WATERCARE SERVICES LIMITED

AGENDA	BOARD MEETING	Wednesday, December 23, 2020
Venue	Watercare Services, Level 3 Meeting Rooms 5 & 6, 73 Remuera Road, Remuera	
Time	08.00 am	

Open Public Meeting

	Item	Spokesperson	Action sought at governance meeting	Supporting Material
	Opening Karakia	Brendon Green		
1	**Apologies**	Chair	Record apologies	Nil
2	**For approval**			
2.1	Management recommendation for investment programme and pricing to support Council's draft 2022-2031 Long Term Plan	Nigel Toms	Approval	Report
3	**Closing Karakia**	Brendon Green		
Date of next meeting		Friday 29 January 2021		

2.1

Watercare
An Auckland Council Organisation

Report to the Board of Watercare Services Limited
Prepared for the 23 December 2020 Board meeting

Investment programme and pricing to support Council's draft 2022 - 2031 Long Term Plan

Purpose			**Team**	
Information	Discussion	Approval	Prepared by	Recommended and Submitted by
		✓	**Carl Tucker** Head of Commercial	**Steve Webster/Nigel Toms** Chief Infrastructure Officer/Acting Chief Financial Officer

Intellectual capital	People and culture	Community and stakeholder relationships	Financial capital & resources	Natural environment	Assets and Infrastructure
		✓	✓		✓

1. Recommendation

That the Board approves the following price increases and capital expenditure programme for input into the Council's draft 2022–2031 Long-Term Plan (LTP) and consultation document.

- Water and wastewater tariff increases of 7% on 1 July 2021 and 1 July 2022 followed by an annual price rise of 9.5% to FY29, with a 3.5% annual price increase for the final 2 years of the LTP.
- Increases in Infrastructure Growth Charges of 12% from 1 July 2021 followed by an 8% price rise annually.
- A capital programme of $8.1b ($real) over the 10-year period from 1 July 2021 to 30 June 2031.

2. Background

- The Asset Management Plan and Funding Plan are formally reviewed every 3 years to consider Watercare's long-term investment strategy and monitor the long-term financial sustainability of Watercare. These also input to the Council Group Infrastructure Strategy and LTP updates.
- The Board has been presented with an assessment of the investment programme to meet Auckland's present and future demand for water services. This proposal has identified the need for higher levels of investment compared to the 2018 AMP. This investment programme (Base Case) has a capital investment of $8.9b ($real) between 2022 and 2031 to address investment requirements.
- As a result of external factors, in particular the impact of COVID-19 on the Auckland Council Group's financial position which has resulted in significant loss of revenue to the Council Group impacting Council's ability to borrow, the Base Case investment profile would require an unaffordable price impact to our customers and is therefore not a viable option under these constraints.
- A pricing scenario is proposed which enables Watercare to fund a reduced capital programme with an increased risk profile that balances the capital constraints with a more affordable price path for our customers. The average price increase for FY22 is $75 per annum or $1.50 per week for a residential

household for water services.[1] The price of IGCs will increase by $1,480 + GST in 2022, moving towards the Productivity Commission recommendation of 100% recovery of the cost of growth.

- This paper also discusses the financial efficiency of Watercare and the impact on investment and prices as set out in the recent Water Industry Commission of Scotland (WICS) report.[2]
  The recommended price profile makes no assumption around the outcome of the current water reform programme.

3. The asset management plan process

In late 2019 Watercare embarked on the development of a revised AMP to support the LTP, period 2022–2031. The approach deviated from past AMP developments and was a "bottom up" approach designed to meet the required service obligations without any price or debt constraints. The purpose of this approach was to inform both Management and the Board of the business's capital requirements.

The key factors influencing the AMP are:

Growth

- We supply water and wastewater services to 1.7m people in 2020. This is expected to increase to 1.93m people by 2031 and 2.33m people by 2051.[3]
- Growth on this scale is significant, and requires Watercare to make long term investments, to give effect to Auckland Council's plans and strategies.
- We are required by legislation to give effect to Auckland Council's plans and strategies as set out in the Auckland Plan and associated documents (s58 Local Government (Auckland Council) Act 2009), and to operate efficiently with a view to keeping the overall costs of water and wastewater services to customers at the minimum levels while maintaining the long term integrity of assets (s57(1)(a) Local Government (Auckland Council) Act 2009).

Statutory compliance

- Compliance with the Network Discharge Consents requires us to continually improve the performance of our network reducing the impact on the environment.
- The conditions on new and existing wastewater treatment plant discharge consents require an increasing standard of environmental outcome driving the need to invest in new technologies to ensure quality environmental outcomes.
- The requirement of the new drinking water standards are driving new increased operational and capital costs compared to historical costs.

Renewals

- Replacement or rehabilitation of assets is a function of the asset age and /or condition. An increasing proportion of our assets will reach the end of their design life in the next decade, driving a change in renewals strategy to increase planned renewals and reduce escalating maintenance costs and disruption to customer service due to asset failures.

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[1] Based on current average household consumption. Business customers would see an average 7% rise in bills.
[2] Water Industry Commission of Scotland report "*A (mock) Draft Determination for Watercare June 2020".*
[3] Auckland Council ARTi11version6 population model.

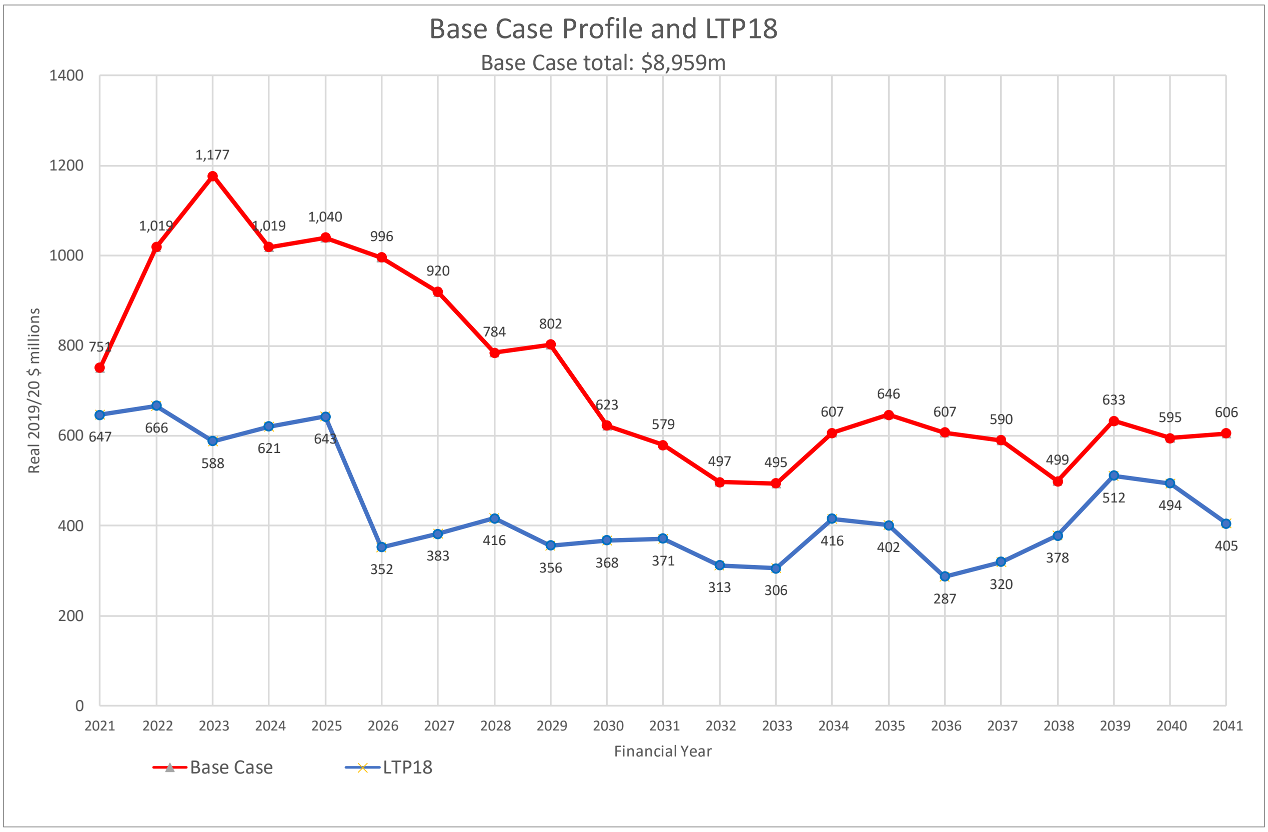
Resilience

- To continue to meet customer expectations of 24/7 services, we must ensure our assets remain resilient to changing conditions such as climate and growth by continuing to invest to remove single points of failure, particularly in critical regional assets.

Climate Change

- Climate change mitigation and adaptation is included in the AMP aligned with our Climate Change and Adaptation Strategy.
- To meet these goals there is a need to invest in both emissions reduction and asset protection because of the impacts of expected climate change, such as sea level rise.

The process for generating the AMP capital investment profile was iterative and challenged across the business. It was reviewed by the Capital Oversight Panel (Executive Team) and progressively challenged by the AMP and Major Capex Committee (Board Committee). This was then reviewed by the Board and accepted as the preferred investment profile for Watercare. This profile is the base case investment programme and is summarised in the graph below.



The peak in investment 2022–2025 is a function of concurrent projects such as:

- the Central Interceptor;
- Huia Water Treatment Plant and associated raw and treated water network renewal;
- the revised asset replacement strategy for linear assets (pipes);
- delivery of the Western Isthmus programme;
- extension of the Waikato Water Treatment Plant to provide a resilient additional water supply for growth;
- North Harbour No.2 watermain;
- preparation for the Māngere Wastewater Treatment Plant upgrades to meet the expected 2032 consent requirements;
- meeting the growth projections for the North East (Warkworth, Snells and Wellsford); and
- continuation of the Rosedale Wastewater Treatment plant upgrades.

4. Internal and external Influences that impact pricing and the capital programme

There have been two significant events during the 2020 calendar year that have influenced the direction of the capital programme. These are COVID-19 and the Auckland region's drought.

COVID-19

The impacts of COVID-19 have resulted in significant loss of revenue to the Council Group, forecast to exceed $1b over the next 3 years. Combined with this, significant asset owners across the group have identified an increasing need for investment to maintain services and cater for the growth projections for the region.

This has resulted in the request from Council for Watercare to reduce its previously planned (LTP18) debt to revenue ratio over the short to medium term. This can only be addressed by increasing customer charges to finance the additional capital spend requirements further than would otherwise be the case.

Auckland Region Drought

During the 2020 calendar year Auckland has experienced continuing drought. To minimise the associated risks with the ongoing drought, Watercare has invested significantly in additional water sources and treatment costing $209m in the financial year to June 2021. This has resulted in forecast debt at the start of the LTP period being $209m higher than previously planned. This has an impact on the level of additional debt we have available to finance the FY22 capital programme.

5. Pricing options

We have investigated pricing options which take account of the internal and external influences on Watercare's business while mitigating, where possible, the impact on our customers. Below are two pricing profiles which attempt to achieve a minimum level of capital spend over the short term (refer to the following section for further information on this capital programme).

The recommended option is for a 7% increase in water and wastewater charges for 2 years ahead of three waters reform.

The following price increases are Management's recommended price increases under the current financing constraints. This sees a price increase of 7% in FY22 and FY23 but results in a breach of Council's affordable debt covenant in the first 3 years of the LTP period as well as FY28. We have agreed with Council officers that this is manageable under the group debt constraints. In the outer years of the LTP we are able to reduce the price rise to 3.5% per annum.

Overall, this sees charges for an average household increase by $75 and $80 per annum in the first 2 financial years (or about $1.50 per week).

In year 3 if water reform has not allowed a restructuring of Watercare debt to provide independence of borrowing from Council, a price rise of 9.5% is required to finance the capital spend profile within Council Group's current debt constraints. Separation of Watercare's balance sheet from Council would allow a significant increase in the ability of Watercare to finance investment in long term assets through debt.

	FY21	FY22	FY23	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31
Price increase		**7.0%**	**7.0%**	**9.5%**	**9.5%**	**9.5%**	**9.5%**	**9.5%**	**9.5%**	**3.5%**	**3.5%**
Average bill Annual ($ pa)	1,069	1,144	1,224	1,341	1,468	1,607	1,760	1,927	2,110	2,184	2,261
Increase per week ($ per week)		1.44	1.54	2.23	2.44	2.68	2.93	3.21	3.51	1.42	1.47
IGC Price increase		12.0%	8.0%	8.0%	8.0%	8.0%	8.0%	0.0%	0.0%	0.0%	0.0%
IGC Metro ($ excl GST)	12,320	13,798	14,902	16,094	17,382	18,773	20,274	20,274	20,274	20,274	20,274
AMP Profile real Scenario 4 ($m)		**720**	**670**	**704**	**822**	**999**	**1,044**	**863**	**849**	**703**	**758**
Debt to revenue Actual		356%	365%	360%	376%	392%	409%	400%	390%	386%	381%
Debt to revenue Covenant		343%	361%	346%	377%	394%	409%	393%	396%	397%	397%
Headroom (breach)*		- 99	- 33	- 127	9	17	0	- 93	81	166	250

* Under this pricing scenario there is no capacity available to manage unforeseen events without requiring further borrowing capacity from the Council Group or increasing price to customers.

To maintain debt within Council group's affordable debt limits would require an 8.4% annual increase in water and wastewater prices.

An alternative pricing option which fully meets the Council group's affordable debt to revenue target each year has also been modelled. This requires a higher price rise of 11.3% in year 1 followed by price rises of 8.4% per annum for the LTP period. This is not recommended as it increases cost to customers ahead of the water reform process. This is targeted to deliver debt separation from Council and drive increasing investment at a lower cost to customers over time. Under this scenario customers are paying $131 extra per annum in FY22 and $100 per annum extra in FY23. IGC prices are modelled as consistent between both pricing options.

	FY21	FY22	FY23	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31
Price increase		**11.3%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**	**8.4%**
Average bill Annual ($ pa)	1,069	1,190	1,290	1,399	1,516	1,644	1,782	1,931	2,093	2,269	2,460
Increase per week ($ per week v prior yr.)		2.33	1.92	2.08	2.26	2.44	2.65	2.87	3.11	3.38	3.66
AMP Profile real Scenario 4 (m)		**720**	**670**	**704**	**822**	**999**	**1,044**	**863**	**849**	**703**	**758**
Debt to revenue Actual		343%	343%	339%	355%	373%	396%	391%	385%	363%	340%
Debt to revenue Covenant		343%	361%	346%	377%	394%	409%	393%	396%	397%	397%
Headroom (breach)		1	153	71	227	235	162	32	154	535	985

Infrastructure growth charges will increase inline with recommendations of the Productivity Commission

Under both pricing options above, IGCs increase by 12% (or $1,480 + GST for metropolitan household connections) on 1 July 2021 followed by 8% per annum for subsequent periods to FY27. This more significant increase in IGCs rectifies historical under-recovery and reflects the recommendation of the Productivity Commission of full recovery for the cost of growth assets. This also better reflects our 'exacerbator pays' pricing principle, i.e. those who cause growth should pay for growth.

6. The risks associated with the recommended pricing scenario

The recommended pricing option has an associated available capital investment profile. This profile is less than the preferred base case investment profile. The table below indicates the affordable profile and compares this to the preferred profile.

$real m	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	Total
Base case (preferred)	1019	1177	1019	1040	996	920	784	802	623	579	8959
Affordable profile	720	670	704	822	999	1044	863	849	703	758	8132
Variance	-299	-507	-315	-218	3	124	79	47	80	179	-827

The years 2022 to 2025 have a $1,339m deficit from scenario 1. This is progressively rectified from 2026. The total deficit 2022–2031 is $827m.

The risks and implications of this reduction in capital expenditure from the preferred scenario 1 profile is summarised in the table below:

What can be delivered	Risks	Implications
Committed and in-flight projects. $1,167m in FY22 to FY24, 56% of the base case capital programme	Approximately 50% of planned network renewals are deferred 2-3 years	**Growth not met** – community and developer discontent including Kāinga Ora, increase in future costs to meet growth, credibility with central government reduced
The Central Interceptor, this is 34% of the capital programme in FY22 to FY24	Huia Water Treatment plant and associated raw and treated water renewals, including North Harbour No.2 watermain replacement postponed 3 years	**Increased risk of asset failure** – increased unplanned maintenance costs, loss of services, increased overflows into the environment, reduced customer trust, revised SOI targets to reflect the revised risk profile
Approximately 50% of the Base Case Planned network renewals	Western Isthmus postponed for 3 years	**Water demand reduction postponed** – leak reduction SOI targets revised to reflect reduced investment, heightened risk under drought conditions
Redhills / Whenuapai HIF programme will continue	Hunua 1 replacement postponed for 3 years	**Reduction in resilience** – loss of supply, revised SOI targets to reflect the revised risk profile
80% of the planned Base Case growth investment for the first 5 years	Warkworth and Wellsford growth postponed for 2-3 years	**Energy neutrality initiatives delayed** – climate change strategy and revised SOI targets to reflect the revised risk profile

What can be delivered	Risks	Implications
Smart meter and new connection installations continue	Warkworth / Snells, Waiuku / Clarks Beach, and Wellsford wastewater treatment plant new consents will not be met	**No funding available for significant emergency events**. –If funding is required, further projects will need to be deferred
Planned control system and major electrical renewals and upgrades	Kāinga Ora growth investment postponed for 2–3 years	Credibility with central government reduced
The second Waikato River intake structure delivered to programme	Leakage detection investment postponed 2–3 years	
	Waikato A postponed a minimum of 3 years	
	Rosedale upgrades postponed 3 years	

7. WICS and options to address Rating Agency constraints on level of debt

During 2020 Watercare engaged the Water Industry Commission for Scotland (WICS) to undertake an independent determination of its performance. This determination stated Watercare was the clear leader in economic performance in the New Zealand water sector, but it could deliver greater gains if it was able to invest more in renewals and resilience.

The review found Watercare had achieved much in its first ten years with the delivery of reliable services and a comprehensive capital works programme while charging its customers $100 million less per year than was forecast by previous councils.

Watercare's unit costs compare very favourably with other parts of New Zealand. Other metropolitan areas report unit operating costs that are 50% to 100% higher than ours.

But these unit costs were still higher than those of leading UK providers who had been able to undertake a much higher level of investment through greater access to borrowing.

The WICS analysis recommended that Watercare:

- Should be looking to increase its level of capital expenditure by around 50%.
- Should seek to improve its operating expenditure efficiency by 4.5% a year in real terms.
- Achieves these outcomes with economically efficient pricing for customers there was a need to address Watercare's current constraining financing structure.

Watercare modelling of the WICS recommendations (noted above) on the investment programme recommended above of $8.1b ($real) over 10 years would see annual price rises of 5.9% per annum over the LTP period. This sees the expected annual residential bill in 2031 being $1,897 compared to $2,261.

Addressing rating agencies view of Watercare's debt would allow us to invest more

Enabling rating agencies to treat Watercare debt as if we were a stand-alone water utility would allow us to invest more in both asset renewal and resilience as well as initiatives to drive further operating costs efficiencies.

Work has been underway with both Council and Government agencies for a number of months to identify ways to achieve this outcome for the benefit of customers. The current options available are:

- An interim Crown indemnity of Watercare debt until the national 3 Waters Reform process establishes new delivery models for water services, this would enable immediate relief to increase the investment programme without substantial increases in customer prices.
- Waiting for the 3 Waters Reform process which may be two to three years away. It is critical that this process provides for economically efficient borrowing structures to ensure prices to customers and the level of investment can be managed.

While work is underway to assess the viability of these options, no assumptions have been made on the outcome of these workstreams. The price path modelling has been developed on a status quo basis in terms of financing.

For the purpose of informing the Council's draft 2022–2031 Long-Term Plan (LTP) and consultation document Management considers that a capital programme of $8.132b ($real) between FY22 and FY31 with an associated tariff increase of 7% for 2 years followed by a 9.5% increase is an acceptable risk position and strikes the right balance with the obligations under s57 Local Government (Auckland Council) Act 2009 being to keep cost to our customers at minimum levels and maintaining the long term integrity of our assets.