Financial Case

The financial case sets out the financial impact of any change and the high-level funding arrangements of the options. The results are presented initially at the regional level then for each council.

Conclusions from the financial case

Financial analysis of the potential costs and benefits of each option was undertaken by comparing each option against the enhanced status quo over a period of ten years of operation for each option (2032).

The enhanced status quo

- modifies each council's forecasts with estimated future cost increases that all the councils may face from changes in regulatory standards. This has been undertaken using information made available by the DIA
- assumes further additional costs for meeting increased compliance requirements for all councils, except Hastings which has already seen a 100% increase in the operational costs of drinking water post Havelock North.

The outcome of the financial analysis, when considered at a regional level, is that all options are able to reduce the future cost of three waters service delivery to less than under the current approach (enhanced status quo). In a strictly financial sense, all options are better than the enhanced status quo. This analysis includes an allowance for transitional costs, ongoing savings and additional costs associated with each model.

Table 22 Summary of costs and benefits (total operating and capital) (NPV)

2021 - 2032	Costs ($000)	Benefits ($000)
Business unit	$9,148	$22,893
Management CCO	$19,945	$47,144
Asset Owning CCO	$23,243	$70,736

These savings translate into lower ratepayer charges and are driven by the creation of efficiencies through improved asset management, the aggregation of purchasing power, and adopting a coordinated approach to procurement across the region. They are balanced against the costs to establish each option and the introduction of some longer-term costs in the CCO models from additional resources and being a separate organisation.

The best performing option and the recommended one is the asset owning CCO. The asset owning CCO by 2032

- creates $16.7M (12.7%) in annual savings in operational costs compared to enhanced status quo
- creates a 10% reduction in the annual costs of the capital programme compared to the enhanced status quo
- reduces regional three waters debt by a total of $28.3 million compared to the enhanced status quo
- saves a total of $117.4 million in operational savings and $31.1 million in capital expenditure when compared to the enhanced status quo.

Furthermore, the asset owning option's ability to regionalise capital and operational costs means that it is the only model that minimises the risk associated with unplanned future capital costs or the risk that the costs of meeting new standards and regulations are higher than anticipated.

For almost all residents it creates the lowest cost service for Central Hawke's Bay, Hastings and Wairoa. While we recognise that it is not the lowest cost option for Napier residents, the difference is within the range of the sensitivity analysis that has been undertaken.

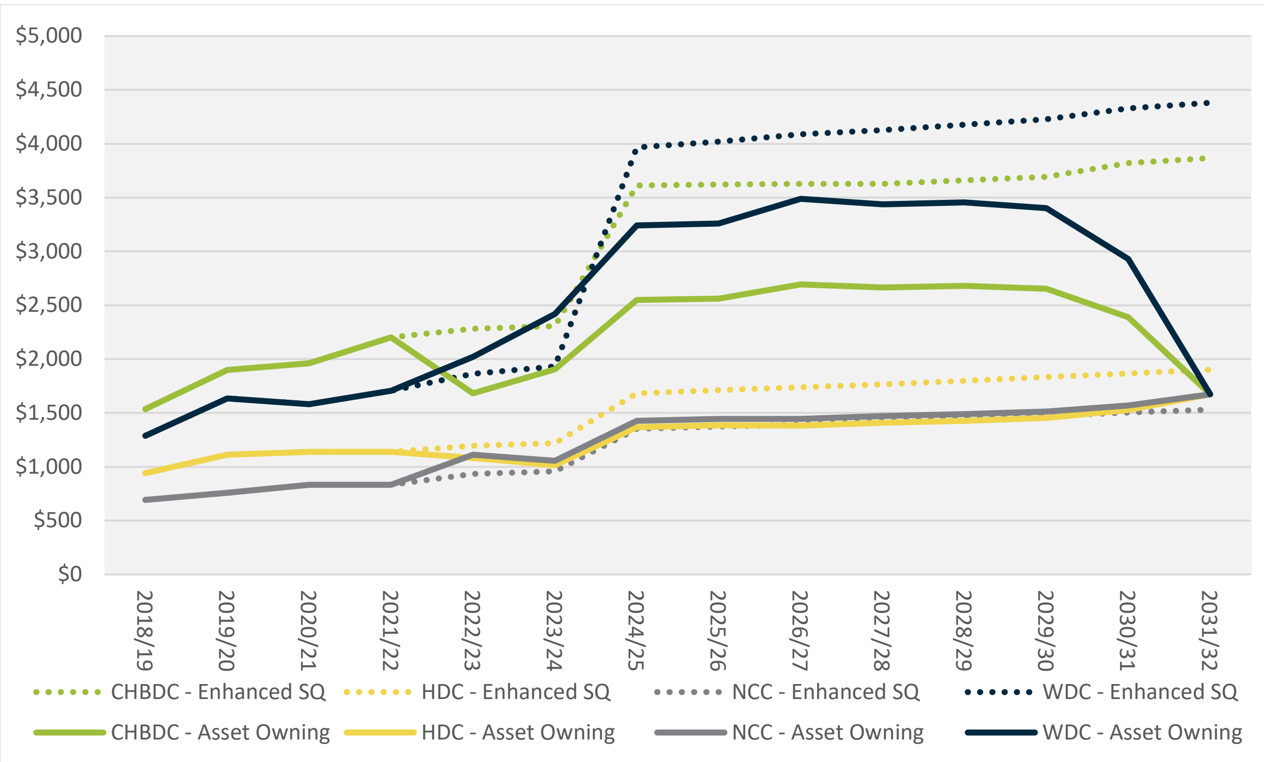
It is important to note that the management CCO option is still a better outcome than the status quo for almost all councils. Central Hawke's Bay, Hastings and Wairoa ratepayers are all better off compared to the status quo under the management CCO option when the average rate in 2032 is considered. However, again while we recognise that it is not the best financial option for Napier residents the difference is within the range of our sensitivity testing.

Equitable regionalisation

To address the perceived inequity that may arise from adopting an asset owning CCO model and regional pricing we have proposed an equitable regionalisation approach. This provides that for a period of time after the establishment of the asset owning CCO, charges would not be regionalised to a standard charge.

There are different options for how this could work which are presented in the financial case. **Figure 46** below demonstrates the approach we believe is the best compromise. Under our proposed approach the asset owning CCO becomes more affordable for ratepayers in Central Hawke's Bay, Hastings, and Wairoa after three years. While Napier ratepayers are not projected to achieve savings under the asset owning model, the difference is within the range that was explored in our sensitivity testing.

Figure 46 Comparison of rates impact under asset owning and enhanced status quo models



Affordability

The asset owning CCO option is the only option that adequately addresses affordability across the region by providing a path to regional pricing.

By 2032 (when we have assumed all costs are regionalised to a standard charge) all councils, other than Wairoa, are below the threshold of spending 2% of average household income on water and wastewater services. Wairoa ratepayers sees a substantial improvement in affordability under the asset owning model, but due to low projected household income levels still exceeds the 2% threshold.

Table 23 Estimated three waters residential rate: Affordability of water and wastewater[42] (2032)

	Central Hawke's Bay	Hastings	Napier	Wairoa
Enhanced Status	4.4%	1.9%	1.5%	5.9%
Shared Service Business Unit	3.9%	1.7%	1.5%	5.3%
Management CCO	3.2%	1.8%	1.7%	4.3%
Asset owning CCO	1.9%	1.6%	1.8%	2.3%

The financial case also addresses key issues such as

- stranded costs
- establishment costs
- anticipated additional costs and savings from each of the models.

Estimating the costs and benefits of change

The financial analysis has relied on making assumptions about what the future costs and potential savings that could be derived by each option may be. Comparison with other similar entities in this case is problematic as there are no similar sized three water organisations in NZ. For comparison, within New Zealand a combined Hawke's Bay regional water CCO would service a population almost as large as Hamilton with the large rural area making for quite a different organisation.

Internationally, water organisations tend to be larger, often, much larger. In Victoria, Australia there are 19 water corporations created under the Water Act 1989. They range in size, including four which service a similar sized population. Central Highlands, Coliban, Gippsland and Western Water all provide water and wastewater services to a population of between 145,000 and 160,000. Interestingly, their annual revenue in each case is between 60% and 120% higher than the combined Hawke's Bay councils three waters revenue. That makes comparison with these entities of little value.

42 GST inclusive water and wastewater rates as a percentage of household income. Relies on 2018 Census data for household income by Council area with Morrison Low projections of future values.

Additionally, there was until 2017 Mid-Coast Water, a water and sewer county council in New South Wales which provided two waters services to an area with a population of 90,000 spread across urban and rural areas. Formed in 1997 to provide water and then subsequently sewerage services across what was at that time three separate council areas. Following a merger of those councils in 2016, the decision was made to fold Mid-Coast water back into the councils. Interestingly, savings of almost $3M were projected to arise from reducing governance and executive costs and removing the duplication of corporate functions. Mid-Coast water was also considered to be heavily indebted following a significant capital investment program.

Given the lack of appropriate organisations off which to benchmark performance, size or scale an alternative approach has been used for estimating the costs and benefits of the changes created by each option. The starting point has been to combine the existing staff and costs of the four councils three waters services. In addition, it was determined that maintaining the existing jobs was important to the regional and rural economies. The modelling then

- calculates the expected costs to implement change (establishment costs)
- estimated any additional costs (whether staff, contractors, consultants, services or otherwise)
- estimated any benefits and savings that may arise from implementing the change. These arise from
  - efficiency – doing things right, with less inputs e.g. a reduction in the costs of contracted services
  - effectiveness – doing the right thing e.g. reduction in re-active maintenance from improved asset management practices
  - efficacy – setting the right objectives (as it relates to three waters e.g. asset management).

The modelling assumptions are set out in **Appendix C** with a summary of the financial impact of those set out in the table below. In each case there are short term costs to establish the change and ongoing increased costs from the day to day operation of separate organisations.

In each case the establishment costs and ongoing additional costs are outweighed by the savings that can be realised from each model.

Table 24 Summary of costs and benefits (total operating and capital) (NPV)

2021 - 2032	Costs ($000)	Benefits ($000)
Business unit	$9,148	$22,893
Management CCO	$19,945	$47,144
Asset Owning CCO	$23,243	$70,736

Establishment costs

While the establishment costs for the SSBU model are significantly lower than those of the asset owning and management CCOs, the SSBU offers only modest net benefits as it is only able to realise small savings when compared to the asset owning and management CCOs.

We note that the period of time covered by the analysis (ten years of change) is relatively short for the true benefits of these options to be realised. The larger benefits over time will be realised through reduced and improved capital expenditure and the financial benefits of that take time to be realised. By 2032 the ongoing savings for the management and asset owning CCOs are 3.7 and 5 times greater than the ongoing costs (respectively).

The establishment costs are summarised below with the assumptions detailed in **Appendix C.** We note that establishment costs do not include costs that are additional and created by the change but are ongoing such as rental of new office space, cost of additional corporate support roles, director fees, wage harmonisation and overheads. These are also set out in **Appendix C.**

Table 25 Establishment Costs

($000)	Capital	Operating
Business unit	1,263	1,163
Management CCO	2,458	2,379
Asset Owning CCO	3,558	2,379

Financial analysis of the options

Debt

The debt associated with the three waters services of each council is transferred to the asset owning CCO as will be the projected borrowings to fund future infrastructure investment. Under all other options current and future debt remains with the Councils.

The Local Government Funding Agency borrowing limits are set out in the table below. We note that all of the four councils are within these limits, forecast to be for the life of the LTPs and will remain within the limits under any of the options considered in this report.

Table 26 Local Government Funding Agency current borrowing limits for councils

Financial covenant	Lending policy covenants	Foundation policy covenants
Net debt / total revenue	<175%	<250%
Net interest / total revenue	<20%	<20%
Net interest / annual rates income	<25%	<30%
Liquidity	>110%	>110%

An asset owning CCO would purchase the three waters assets from each council. While the Councils will also need to provide a modest amount of capital to start the CCO off, it will not be sufficient to purchase the three waters assets. The asset owning CCO would therefore borrow in order to pay the Councils sufficient cash so that their loans can be repaid.

Each council will report their proportion of the CCO's debt (and assets) relative to their shareholding. The table below shows the relative debt positions under the different options. Under the asset owning CCO the italicised figures represent each council's proportion of the CCO debt based on shareholding by a depreciated replacement cost.

Table 27 Comparison of debt

Debt at 2030	Enhanced Status Quo	Business Unit	Management CCO	Asset Owning CCO
Central Hawke's Bay	$86M	$84M	$83M	*$23.4*
Hastings	$81M	$78M	$77M	*$148.1*
Napier	$84M	$81M	$81M	*$106.7*
Wairoa	$65M	$64M	$62M	*$10*
CCO	-	-	-	$288M
Region wide	$317M	$307M	$303M	$288M

As part of this review an initial conversation has been held with the LGFA. They have advised that the shareholders of LGFA have just recently approved lending directly to CCOs with water CCOs in mind. The different nature of a three waters CCO was understood by the LGFA and appropriate covenants for a water 'business' would be put in place. This means that debt/revenue ratios would likely be higher for a water business, and any new three waters CCO would be unlikely to be limited by the debt covenants imposed. We also understand that as of July 2020 the LGFA has announced an increase in net debt/total revenue limit to 300% for A rated councils.

Regionalisation of costs

One of the challenges to adopting an asset owning CCO model that is regularly encountered in business cases, and through the consultation process, is the perceived inequity that arises when councils are transferring different levels of debt or assets of varying conditions. Where this happens, ratepayers may feel that they are inheriting someone else's problem.

A different approach

To address this issue, we have proposed an equitable regionalisation approach where three waters charges are gradually regionalised for a period of time after the establishment of the asset owning CCO. Over that period, residents in each former council area would have charges that included a contribution based on the proportion of 'liability[43]' each council contributes to the CCO. In our view this creates a more equitable path toward a standard regional charge.

[43] A combination of debt, future required compliance upgrades, and costs to bring assets up to the regional average condition

In this approach the debt of each council has been considered alongside the condition of the current assets (as compared to a regional average) and the forecast investment required over the next ten years.

The total of all of these has been summed together and the proportion relating to each council is then used to determine a share of the revenue requirement over a period of time to represent the relative liability that each council contributes to the CCO.

As this approach is based on developing a 'fair' solution ultimately the decision as to whether such an approach is used, and if so, what the recovery period should be, is for the Councils to decide.

We have modelled various scenarios which show impacts on different groups of ratepayers but acknowledge that there are numerous alternative scenarios which could be adopted.

- Immediate regionalisation of all costs
- 100% of the relative liabilities brought by each council with a repayment period of
  - 20 years
  - nine years (ten years of the CCOs operations)
- 50% of the relative liabilities brought by each council
  - 20 years
  - nine years (ten years of the CCOs operations)

Each of these scenarios is presented in the charts below and compared to the enhanced status quo. We note that the scenarios include some 'smoothing' of the charge where necessary and we note that further smoothing could be applied to soften the impacts on specific ratepayer groups.

In our view the scenario that best balances the competing interests is '50% of the liability over a nine year period' because:

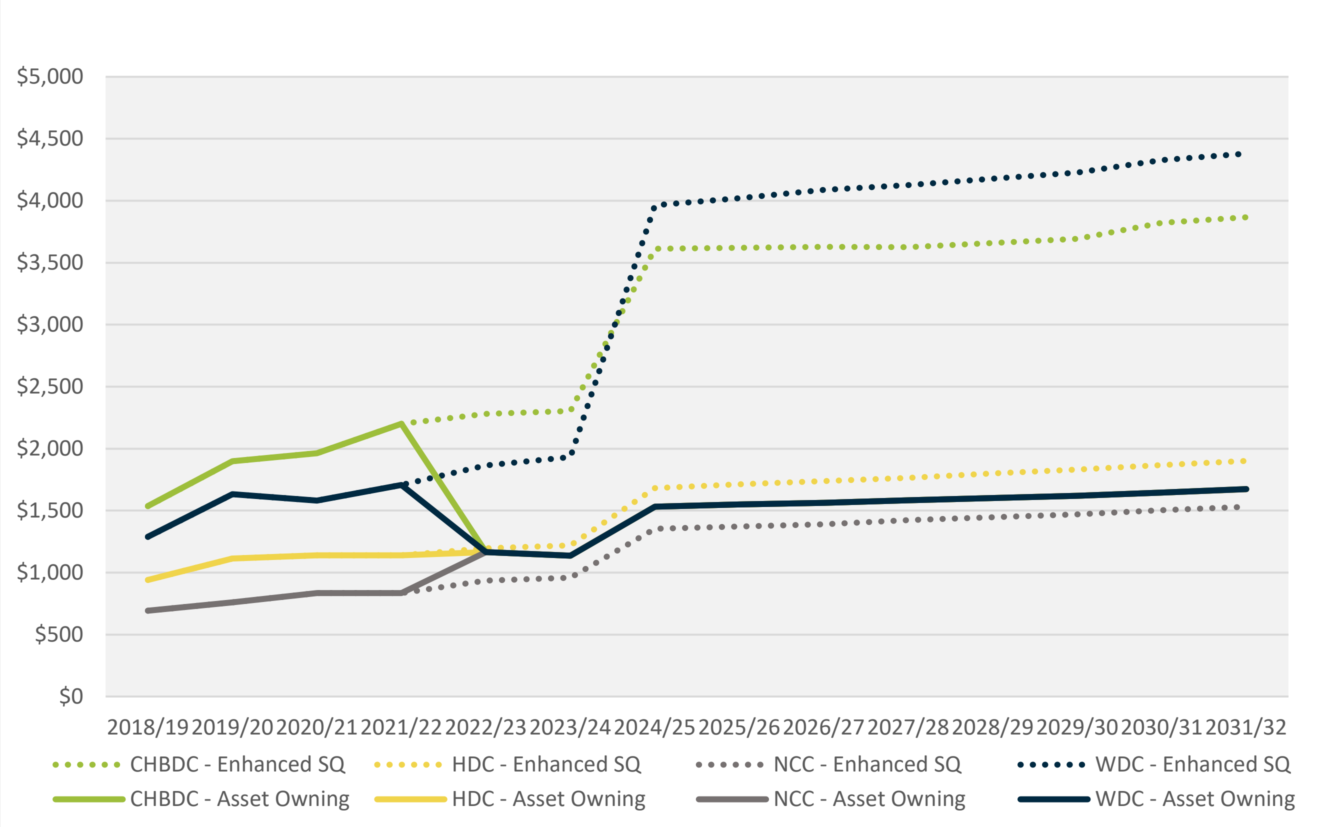
- the full benefits of regionalisation are not achieved until all ratepayers are paying a regional rate: that is the point at which community affordability is best addressed. A 20 year period would significantly delay these benefits from being realised.
- recovery of the full amount of the relative liability over such a short time frame would be inequitable. The costs being recovered by this calculation are for capital investment and are typically recovered over an extended timeframe taking into account the life of the assets.

These options do not include the impact of any government funding for infrastructure upgrades. The potential for such financial support may become part of the package announced in July 2020 but at this stage we do not know if or how much that might be. If such funding was available, then that has the potential to remove any issues relating to the regionalisation of costs. That would allow for an immediate regionalisation on day one without negative financial impacts on any group of ratepayers.

Immediate regionalisation of costs

This option does not address concerns about differing asset condition or debt levels but addresses community affordability quickly for some councils.

Figure 47 Immediate regionalisation of costs



With no regional equalisation, there is an immediate, significant reduction in three waters charges for Central Hawke's Bay and Wairoa of $1,116(49%) and $699 (38%) respectively. Hastings ratepayers also see a reduction of $30 (2%).

Under this option, Napier ratepayers see an increase in rates, compared to the status quo, after formation of $230 (25%), with all ratepayers paying the same regional rate in year one.

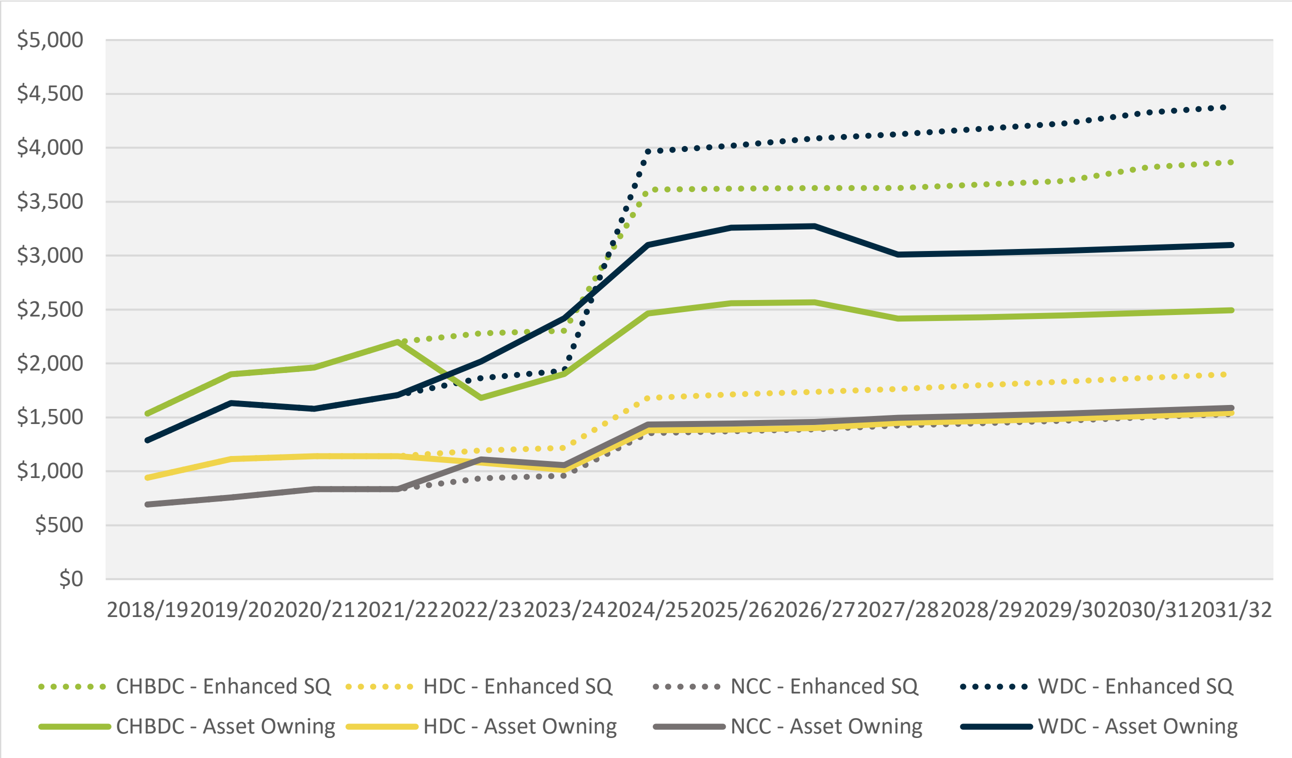
20 year period recovering 100% of the relative liability

A 20 year equalisation period with 100% recovery of relative liability would give Central Hawke's Bay an immediate rates reduction of $601 (26%) and Hastings a reduction of $113 (9%) in the first year. Napier and Wairoa would see increases in rates of $177 (19%) and $156 (8%) respectively, although the increase in rates for Wairoa would last three years when compared to the enhanced status quo.

The full benefits of a regional rate would not be passed on to Central Hawke's Bay or Wairoa for 20 years.

Under this option communities are still forced to repay infrastructure costs over a shorter time than would otherwise be required and the length of time until community affordability issues are addressed is considered to be too long.

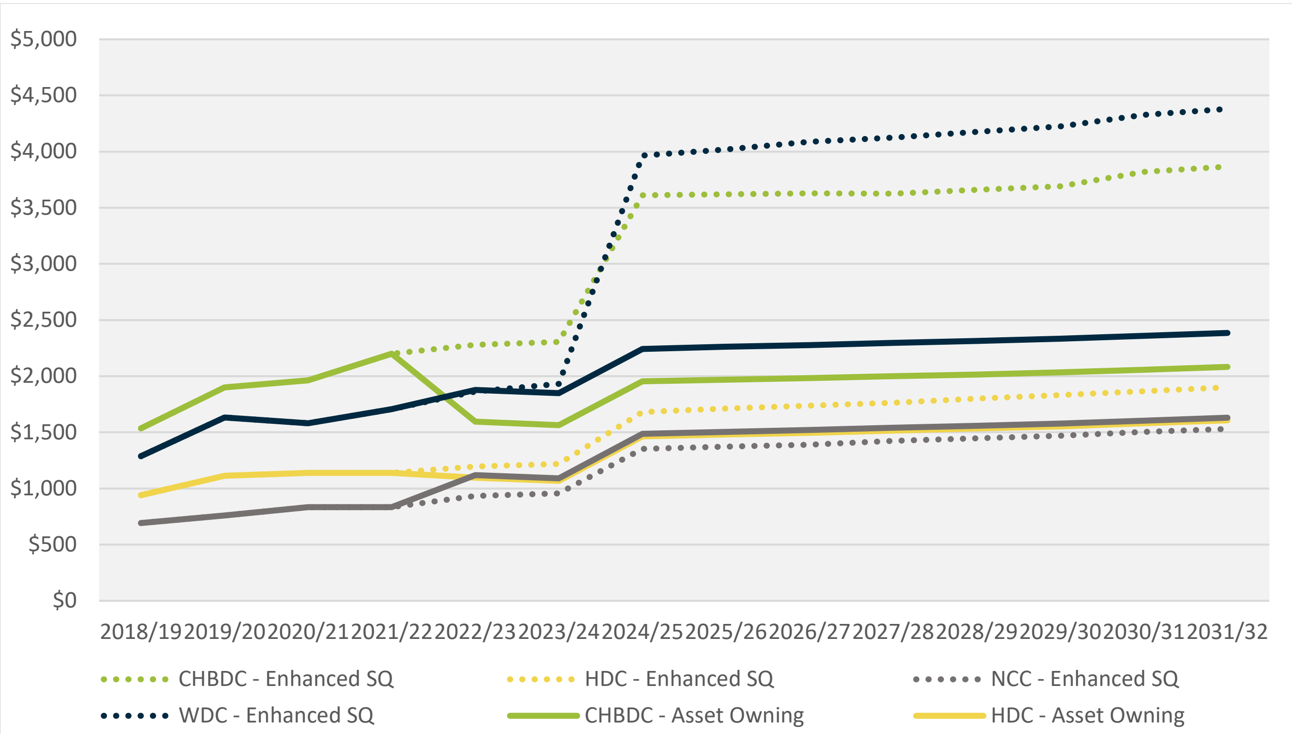
Figure 48 20 year recovery period of 100% or relative liability



20 year equalisation period recovering 50% of the relative liability

The length of the repayment period in this option is too long. It prevents true benefits of regionalisation from occurring for 20 years.

Figure 49 20 year equalisation of 50% of relative liability



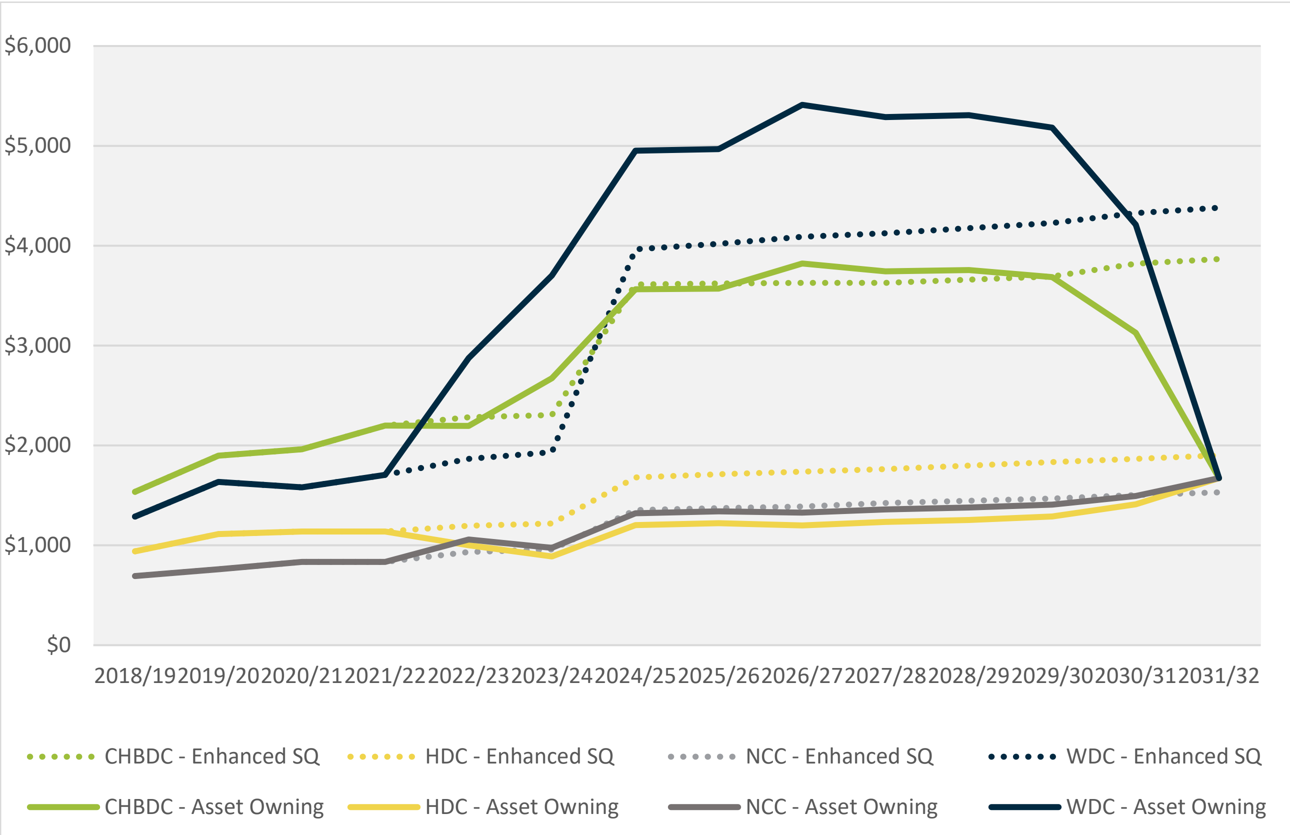
A 20 year equalisation period would give Central Hawke's Bay an immediate rates reduction of $687 (30%) and Hastings a reduction of $99 (8%) in the first year. Napier and Wairoa would see increases in rates of $186 (20%) and $13 (1%) respectively, although the increase in rates for Wairoa would only last one year when compared to the enhanced status quo.

The full benefits of a regional rate would not be passed on to Central Hawke's Bay or Wairoa for 20 years.

Nine year equalisation period recovering 100% of relative liability

Under this option communities are forced to repay infrastructure costs over a substantially shorter time than would typically be undertaken, which increases the affordability challenge over that period rather than addresses it. Over the nine-year period Central Hawke's Bays rates would track closely to its enhanced status quo forecast but Wairoa rates would be less affordable than the status quo during the nine year period.

Figure 50 Nine year recovery period of 100% of relative liability



A nine year equalisation period 100% would see Central Hawke's Bay see an immediate rates reduction of $85 (4%) and Hastings a reduction of $196 (16%) in the first year. Over the nine-year period Central Hawke's Bays rates would track closely to its enhanced status quo forecast.

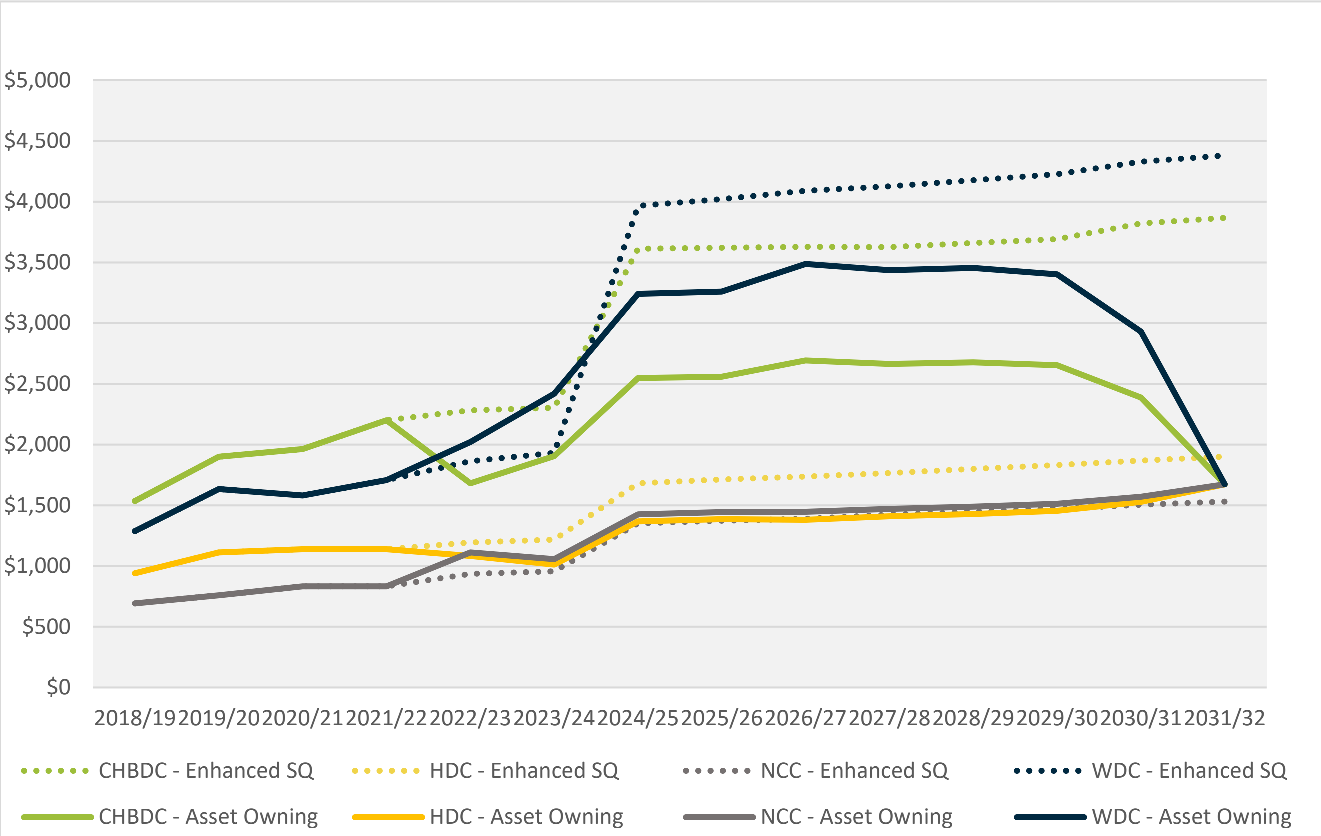
Napier and Wairoa would see increases in rates of $123 (13%) and $1011 (54%) respectively. Wairoa's rates would be less affordable during the nine year period than under the enhanced status quo.

The full benefits of a regional rate would not be passed on to Central Hawke's Bay or Wairoa for ten years.

Nine year payback period recovering 50% of the relative liability

In our view this option best balances concerns about unfairness with requiring communities to repay infrastructure over a shorter time than would typically be undertaken. While it increases the affordability challenge over an immediate regionalisation of costs, it is still less than the status quo in most situations and reaches a standard regional charge faster than a 20-year period.

Figure 51 Nine year equalisation of 50% of relative liability



With a nine year equalisation period, Central Hawke's Bay sees an immediate rates reduction (compared to status quo in the same year) of $601 (26%), and Hastings a reduction of $113 (9%). Meanwhile Napier and Wairoa see increases of $177 (19%) and $156 (8%) respectively. By year 10, all councils are paying the same regional rate. Wairoa would begin to see some of the benefits of regionalisation after three years.

Comparison of the options

When considered at a regional level all options provide a better financial outcome over time than the status quo

This section compares each option. Initially, at the regional level and then for each council using the average residential three waters rate as a consistent measure. Each of the options is based on the creation of efficiencies through improved asset management and the aggregation of purchasing power. They are balanced against the establishment costs and the introduction of some longer-term costs in the CCO models. The outcome at a regional level is set out in the table below.

When compared to the enhanced status quo option

- the asset owning CCO is projected to create operational savings of $16.7M (12.7%) per annum
- the management CCO is projected to create savings of $9.6M (7.3%) per annum.

Table 28 Regional three waters operational expenditure

$M	2021/22	2022/23	2023/24	2024/25	20252/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Enhanced status quo	74.7	77.7	79.8	112.8	115.1	117.3	119.9	122.5	125.1	128.6	131.5
Business unit	75.1	76.9	77.7	106.2	108.2	110.0	112.2	114.2	116.4	119.0	121.7
Management CCO	79.2	79.5	79.3	106.6	108.5	110.3	112.5	114.4	116.6	119.2	121.9
Asset owning CCO	77.1	76.4	75.1	100.9	102.7	104.3	106.3	108.0	110.0	112.4	114.8

Operational cost savings only show part of the picture. It is important to note that

- the asset owning model also sees improvements in the management and procurement of capital works, which results in a 10% reduction in capital costs.
- the management CCO shows a reduction of 6% in capital costs, and
- the business unit 3%

These reductions translate into operating savings over a longer period of time but will have an immediate impact on cash flow and debt levels.

Table 29 Comparison of financial performance of service delivery models

2032 ($M)	Debt	Cumulative capital spend	Annual operating cost
Enhanced status quo	$316.7	$758.5	$131.5
Shared service business unit	$307.5	$749.7	$121.7
Management CCO	$303.1	$745.6	$121.9
Asset owning CCO	$288.4	$727.4	$114.8

Comparative analysis by council

Central Hawke's Bay District Council

The difference in the three waters average residential rate for Central Hawke's Bay ratepayers in 2032 between the enhanced status quo and asset owning option is a saving of $2,194.

Figure 52 Comparison of options for Central Hawke's Bay District Council (average residential three waters rate)

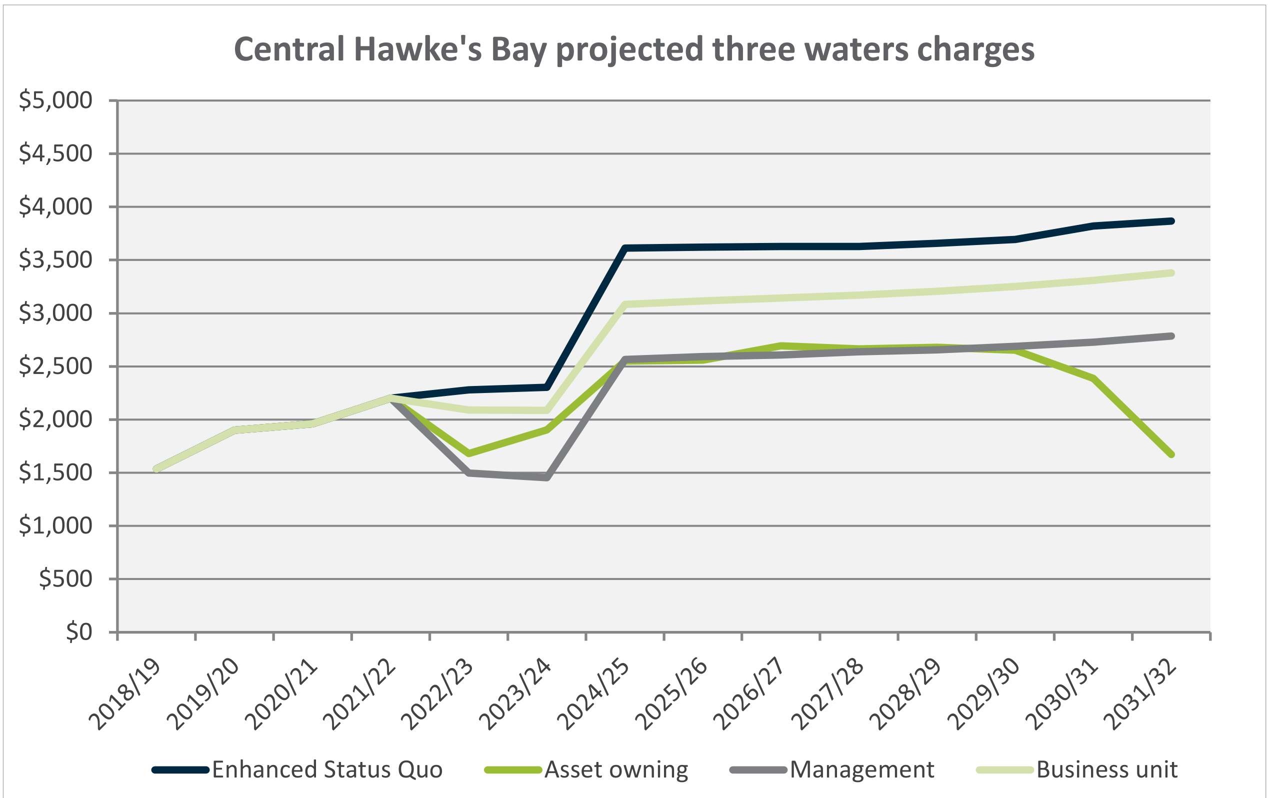


Table 30 Comparison of options for Central Hawke's Bay District Council year by year (average residential three waters rate)

$	2021/22	2022/23	2023/24	2024/25	20252/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Enhanced Status Quo	$2,200	$2,281	$2,304	$3,611	$3,621	$3,628	$3,627	$3,659	$3,692	$3,821	$3,867
Business unit	$2,200	$2,089	$2,086	$3,084	$3,116	$3,144	$3,171	$3,206	$3,252	$3,307	$3,379
Management	$2,200	$1,497	$1,454	$2,565	$2,592	$2,609	$2,637	$2,656	$2,688	$2,728	$2,785
Asset owning	$2,200	$1,681	$1,905	$2,549	$2,560	$2,693	$2,665	$2,679	$2,653	$2,388	$1,673

Hastings District Council

The difference in the three waters average residential rate for Hasting's ratepayers in 2032 between the enhanced status quo and asset owning option is a saving of $228.

Figure 53 Comparison of options of Hastings District Council (average residential three waters rate)

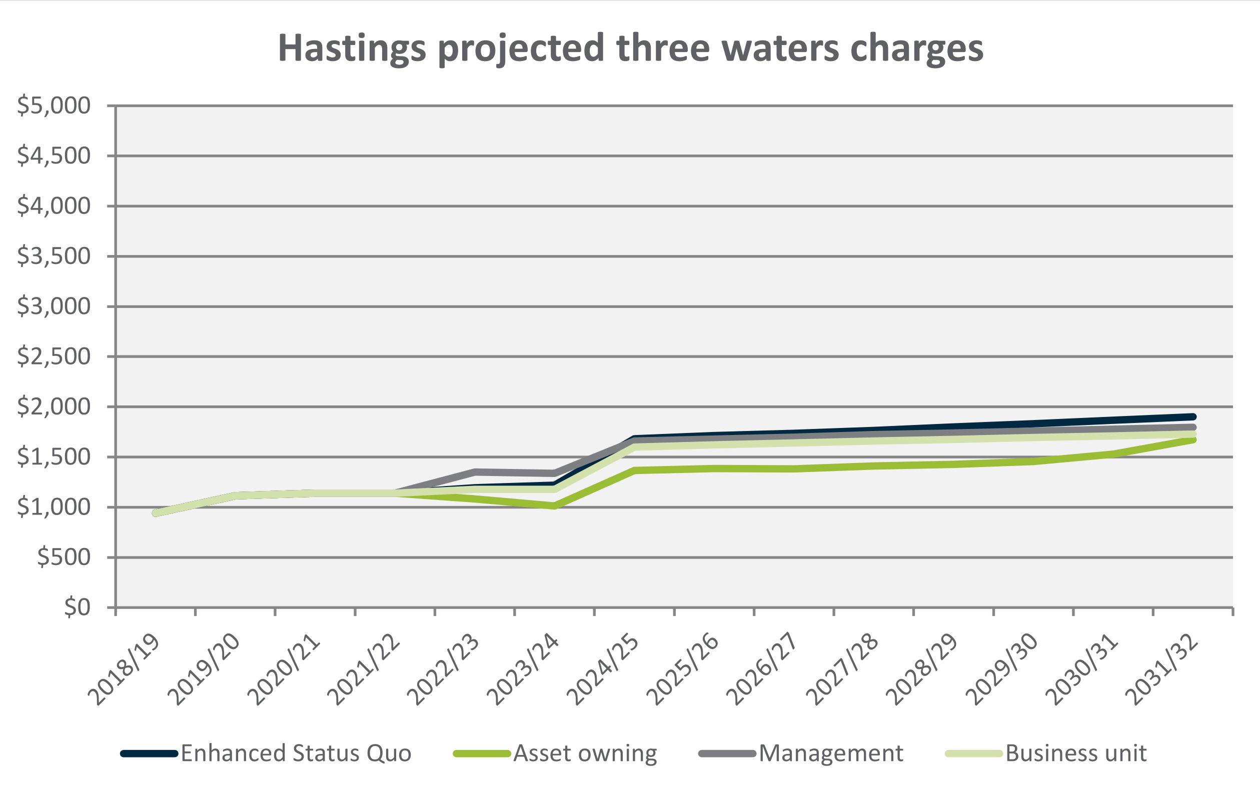


Table 31 Comparison of options for Hastings District Council year by year (average residential three waters rate)

$	2021/22	2022/23	2023/24	2024/25	20252/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Enhanced Status Quo	$1,140	$1,195	$1,219	$1,681	$1,712	$1,737	$1,764	$1,799	$1,832	$1,867	$1,901
Business unit	$1,140	$1,177	$1,177	$1,599	$1,623	$1,639	$1,660	$1,676	$1,694	$1,711	$1,729
Management	$1,140	$1,351	$1,339	$1,660	$1,680	$1,697	$1,722	$1,739	$1,758	$1,777	$1,796
Asset owning	$1,140	$1,082	$1,012	$1,367	$1,386	$1,381	$1,409	$1,428	$1,454	$1,528	$1,673

Napier City Council

The difference in the three waters average residential rate for Napier's ratepayers in 2032 between the asset owning option and enhance status quo is an additional cost of $142.

Figure 54 Comparison of options for Napier City Council (average residential three waters rate)

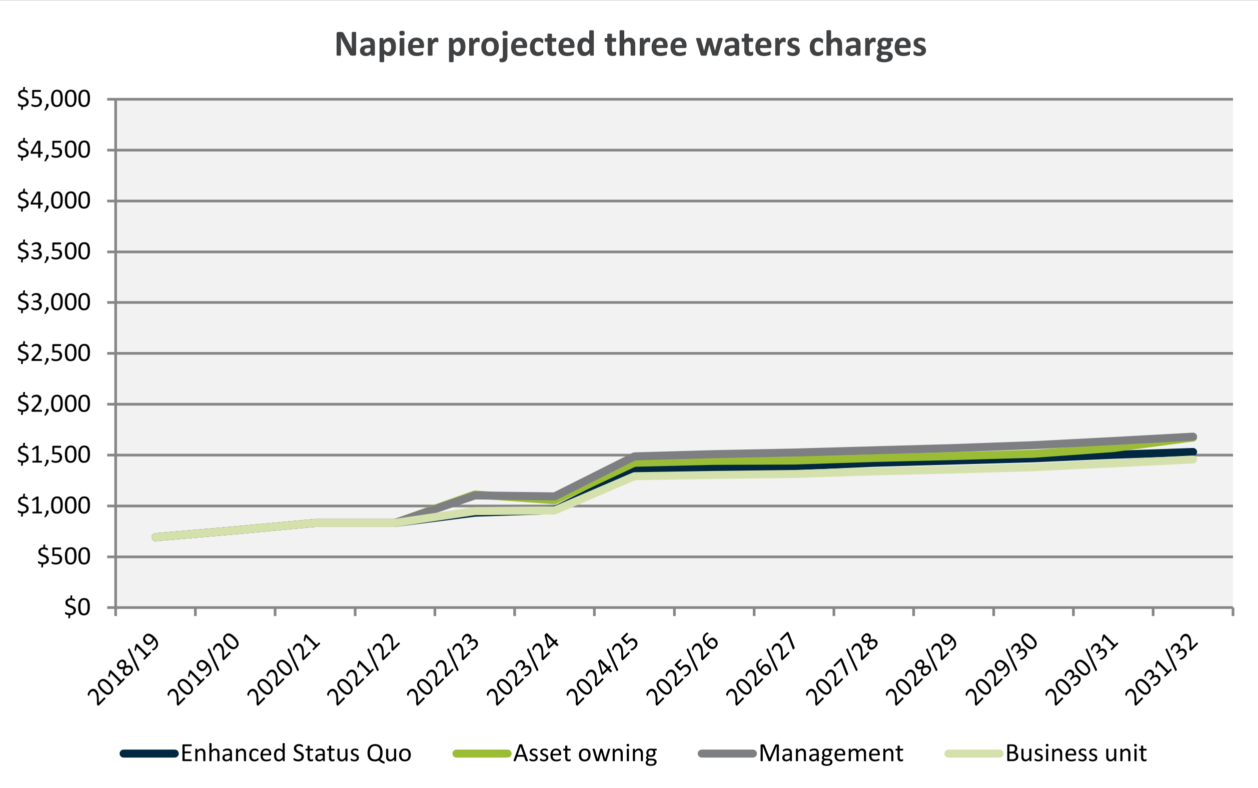


Table 32 Comparison of options for Napier City Council year by year (average residential three waters rate)

$	2021/22	2022/23	2023/24	2024/25	20252/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Enhanced Status Quo	$834	$934	$958	$1,353	$1,373	$1,390	$1,424	$1,447	$1,470	$1,504	$1,531
Business unit	$834	$950	$954	$1,291	$1,305	$1,315	$1,339	$1,358	$1,381	$1,419	$1,457
Management	$834	$1,104	$1,092	$1,487	$1,509	$1,525	$1,546	$1,569	$1,597	$1,639	$1,681
Asset owning	$834	$1,111	$1,056	$1,425	$1,444	$1,446	$1,471	$1,489	$1,513	$1,570	$1,673

Wairoa District Council

The difference in the three waters average residential rate for Wairoa's ratepayers in 2032 between the enhanced status quo and asset owning option is a saving of $2,708.

Figure 55 Comparison of options for Wairoa District Council (average residential three waters rate)

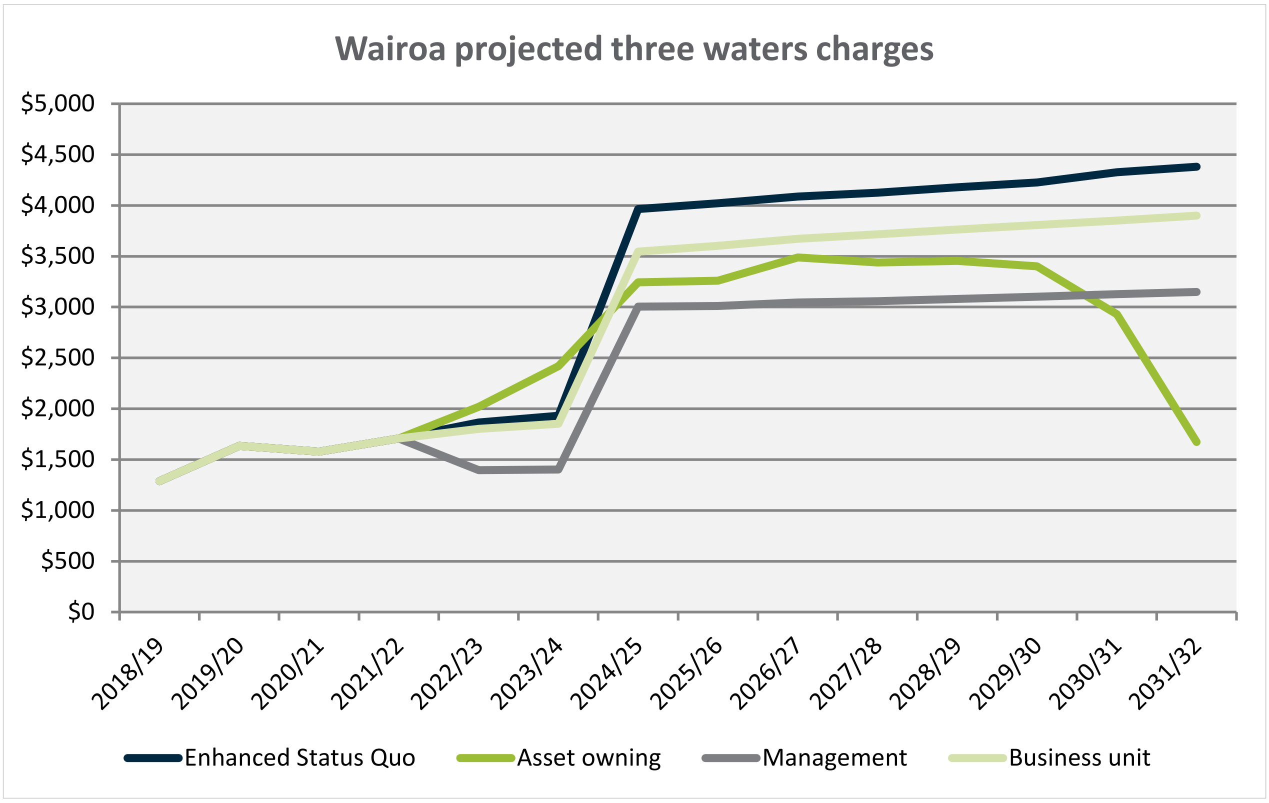


Table 33 Comparison of options for Wairoa District Council year by year (average residential three waters rate)

$	2021/22	2022/23	2023/24	2024/25	20252/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Enhanced Status Quo	$1,707	$1,864	$1,932	$3,965	$4,020	$4,088	$4,126	$4,177	$4,226	$4,328	$4,380
Business unit	$1,707	$1,801	$1,853	$3,545	$3,603	$3,671	$3,716	$3,763	$3,807	$3,853	$3,899
Management	$1,707	$1,397	$1,403	$3,005	$3,011	$3,045	$3,057	$3,081	$3,103	$3,126	$3,149
Asset owning	$1,707	$2,020	$2,419	$3,242	$3,260	$3,488	$3,437	$3,454	$3,402	$2,930	$1,673

Sensitivity analysis

Sensitivity analysis has been undertaken in different ways in order to understand where the greatest risks are and what factors have the greatest impact on the overall outcome.

The sensitivity testing demonstrates that:

- the asset owning model compares favourably even in pessimistic scenarios
- the asset owning model is the model which is most resilient to cost increases or overruns
- the asset owning model soften the impact of unforeseen expenditure for all ratepayers (including Napier)
- there are significant financial benefits for all Hawke's Bay residents if the region is successful in its application for government funding of three waters shovel ready projects
- there is a need to adopt a regional valuation approach as part of the transition to any new entity
- under some circumstances the asset owning model may be a cheaper option for Napier than the enhanced status quo.

Sensitivity to changes in costs and benefits of each option

Initially sensitivity analysis was undertaken on each option by varying the costs and benefits of change. In each a pessimistic scenario was modelled where costs of change (transitional and ongoing) increase by 50% and the benefits of change decrease by 50%. An optimistic scenario was run as an alternative where benefits increase by 50% and costs of change decrease by 50%.

These were found to have little impact on the outcomes of the asset owning option and minor impacts on the management option. These results were not surprising given the scale of the entities when compared to the modest establishment costs and benefits.

Table 34 Sensitivity analysis of changes in costs and benefits of change for management option – average three water rate (2032)

Management CCO	Pessimistic	Mid-point	Optimistic
Central Hawke's Bay	$2,911	$2,785	$2,660
Hastings	$1,876	$1,796	$1,716
Napier	$1,758	$1,681	$1,604
Wairoa	$3,276	$3,149	$3,021
Asset Owning CCO	$1,786	$1,673	$1,559

The sensitivity modelling was more sensitive to changes in future capital expenditure costs. Given the uncertainty over future upgrades and an increasing trend for capital projects cost increases we modelled two different sensitivities for capital costs.

Scenario 1: A capital expenditure increase of 50%

The result was significant increases in the average three waters residential rate for Wairoa (22%), Central Hawke's Bay (19%). Hastings (11%) and Napier (11%) had more modest increases to rates. In contrast the increase for the asset owning CCO in the same scenario was only 11% across the region. This demonstrates the extent to which the asset owning CCO best mitigates the risk of future increases in capital expenditure requirements for the region.

Table 35 **Sensitivity analysis in changes in future capital costs common to each council – average three water rate (2032)**

50% increase in Capex	Enhanced Status Quo	SSBU	Management Option	Asset Owning Option
Central Hawke's Bay	$4,583	$3,976	$3,372	$1,861
Hastings	$2,104	$1,895	$1,960	$1,861
Napier	$1,696	$1,616	$1,837	$1,861
Wairoa	$5,347	$4,685	$3,913	$1,861

Scenario 2: A one off significant capital project to represent a major unforeseen upgrade or replacement

We assumed $20M for either Wairoa and Central Hawke's Bay, and $80M for Napier and Hastings. Under that scenario it is only the individual council where the increased costs are applied. This scenario highlights the mitigation of risk for a single community of a major unforeseen or unplanned expenditure.

The result shows the ability of the asset owning CCO to insulate the region's ratepayers from such one off cost shocks. Even in Napier, where the enhanced status quo remains the cheapest option under this testing, the rates increases faced by ratepayers are substantially higher under the enhanced status quo (increase of 12%) than in an asset owning model (up 3%).

Table 36 **Sensitivity analysis of changes in future capital costs for one off expenditure – average three water rate (2032)**

One off increase	Enhanced Status Quo	SSBU	Management Option	Asset Owning Option
Central Hawke's Bay	$4,175	$3,616	$3,017	$1,686
Hastings	$2,061	$1,855	$1,919	$1,726
Napier	$1,707	$1,597	$1,818	$1,726
Wairoa	$4,904	$4,324	$3,562	$1,686

Asset valuation and condition assessment sensitivity

Engaged as part of this review, WSP undertook a regional review of asset values and condition **(May 2020 Appendix D)**. WSP found that asset values were within an expected range but with wide variations. The relative value of assets impacts shareholding and depreciation costs.

We also modelled the impact of applying the 'normalising adjustments' from the WSP report on asset unit rates to the asset values for all the Councils. The adjustments ensure the preliminary and general cost overheads are consistent across the region, and that all unit rates are indexed to 2019/20 dollars.

The WSP report also provided a set of bounds for sensitivity testing the impact of asset values. These adjustments are applied on top of the normalised unit rates from above. The sensitivity adjustments applied to asset values are outlined in the table below.

Table 37 WSP recommended adjustments to baseline costs and upper and lower valuation bounds

Asset value adjustment	Base normalising adjustment	Lower bound adjustment	Upper bound adjustment
Central Hawke's Bay	17.4%	-35%	2.8%
Hastings	-2.8%	-6%	56%
Napier	19.4%	-27.3%	31%
Wairoa	17.4%	-24.4%	57.2%

The key outcome of the sensitivity analysis in the following charts is the overlap in the potential three waters rates for Napier and Hastings. This demonstrates the impact of variations in asset valuation approach to the potential financial forecasts of the new entity. It reinforces the need for a regional, consistent valuation to be undertaken as part of the formation of any new water entity.

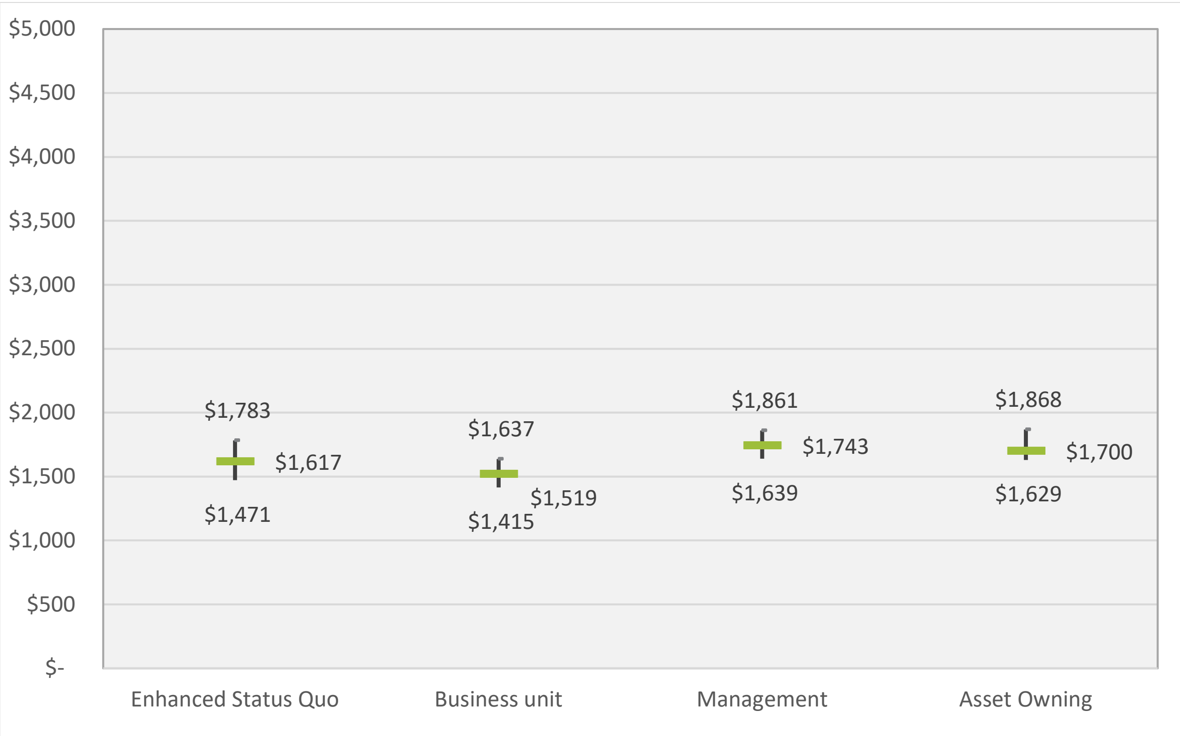
Figure 56 Sensitivity analysis of changes in asset values – Average three water rate 2032 Central Hawke's Bay

The sensitivity analysis makes no difference to the recommendation for Central Hawke's Bay.

Figure 57 Sensitivity analysis of changes in asset values –Average three water rate 2032 Hastings

The sensitivity analysis confirms the asset owning model for Hastings but also shows the importance of comparable, consistent valuations in implementing the CCO.

Figure 58 Sensitivity analysis of changes in asset values –Average three water rate 2032 Napier



The sensitivity analysis shows the overlap between options for Napier and demonstrates the importance of comparable, consistent valuations in implementing the CCO.

Figure 59 Sensitivity analysis of changes in asset values –Average three water rate 2032 Wairoa

The sensitivity analysis makes no change for Wairoa.

Covid-19 recovery funding sensitivity

In April 2020 the Government, through Crown Infrastructure Partners, sought a list of "shovel ready" projects from councils and private enterprise across New Zealand. The process sought to identify major projects which could be commenced in a short period of time to provide economic stimulus.

As part of that process, the Hawke's Bay councils submitted a joint programme of work covering three waters assets. The application included over $300 million of three waters projects in the region.

We understand that, at the time of writing, some of these projects have been shortlisted for funding, but that no funding decision or announcement has yet been made. We are unaware of the quantum of projects that have been shortlisted by the Government, or the likelihood of shortlisted projects making the final cut. Similarly, while it has been indicated that such funding may come with additional conditions, these conditions are yet to be confirmed.

It is clear from our analysis that there is significant benefit for the region in obtaining that funding. We have tested two different scenarios below:

- All councils receive the full amount of funding applied for.
- All councils receive only half of the funding applied for.

Table 38 Sensitivity analysis of receiving full amount of CIP funding request - impact on average three water rate

CIP funding 100%	Enhanced Status Quo	SSBU	Management Option	Asset Owning Option
Central Hawke's Bay	$3,012	$2,060	$1,467	$1,413
Hastings	$1,794	$1,557	$1,625	$1,413
Napier	$1,459	$1,340	$1,565	$1,413
Wairoa	$3,265	$2,047	$1,296	$1,413

The significant reduction in the burden for ratepayer funded capital works means that for Wairoa the management option becomes the lowest cost. If the funding is available under that model. For all other councils the asset owning option becomes the lowest cost option.

Table 39 Sensitivity analysis of receiving half of CIP funding request - impact on average three water rate

CIP funding 50%	Enhanced Status Quo	SSBU	Management Option	Asset Owning Option
Central Hawke's Bay	$3,439	$2,720	$2,126	$1,543
Hastings	$1,847	$1,643	$1,710	$1,543
Napier	$1,495	$1,399	$1,623	$1,543
Wairoa	$3,823	$2,973	$2,222	$1,543

A reduction in the burden for ratepayer funded capital works through 50% of the CIP funding confirms the asset owning option as the lowest cost for Central Hawke's Bay, Hastings and Wairoa and with a reduction in the impact on Napier.

Government funding contribution

We understand that government contributions may be possible to support a transition to a new model. However, it is important to note that this modelling does not include any such government contribution. All costs are currently assumed to be borne by the ratepayers of Hawke's Bay either through rates to their council or a combination of rates and charges imposed by a regional water CCO.

We note that the modelling shows that it would require an estimated $3.8 million per year average subsidy to reduce an asset-owning CCO's water charges to the level that the average residential three waters rate in Napier would otherwise be. This amount is sufficient to subsidise the costs of Napier ratepayers only. There would be no impact on ratepayers of other council areas.

Stranded costs

In each council there are currently organisational costs which are spread across each council and the services that it delivers. They include costs for things like the administrative building, governance costs (councillors and related costs), IT, HR, insurance etc. Each council calculates them differently and spreads them across its services and activities differently but for the purposes of this analysis we refer to them generically as corporate overheads. What is important is that they form part of the overall cost of each council and therefore contribute to the charges on ratepayers.

The three waters services are a substantial part of each council's operation, typically one third by value. The three waters services therefore bear a substantial part of the corporate overheads. Through the creation of a separate organisation (either the management CCO or asset owning CCO option) the three waters services no longer form part of the council and that proportion of the corporate overhead that was previously borne by the three waters services must now be spread over the remaining services within the council or where possible transferred to the regional water CCO.

There are some aspects of the corporate overhead cost that can be transferred to the regional water CCO however the vast majority of the remaining cost that make up the corporate overhead charge previously borne by the three waters services in each council are costs which are in our view difficult to change. For example, each council will continue to bear the costs of their administrative building, their governance costs, CEO etc.

Similarly, some overhead costs such as IT services, communications, and human resources support may not immediately transfer with the three waters activities but may be able to be reduced over a period of time. For that portion of overhead costs that have been allocated across the three waters (not the entirety of the cost centre budget), we have assumed a gradual reduction such that only 50% of those overheads remain in 2030.

Costs which are assumed to transfer are those corporate overheads that relate directly to an identified staff member who is also assumed to transfer to the regional water CCO e.g. vehicles, training. In addition, within the corporate overhead charge there are costs for the services provided by other areas of council to the three waters services e.g. HR, IT and legal. Where the regional water CCO has identified one of these as a function required to be performed and there is sufficient alignment between the resourcing in a council (typically either Napier or Hastings) and the estimated cost for the regional water CCO to justify a transfer of a corporate staff member those costs have been identified and a consequential reduction in the amount of stranded costs for that Council calculated.

The assumption is that the stranded costs will be borne by each council. The rationale for this is that these are not costs related to the three waters services and should not form part of the costs of that service. Stranded costs already exist, are not a new cost, are the result of decisions and choices by each council over time and only the Councils themselves can influence any reduction in these costs. If a repayment of the stranded costs as has been proposed in previous approaches is created, then the incentive to reduce the costs disappears.

> For ratepayers in Central Hawke's Bay, Hastings and Wairoa the savings afforded by an asset owning CCO exceed the value of stranded costs. This means that the total cost of local government services is likely to be lower for ratepayers in those regions under an asset owning CCO.

Staff who have minor contributions to three waters activities

The information supplied by the Councils highlighted that there are some staff who spend relatively small proportions of their time on three waters. The build-up of the cost model for the CCOs therefore includes an allowance for the cost of that resource but does not transfer the resource into the CCO. The full cost of that resource remains with the council and is a stranded cost. We note that through the creation of the three waters CCO there will be capacity created within the council as that service will no longer be required from that staff member. In some councils that increased capacity will be seen as a benefit.

The total stranded costs are set out in the following table and have been included in the modelling of each option.

Table 40 Stranded costs by council

	2019/20		2031/32 (inflation adjusted)	
	Per ratepayer	Actual $000	Per ratepayer	Actual $000
Central Hawke's Bay	$27.05	**$209**	$26.23	**$217**
Hastings	$28.44	**$886**	$ 20.61	**$690**
Napier	$17.89	**$471**	$ 17.27	**$492**
Wairoa	$121.10	**$872**	$ 105.48	**$760**

It is important to highlight that these are not new costs. They already exist and have been met by the ratepayers of each council.

Table 41 Average 2032 three waters residential rate plus stranded costs

($)	Central Hawke's Bay	Hastings	Napier	Wairoa
Enhanced status quo	$3,867	$1,901	$1,531	$4,380
Business unit	$3,406	$1,749	$1,474	$4,005
Management	$2,812	$1,817	$1,698	$3,254
Asset owning	$1,699	$1,693	$1,690	$1,778

From a ratepayer perspective in almost every case for ratepayers who are connected to water and water services across the region, they would pay less under the asset owning CCO option.

Working capital

The Councils would need to provide initial funding for the CCO to operate. The table below sets out the funding requirements based on one to three months. The Councils would contribute to this in proportion to their shareholding.

The working capital effectively funds the CCO to allow it to operate from day one. This is before it can collect the income associated with providing the service. The funding should therefore be in the form of loans to the CCO to be repaid over time once the revenue has been collected.

Table 42 Weeks cover of operation expenditure (assumes borrowings for capital)

	4	6	8	10	12
Management CCO	$3.13M	$4.70M	$6.26M	$7.83M	$9.40M
Asset Owning CCO	$3.58M	$5.37M	$7.16M	$8.94M	$10.73M

Total council contributions

The total funding contributions that would be required to establish a new asset owning CCO are outlined in **Table 43** below. The basis of the stage one (consultation and engagement on options) and stage two (transition to a CCO) costs are set out in the management case.

Table 43 Total funding contributions required

	Total contribution ($m)
Stage one costs	$2.4
Stage two capital	$3.56
Stage two operating costs	$2.4
Working capital (12 weeks)	$10.7
Total required	$19

Stage two capital costs have been assumed to be debt funded, and we would anticipate that these would be funded by way of loans from the shareholding councils. Similarly, we would anticipate that working capital would be provided to the new entity by way of a loan from the shareholding councils.

Exactly how the costs are apportioned across each of the councils is a matter that is yet to be decided and will depend on whether there are any external contributions from central government. If allocated based on shareholding, the following contributions would be required (assuming no funding from central government).

Table 44 Funding contributions allocated based on shareholding

($000)	Operating costs	Loans to CCO
Central Hawke's Bay	$390	$1,166
Hastings	$2,455	$7,340
Napier	$1,769	$5,290
Wairoa	$165	$494

Impact on existing councils

The removal of the three waters from each council under the asset owning option has a significant impact on the organisation. Revenue, expenses, external debt and the value of the assets of each council change as a result of the removal of the three water operations.

The tables below show the impact for each council. In each table the 'group' includes the proportional share of the regional water CCO that the Council 'parent' would report under current reporting requirements. This highlights the direct impact of the stranded costs. In the case of Central Hawke's Bay, it demonstrates that there may be a need to increase rates to recover the increased costs, whereas in other councils a surplus is still generated.

Table 45 Impact of change on Central Hawke's Bay Council financial position 2027/28 (final LTP year)[44]

Central Hawke's Bay ($000)	LTP	Enhanced Status Quo	Business Unit	Management CCO	Asset Owning (Parent)	Asset Owning (Group)
Operating income	39,506	44,824	43,068	41,008	29,917	39,264
Operation expenditure	40,230	46,622	44,866	42,806	31,934	40,608
Surplus/deficit	-724	-1,798	-1,798	-1,798	-2,017	-1,344
Debt	8,653	72,182	70,438	68,575	-	11,964
Assets (NBV)	994,337	1,079,656	1,048,969	1,047,106	882,921	993,438
Debt to revenue ratio	22%	161%	164%	167%	0%	30%

Table 46 Impact of change on Hastings District Council financial position 2027/28 (final LTP year)

($000)	Current	Enhanced Status Quo	Business Unit	Management CCO	Asset Owning (Parent)	Asset Owning (Group)
Operating income	165,319	189,256	186,266	188,044	130,183	189,002
Operation expenditure	146,561	163,541	160,551	157,459	108,699	163,282
Surplus/deficit	18,758	25,715	25,715	30,585	21,484	25,720
Debt	116,356	66,687	64,374	61,805	-	106,581
Assets (NBV)	2,715,411	2,854,398	2,711,664	2,709,095	2,049,762	2,745,221
Debt to revenue ratio	70%	35%	35%	33%	0%	56%

Table 47 Impact of change on Napier City Council financial position 2027/28 (final LTP year)

($000)	Current	Enhanced Status Quo	Business Unit	Management CCO	Asset Owning (Parent)	Asset Owning (Group)
Operating income	139,952	153,698	151,499	156,843	112,660	155,050
Operation expenditure	133,439	145,602	143,483	147,413	106,448	145,785
Surplus/deficit	6,513	8,096	8,016	9,430	6,212	9,265
Debt	-	20,508	18,401	16,883	-	120,959
Assets (NBV)	1,932,271	2,069,954	1,979,310	1,977,792	1,546,346	2,047,559
Debt to revenue ratio	0%	13%	12%	11%	0%	78%

44 Last year LTP used as no whole of council projects exist beyond there

Table 48 Impact of change on Wairoa District Council financial position 2027/28 (final LTP year)

($000)	Current	Enhanced Status Quo	Business Unit	Management CCO	Asset Owning (Parent)	Asset Owning (Group)
Operating income	30,679	35,278	34,382	32,943	25,370	29,329
Operation Expenditure	30,982	35,355	34,559	33,021	26,278	29,952
Surplus/Deficit	-303	-77	-177	-77	-908	-623
Debt	12,281	74,144	72,629	69,600	1,617	12,913
Assets (NBV)	338,920	422,342	404,633	403,119	298,644	345,451
Debt to revenue ratio	40%	210%	211%	211%	6%	44%