Wellington City Council

Balance Sheet Review

Discussion Paper

May 2023

Disclaimers

Summary Report

This report has been prepared and is delivered by KPMG, a New Zealand partnership (KPMG, our) subject to the agreed written terms of KPMG's Consultancy Services Order with Wellington City Council (WCC, Client, you) dated 27 January 2023 (Engagement Contract).

This report provides a summary of KPMG's findings during the course of the work undertaken for Client under the terms of the Engagement Contract. The contents of this report do not represent our detailed findings, which will only be contained in our final detailed report. This report should be read in conjunction with our full report. Nothing in this report constitutes legal advice or legal due diligence and you should not act upon any such information without seeking independent legal advice.

This report is provided solely for Client's information and is not to be copied, quoted or referred to in whole or in part without KPMG's prior written consent. KPMG and its controlled entities accept no responsibility to anyone other than Client for the information contained in this report. Accordingly, any third party choosing to rely on this report does so at their own risk.

Inherent Limitations

This report has been prepared and is delivered by KPMG, a New Zealand partnership (KPMG, we, us, our) subject to the agreed written terms of KPMG's Consultancy Services Order with Wellington City Council (Client, you) dated 27 January 2023 (Engagement Contract).

Unless stated otherwise in the Engagement Contract, this report is not to be shared with third parties without KPMG's prior written consent. However, we are aware that you may wish to disclose to Councillors elements of any report we provide to you under the terms of this engagement. In this event, we will not require Councillors to sign any separate waivers.

The services provided under our Engagement Contract (Services) have not been undertaken in accordance with any auditing, review or assurance standards. The term "Audit/Review" used in this report does not relate to an Audit/Review as defined under professional assurance standards.

The information presented in this report is based on [that made available to us in the course of our work/publicly available information/information provided by Wellington City Council Management. We have indicated within this report the sources of the information provided.

Unless otherwise stated in this report, we have relied upon the truth, accuracy and completeness of any information provided or made available to us in connection with the Services without independently verifying it. Nothing in this report constitutes legal advice or legal due diligence and you should not act upon any such information without seeking independent legal advice.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, Wellington City Council management and personnel consulted as part of the process.

In relation to any prospective financial information/forecasts/projections included in the report, we do not make any statement as to whether any forecasts or projections will be achieved, or whether the assumptions and data underlying any such prospective financial information/forecasts/projections are accurate, complete or reasonable. We do not warrant or guarantee the achievement of any such forecasts or projections. There will usually be differences between forecast or projected and actual results, because events and circumstances frequently do not occur as expected or predicted, and those differences may be material.

This report was based on information available at the time it was prepared. KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

Third Party Reliance

This report is solely for the purpose set out in the Consultancy Services Order dated 27 January 2023 and for Client's information, and is not to be used for any other purpose or copied, distributed or quoted whether in whole or in part to any other party without KPMG's prior written consent.

Other than our responsibility to Client, none of KPMG, any entities directly or indirectly controlled by KPMG, or any of their respective members or employees assume any responsibility, or liability of any kind, to any third party in connection with the provision of this report. Accordingly, any third party choosing to rely on this report does so at their own risk.

Additionally, we reserve the right but not the obligation to update our report or to revise the information contained therein because of events and transactions occurring subsequent to the date of this report.

KPMG Centre
18 Viaduct Harbour Avenue
PO Box 1584
Auckland 1140

Tel +64 9 367 5800

Private and confidential

Barbara McKerrow and Andrea Reeves
113 The Terrace
Wellington Central
Wellington 6011

[redacted]

Dear Barbara and Andrea

Balance Sheet Review – Discussion Paper

Thank you for the opportunity to support the Wellington City Council (the "Council" or "WCC") as it considers options to address its balance sheet constraints.

Our work has been performed in line with the scope of our All of Government Consultancy Services Order (CSO) dated 27 January 2023 and is based on information provided by the Council or collected from publicly available sources.

Our work has focused on identifying the current balance sheet constraints being experienced by the Council, and identifying options which could be explored further to mitigate some of the constraints.

We note that this report is a summary of the full Balance Sheet Review, and should be read in conjunction with the full report.

Please don't hesitate to contact me if you have any questions.

Kind regards

[redacted]

[redacted]

WCC is not alone in the challenges it is facing

Local authorities across New Zealand are facing a myriad of challenges as they look to plan and invest for the future.

Bear the costs of growth but none of the benefits

As Councils invest in infrastructure, there is a lag between the timing of capital expenditure and the receipt of increased rates revenue. For many local authorities growth represents as cost rather than a benefit.

Aging infrastructure starting to bite

Many Councils have infrastructure that is starting come to the end of its useful life. Significant deferred maintenance liabilities have accrued while successive councils prioritise building new.

COVID-19 & cost increases

COVID-19 impacted Councils in varying ways, with most experiencing significant operational disruption as well as lower than expected revenue, which in many cases has resulted in higher debt levels.

Balance sheet constraints

Local authorities are limited by a combination of LFGA covenants and internal policies, with headroom for further borrowing reducing as investment increases. Recent interest rate increases mean that the debt servicing burden has become more challenging.

Councils cut, prune to minimise rate rises
Stuff

Council debt may exceed agreed level, require extra
Otago Daily Times

Auckland Council airport shares still on chopping block to fill $295m budget hole
RNZ

Putting off projects, spending cuts considered as Hamilton City Council tries to save $6m
Stuff

Christchurch council looking at 'every financial lever' amid 9% rates hike prediction
Stuff

'No cuts' - protesters crowd Auckland Council budget meeting
RNZ

Tauranga council hits back at 'budget blowout' claims, says Covid costs out of its control
Stuff

Simon Wilson: Rates versus airport shares - inside the battle of the Auckland Council budget
nzherald.co.nz

How did we get here?

WCC has strategically invested in Wellington infrastructure, resulting in increased debt levels.

FY17

- *Borrowings:* ***$496m***
- *Stage one of* ***Harbour Escarpment Walkway*** *was completed.*

FY18

- *Borrowings:* ***$582m***
- ***LGWM*** *partnership was announced.*

FY19

- *Borrowings:* ***$689m***
- ***$34m*** *strengthening of* ***St James Theatre*** *began.*

FY20

- *Borrowings:* ***$776m***
- ***$13.6m*** *loss in revenue and project* ***delays*** *due to Covid-19.*
- *Major water network failures occur.*

FY21

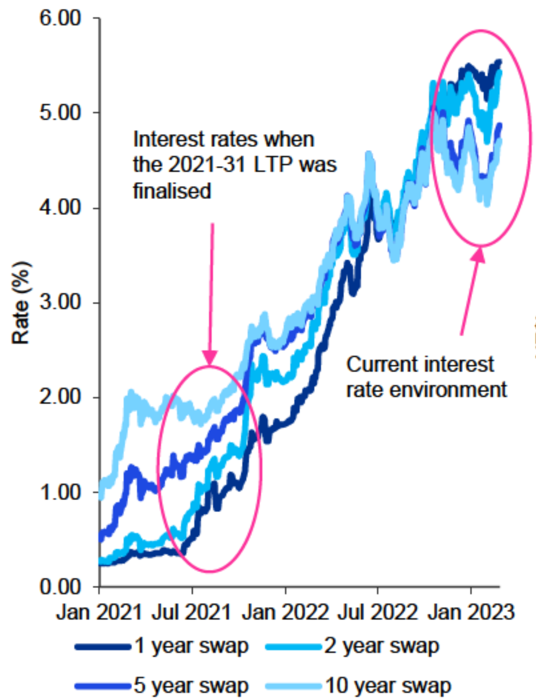
- *Borrowings:* ***$909m***
- ***Town hall and National Music Centre*** *redevelopment began.*
- ***$19.6m*** *COVID-19 related loss in revenue.*

FY22

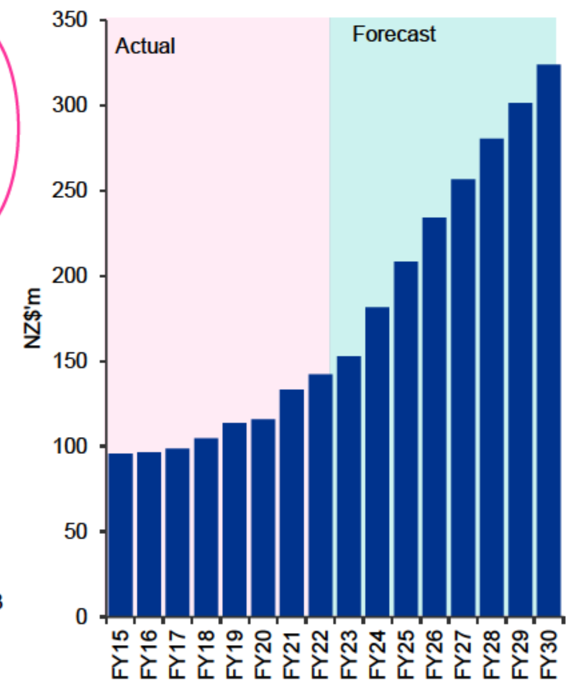
- *Borrowings:* ***$1.07b***
- *Record capital spending.*
- ***$61.9m*** *spent on water infrastructure.*
- ***$26.6m*** *COVID-19-related loss in revenue.*

Interest rates have risen sharply, resulting in a higher debt servicing burden. Increased investment has resulted in greater asset depreciation expenses.

RBNZ Interest Rate Swaps



Depreciation over time



The environment in which WCC is preparing its next Long-Term Plan is considerably more challenging than when the previous Plan was prepared.

KPMG

WCC's balance sheet faces multiple constraints

The Council has made strategic decisions in recent years to take on additional debt and invest heavily in improving Wellington's services and infrastructure. This has resulted in borrowing nearly doubling since 2017, with multiple high-priority projects currently ongoing or in the planning stages. WCC is facing a number of balance sheet constraints that may impact its ability to deliver on its work programmes and maintain a strong financial position. These present an imminent financial challenge that must be managed and navigated carefully.

Borrowing constraints

WCC's debt levels have almost doubled over the past five years to over $1 billion. Borrowing is expected to continue increasing, with WCC forecast to breach its self-imposed Net Debt to Total Revenue covenant (including a $270m insurance buffer) from FY23 to FY30. If further debt is raised, WCC may also get close to breaching the LGFA Net Debt to Total Revenue covenant, which would have adverse consequences.

Rates affordability and tolerance

Rates have increased over recent years, with further increases forecast. Affordability assessments for low-income households are very tight, especially in a high inflation environment that is increasing financial stress for many households. Public perception of the pace of rates increases may also limit WCC's scope and draw greater scrutiny to WCC's financial management.

Cost increases - particularly interest, insurance and depreciation

Interest rates in New Zealand have increased significantly since the 2021 LTP was finalised. Insurance premiums are set to rise while access to insurance for many of WCC's assets is becoming more challenging. Depreciation is also forecast to increase as investment occurs and asset values increase. These BAU costs absorb much-needed rates revenue.

Insufficient insurance headroom

WCC has been maintaining additional borrowing capacity as an insurance buffer to cover the impact of natural disasters. The current buffer may be insufficient given the lack of geographic diversification of assets and it may be spread too thinly, particularly in the event of a large earthquake. There is essentially no capacity to increase insurance headroom and taking additional insurance would result in significant extra cost.

Less financial flexibility

There have been material changes in the economic environment since the 2021 LTP financial forecasts were prepared. There are also other costs and spending priorities that are not yet fully included in the forecasts. Headroom for contingencies, cost inflation and new spending priorities is insufficient and financial flexibility is expected to worsen.

Exposure to risk

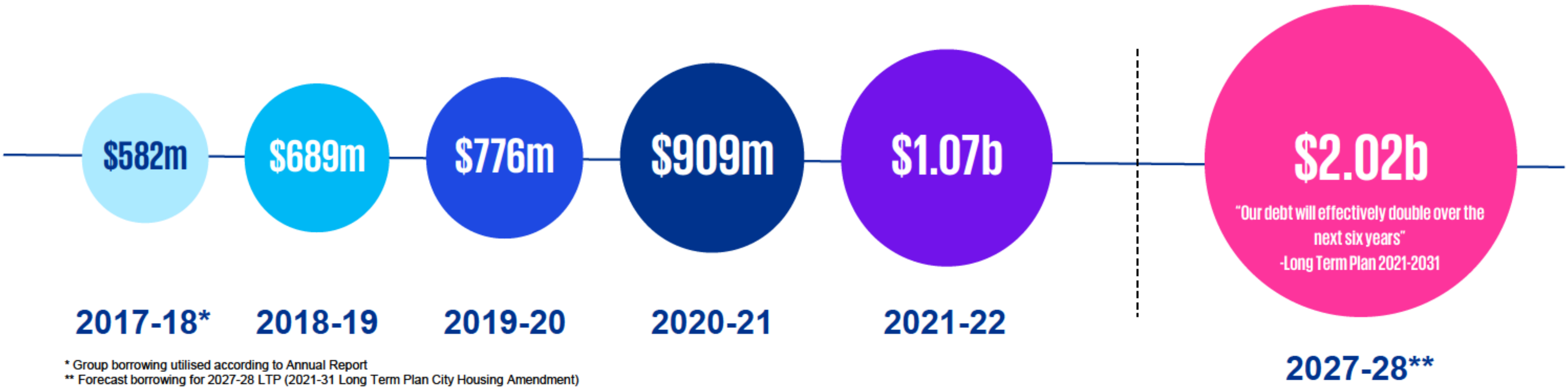
WCC's portfolio has little geographic diversification, leaving it highly exposed in the event of a natural disaster. From an economic and environmental perspective, the current landscape and outlook makes mitigation and risk diversification even more important.

Limited revenue sources

Given that WCC may not be able to rely on material rates increases or additional borrowing above current forecasts to fund future initiatives, new revenue streams or unlocked capital will likely be required in order for WCC to fund its commitments and future ambitions for the city.

Borrowing constraints

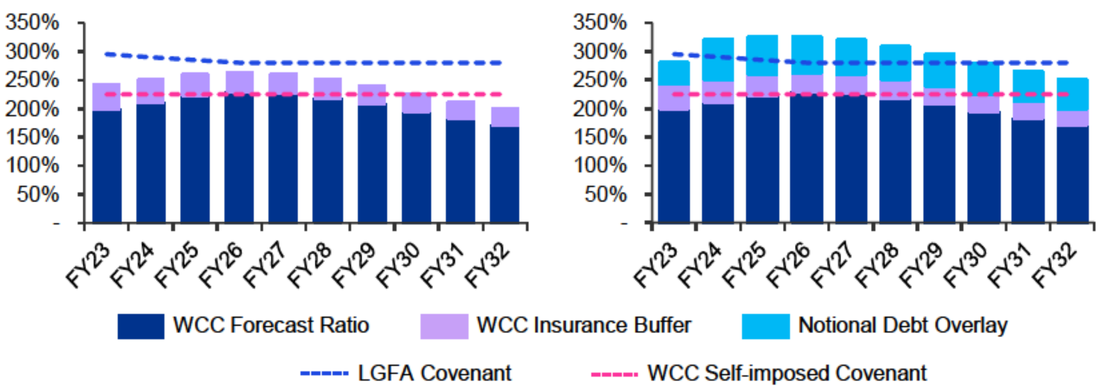
WCC is forecast to breach its self-imposed Net Debt to Total Revenue limit of 225%. With additional debt, WCC could get close to breaching the LGFA Net Debt to Total Revenue covenant, which would have significant adverse consequences for the Council.



* Group borrowing utilised according to Annual Report
** Forecast borrowing for 2027-28 LTP (2021-31 Long Term Plan City Housing Amendment)

Net Debt/ Total Revenue in 2021-31 Long Term Plan

Net Debt/ Total Revenue including notional $500m additional debt



In the 2021-31 LTP document, WCC includes $270m as an insurance buffer in its Net Debt calculations. When this $270m buffer is included, WCC is forecast to breach its self imposed covenant limit of 225% throughout the majority of the forecast period.

In addition to cost inflation, some new WCC projects and expenditure priorities are not fully reflected in the 2021-31 LTP. While the cost of these projects are often not yet known, we consider that it is possible that WCC could require an extra $500m of additional borrowings to cover increased operating and capital expenditure, noting that we consider $500m to be a conservative (i.e. lower bound) estimate of additional borrowing. We have applied this notional $500m debt overlay to the covenant calculations to show the impact of additional debt raised.

With $500m of additional debt, WCC would breach its self imposed 225% limit throughout the forecast period and would also breach the LGFA Net Debt to Total Revenue covenant (which excludes the insurance buffer) from FY25 to FY27. An unremedied LGFA covenant breach would likely have adverse consequences for WCC in relation to debt pricing and ability to access further debt finance.

Source: 2021-31 Amended LTP, WCC Financial Statements FY15 – FY22, KPMG Analysis

Rates affordability and tolerance

There is significant variation across the Wellington region when rates are considered as a percentage of household income.

The report of the Local Government Rates Inquiry 2007 noted, as a rough benchmark, that **affordability problems could arise where rates exceed 5% of gross household income.**

Wellington City as a whole remains below this indicative benchmark level throughout its forecasts, with a median rates bill which is 2.9% of the gross median household income, increasing to a forecast peak of 3.3% in FY28 (including the proposed sludge levy).

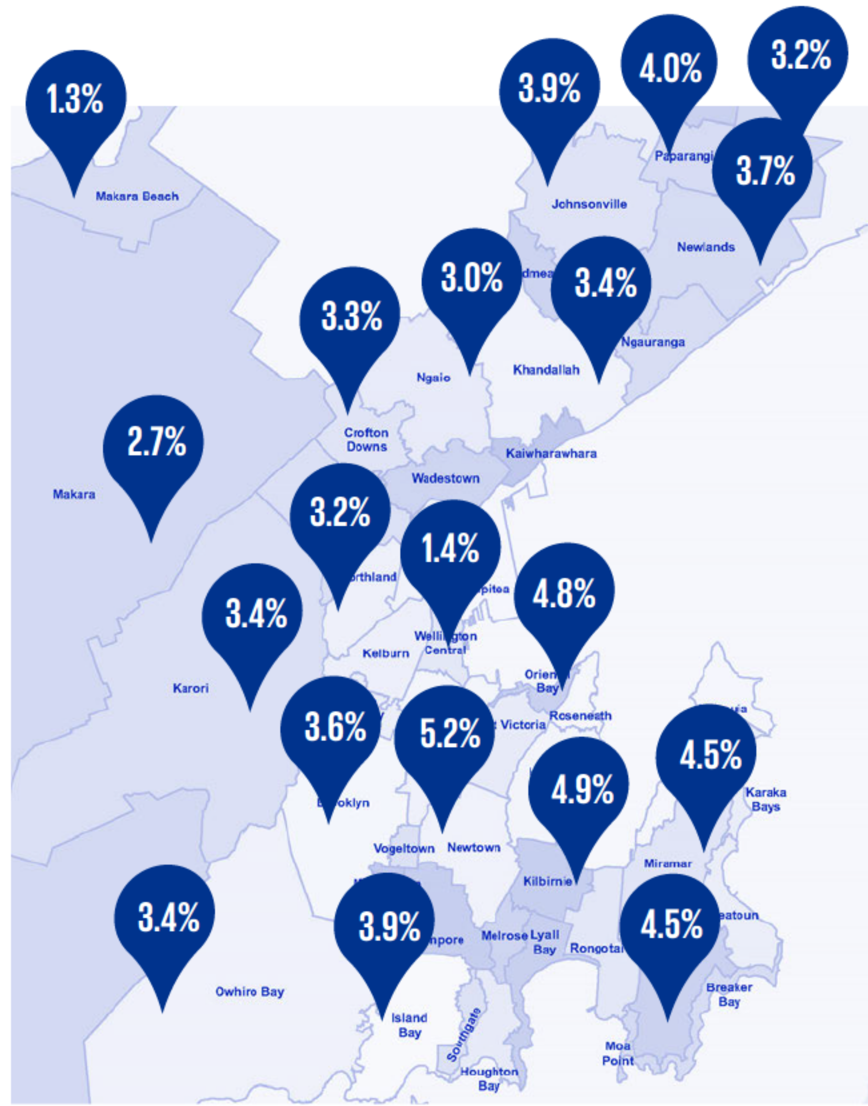
Rates across the Wellington region vary greatly. The map to the right shows forecasted rates as a percentage of median gross household income by suburb in FY28. Broad analysis of the Wellington region shows that only one suburb is forecasted to breach the 5% affordability benchmark.

While rates are forecast to be affordable based on current forecasts, indications are that the current rates path may be approaching the limits of affordability for some ratepayers (particularly those on lower incomes) in some Wellington suburbs.

This indicates that there may be limited scope for continued large increases in the near-to-medium term to meet any funding gaps.

How much would your rates be if they were 5% of your gross household income?

If your annual gross household income is…	\$100,000	\$142,148*	\$150,000	\$200,000	\$250,000
At the current median, rates level of 2.9% of your rates bill would be…	\$2,900	\$4,122	\$4,350	\$5,800	\$7,250
At 5%, your annual rates bill would be…	\$5,000	\$7,107	\$7,500	\$10,000	\$12,500



Note this display is non-exhaustive and for demonstration purposes only.

*Median household income from KPMG's sludge analysis.

Cost increases - interest, insurance & depreciation

WCC's costs are increasing. There are factors that sit outside of the Council's control yet can have a material influence on costs. Interest rates, insurance premiums and depreciation in particular are being driven by global and local macro-economic trends.

While the 2021-31 Amended LTP includes forecast financial statements that demonstrate how WCC will fund the activities and commitments outlined, the associated costs are not fixed. Unfortunately, there are factors outside of WCC's control impacting its costs significantly, and at pace. These costs already consume a notable percentage of WCC's revenue.

Interest rates

The global economic environment has had an impact. Rising inflation has caused interest rates to surge in New Zealand, meaning that WCC is likely to face higher than forecast interest rates. As outlined in the following slides, the implications could be considerable, particularly if further debt is required to fund interest rates (which would in turn further increase WCC's interest costs).

Depreciation

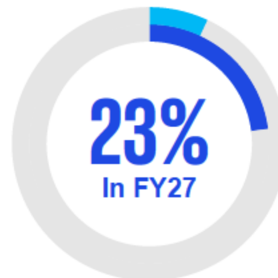
WCC's capital expenditure policy tends to involve funding capital expenditure initially by borrowing and then repaying borrowings by rating for depreciation. WCC fully funds depreciation expense and regularly revalues its major assets, which has the impact of increasing depreciation. WCC's asset market values have historically increased over time and are forecast to continue increasing. As a result, depreciation expenses are forecast to grow, which will ultimately be passed on to ratepayers.

Insurance premiums

The natural environment is also playing a role in WCC's increased costs. Insurance premiums are expected to continue rising as insurers consider the risks of natural disasters or extreme weather.

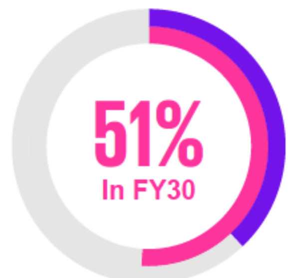
In 2022 alone, New Zealand has already experienced a number of extreme weather events that have highlighted local and central government exposure and the cost of rebuilding infrastructure. At the time of this balance sheet review, 147 road, six state highways and 40 bridges are closed as a result of flooding and Cyclone Gabrielle across the North Island.

WCC's asset base is heavily comprised of infrastructure, with WCC owning more than $10b worth of property, plant and equipment. Not all of these assets are adequately insured.



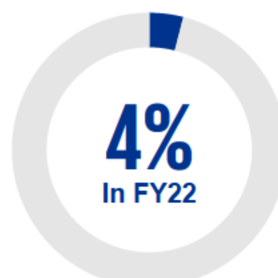
Net finance costs

In FY22, net finance costs were 7% of rates revenue. Net finance costs could reach as high as 23% of rates revenue in FY27 due to the increase in interest rates.



Depreciation

In FY22, depreciation consumed 38% of rates revenue. Depreciation is forecast in the LTP to consume 51% of rates revenue in FY30.



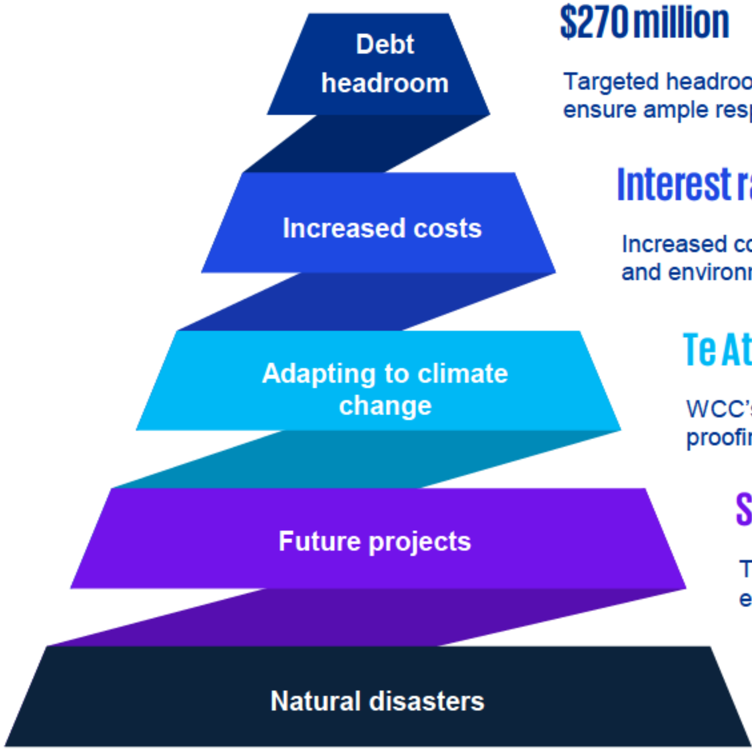
Insurance premiums

Consumed 4% of rates revenue in FY22 and is likely to increase materially over coming years.

Source: WCC FY22 Annual Report, KPMG Analysis

Insufficient insurance headroom

WCC has maintained headroom of $270 million for known and unknown future costs risks. These include insurance, interest rates changes, the price of carbon, the need to adapt to climate change, and the risk of an earthquake or other natural disaster.



$270 million

Targeted headroom below the LGFA covenant held to ensure ample response to future events.

Interest rate risk and insurance costs

Increased costs resulting from the changing economic and environmental landscape.

Te Atakura and climate resilience

WCC's commitment to a sustainable future and future-proofing Wellington will require further spending.

Sewage Sludge, LGWM and Growth

These projects will likely result in significant expenditure.

Self-insurance and WCC's response

Estimates show that the probable loss to uninsured assets from a large event will not be covered by WCC's current headroom.

Future risks and headroom application

The Council has three ways to address the risks associated with its asset portfolio, particularly in the case of a major event:

- insure the full value of the portfolio
- maintain sufficient headroom for probable loss
- divest high-risk or exposed assets.

It is apparent that the current debt headroom is already spread thinly across multiple future events and may further erode as new projects are approved. With many of these factors coming into play simultaneously and with significant cost implications, it is likely that the existing headroom will not be sufficient if any unexpected events occur.

WCC is currently undertaking an insurance review with the assistance of AON. Preliminary estimates show that the WCC's headroom is significantly smaller than the probable loss it would incur in a large event.

With WCC's internal debt covenants forecast to breach throughout the forecast period, and LGFA covenants tightening when headroom is factored in, there is a significant risk that WCC does not have enough headroom for future events.

Source: 2021-31 LTP Volume 1, 2021-31 LTP Volume 2, 2021-31 Amended LTP, KPMG Analysis

Opportunities to alleviate balance sheet pressure

Given the multiple constraints that WCC faces, it is likely that a combination of actions will be required. Below is a summary of the four options we consider will be the most effective in addressing WCC's current challenges and enabling it to deliver high priority projects into the future.

01

Review non-rates revenue, service levels & capex phasing or prioritisation

These matters are already considered regularly at WCC and will be a component of the 2024-34 LTP planning process.

The LTP planning will include the development of a finance and infrastructure strategy which could consider and incorporate some of the constraints and opportunities outlined in our report.

Key focus areas:

- Phasing of major capital expenditure projects to smooth projected cashflows and provide additional headroom
- Maximising non-rates revenue where possible
- Identifying opportunities to review the level of service WCC provides to help alleviate or offset cost pressures

02

Consider rationalising the WCC investment portfolio

WCC has acquired its asset base over a number of years and it would be timely to review the portfolio to determine whether significant holdings remain aligned with current Council priorities.

Investment review criteria:

- <u>Returns</u> – whether projected investment returns will deliver good value for ratepayers
- <u>Diversification</u> – consider traditional investment criteria, including financial and geographic concentration and potential risk mitigation
- <u>Strategic Alignment</u> – whether investments are fully aligned with current Council objectives
- <u>Governance</u> – assess whether oversight of investments is suitable or could be strengthened by bringing in asset management expertise

Divesting non-essential assets could enable reinvestment in new assets or priority spending areas, whilst potentially reducing the costs of ownership and boosting financial returns.

03

Utilise IFF further to fund & finance infrastructure

The Infrastructure Funding and Financing ("IFF") Act provides an effective framework for financing infrastructure projects, which is being successfully deployed on the sludge waste minimisation project.

IFF structures allow WCC to move debt off balance sheet into a Special Purpose Vehicle (SPV), thereby providing greater headroom on LGFA debt covenants.

It does not necessarily alleviate ratepayer affordability, as ratepayers repay the debt via additional levy payments.

Further utilisation of the IFF framework will be useful when considering funding and financing options for capital expenditure projects such as those included under Let's Get Wellington Moving.

04

Review insurance & internal covenant settings

The Council currently imposes a stricter Net Debt to Total Revenue covenant on itself than that applied by the LGFA, which involves including a $270m debt capacity buffer to cover potential future insurance shortfalls following a natural disaster.

A review of WCC insurance arrangements is currently being undertaken in conjunction with Aon, which will likely include exploring alternative forms of coverage such as parametric insurance.

Changing insurance settings will likely influence with the Council's overall financial risk profile.

A reconfiguration of the Council's insurance strategy may provide an opportunity to review debt headroom requirements and potentially increase balance sheet capacity.

Evaluating the options

There is no silver bullet or single all encompassing solution. WCC has multiple competing responsibilities, stakeholders and priorities, so there are a number of factors to consider when assessing the options available. We have applied the criteria below to evaluate the effectiveness and appeal of each option at a high level, with the overarching aim of improving WCC's financial position both now and into the future.

Assessment Criteria

Strategic alignment and governance
Whether the options being considered will continue to align with WCC's long-term strategy and values.

Funding and financing capacity
The extent to which the options would likely provide WCC with additional funding and financing capacity whilst minimising additional administrative burden.

Impact on rates
The likely medium to long term impact of the options on rates levels (including levies arising under IFF financing structures) and ratepayer affordability.

Supports council resilience
Impact of the options on overall WCC resilience, including the ability to withstand unexpected environmental or economic events.

Public perception
Likely ratepayer perception and publicity arising from announcement/deployment of the options.

Feasibility
Whether options can be carried out under current legislation and regulatory frameworks.

		Strategic alignment & governance	Funding & financing capacity	Impact on rates	Supports council resilience	Public perception	Feasibility
1	Review non-rates revenue, service levels & capex phasing	Positive / High	Unknown	Unknown	Positive / High	Negative / Low	Positive / High
2	Consider rationalising the WCC investment portfolio	Positive / High	Positive / High	Positive / High	Positive / High	Negative / Low	Positive / High
3	Utilising IFF further to fund & finance infrastructure	Positive / High	Positive / High	Neutral / Medium	Positive / High	Unknown	Positive / High
4	Review insurance & internal covenant settings	Positive / High	Unknown	Unknown	Positive / High	Unknown	Positive / High

Positive / High   Neutral / Medium   Negative / Low   Unknown

The contacts at KPMG in connection with this report are

[redacted]

[redacted]

[redacted]

kpmg.com/socialmedia