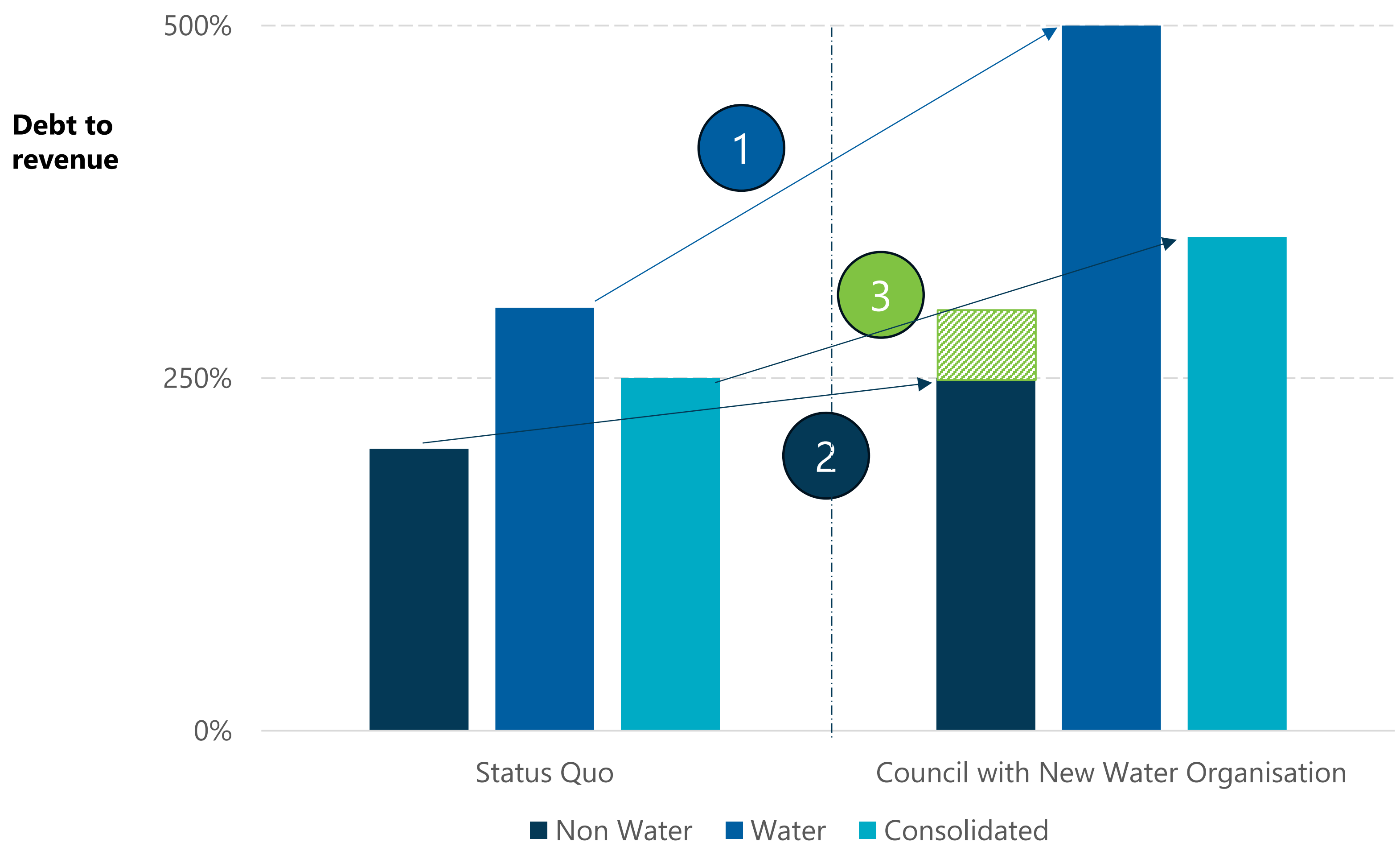
Expected LGFA / S&P Treatment:

LGFA council lending cap of 285% will only apply to non-water debt/revenue only. **LGFA** lending to water organisation capped at 500% (subject to council guarantee) – not counted toward council LGFA limit.

S&P treats water debt as council **contingent liability**, providing a relatively improved rating impact (but may still place downward pressure on rating outlook depending on size)

- Relieves rates burden from needing to inefficiently fund infrastructure investment with current revenues
- Enables reductions in water and non-water rates through more efficient gearing of the water organisation
- Higher rates of investment will drive improved network performance, with public health and environmental benefits
- Asset-owning water organisation will support better alignment between investment requirements and funding decisions
- Strengthened governance and management, subject to economic regulation

Example of efficient financing opportunity



1 Based on foundation policy covenants. Lending policy covenants remain at 175%

1. Additional water borrowing allows accelerated water investment
2. Additional non-water borrowing could allow rates to be reduced (spreading council debt repayment over a longer period) or to fund non-water investment
3. Increase in aggregate borrowing reflects more efficient financing of long-term infrastructure but increases repayment burden for future ratepayers.

Slightly higher interest costs offset by improved operating and capital efficiency of water entity.

Example of rates reduction opportunity

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Financials	Water	Non-water	Total
LTP Year 1			
Debt	$103.0m	$101.0m	$204.0m
Revenue	$29.2m	$56.1m	$85.3m
D/R	353%	180%	239%
Rates increase	20.3%	10.4%	13.6%
Post water organisation			
Debt	$105.2m	$104.8m	$210.0m
Revenue	$27.0m	$52.3m	$79.3m
D/R	390%	200%	265%
Rates increase	11.4%	2.9%	5.6%
Savings to current communities			
Savings ($)	$2.2m	$3.8m	$6.0m
Savings (%)	7.5%	6.8%	7.0%
Changes to capital funding approach			
Change in debt-funded capex	+$2.2m	+$3.8m	+$6.0m
Change in revenue-funded capex	-$2.2m	-$3.8m	-$6.0m

- Current debt limits act as a constraint on borrowing to fund water infrastructure – contributes to renewals backlog and ageing infrastructure
- Under these constraints, the only way for councils to balance the budget while making the required investment is to increase rates
- This is inefficient as current ratepayers are paying for a disproportionate share of long-lived infrastructure.
- With new structures, councils could utilise additional borrowing capacity of a new water organisation to reduce water rates rises, while making the required investment

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Economic regulation is coming

England and Wales: Ofwat Model

Delivering for customers and the environment

18%

Increase in the average household bills above the rate of CPIH inflation. 21% for water and wastewater companies, and a 6% increase in water only companies' bills,.

1.4m

More customers receiving reduced tariffs, supported by a wide-range of affordability measures.

More than 2,500 projects to reduce spills from storm overflows. Upgrades to over 1,500 wastewater treatment work. Improving or protecting over 15,000 km of rivers.

44%	Reduction in storm overflow spills (2021-29)	**13%**	Reduction in leakage
39%	Reduction in pollution events	**95%**	Improvement in supply interruptions (compared to 2020-23 average)
13%	Reduction in internal sewer flooding	**4%**	Reduction in per capita consumption
21%	Reduction in drinking water quality contacts	**11%**	Reduction in operational greenhouse gas emissions

Draft allowances

£88bn

A step up in overall cost allowance of >50% in real terms compared to allowances in the previous control period.

An increase in the allowed cost of capital (real, CPIH) of 43 bps compared to Ofwat's early view

3.72%

23%	Real increase in RCV 2025-30	**25**	Major projects to be delivered through DPC / SIPR and other alternative means
2%	Notional dividend yield	**70%**	New cap on gearing subject to consultation
1.0%	Per annum frontier shift	**50%**	Real increase in totex allowance compared to PR19

Re-openers

Re-openers for storm overflows, and a delivery mechanism for Southern Water and Thames Water. Use of conditional allowances.

c.3,000

Pages of draft determinations and c.500 supporting models.

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Watercare to be the first regulated water company

Watercare Charter
(regulation)

Minimum quality service standards

- Customer service quality
- Network performance
- Drinking water quality
- Environmental compliance
- Capital delivery

Financial performance objectives

- Investment Grade Credit Rating

Interim price quality path

Crown monitor

Commerce Commission is responsible for annual reporting on Watercare's compliance with Charter

Can take enforcement action to apply penalties in the High Court

Watercare must align its business plan to the Charter

Watercare must disclose information and report on performance to Crown monitor

Commerce Commission can apply to the High Court to take enforcement action

Watercare

Other considerations

Some things to consider when establishing a new water organisation:

- **Pricing transition**: initial differences in asset condition and water debt can be addressed through differential charging and negotiated investment, harmonising over time as service levels equalise
- **Capital structure**: potential to swap debt for equity (or use subordinated debt with deferred payment terms) to improve initial capital structure
- **Forward investment planning**: agreeing forward investment plan for each district, and strengthening oversight of capital delivery, will build greater confidence for shareholders and communities
- **Crown monitor**: consider requesting interim regulation of new water organisation until economic regulation is embedded.

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Summary of benefits of multi-council owned model

- Transfer of water debt and revenues will improve council financial metrics – debt/revenue, balance after capital account
- Water debt is contingent liability (not consolidated into council debt burden assessment) with improved credit rating outcomes
- Relieves rates burden from needing to inefficiently fund infrastructure investment with current revenues (driven by LGFA covenants)
- Enables reductions in combined water and non-water rates through more efficient gearing of the water organisation
- Can retain local/city-based pricing and agree transition to harmonised pricing subject to investment and service level equalisation
- Higher rates of investment will drive improved customer and network performance, with public health and environmental benefits
- Asset-owning water organisation will support better alignment between investment requirements and funding decisions and smooths impact on prices
- Supports strengthened governance (generic corporate and sector specific)
- Model is better suited to future economic regulatory regime

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Additional benefits from Crown monitor regime

- Independent external scrutiny of the water company's performance
- Greater transparency and accountability to council owners and consumers
- Incentives for improvement in service quality and customer responsiveness
- Strengthens accountability for capital delivery – funded plans get delivered
- Drives operating and capital efficiency
- Improves quality of information on asset condition and network performance, leading to improved targeting of investment and better asset management
- Supports transition to enduring economic regulation by the Commerce Commission

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