

To: Auckland Council Governing Body

From: Watercare Services Limited

Subject: Report to the Governing Body seeking endorsement of Watercare's commercial relationship with the Waikato District Council

Date: 16 April 2019

1. Recommendation

That the Governing Body endorses Watercare entering into a commercial relationship with Waikato District Council (WDC), with the following principles:

- Watercare will ensure its obligations and service to Aucklanders is not comprised (i.e. Watercare must continue to operate its business in Auckland in accordance with our Statement of Intent and obligations under s57 of the Local Government (Auckland Council) Act 2009).
- No cross subsidy from Watercare customers
- Watercare must make an acceptable return for delivering the services to customers of WDC

2. Purpose and context

The Mayor requested that Watercare submit a report to the Governing Body to secure Council endorsement of the new relationship with WDC. While the decision to enter into the commercial relationship is one for the Watercare Board, the Mayor has noted:

- The WDC transaction is of high public interest.
- It creates new opportunities and risks in Auckland Council's relationship with other Councils at a political level, which warrant discussion before the contract is signed.
- The transaction is of strategic importance. It will be regarded by many key stakeholders as a credible model for accelerating the improvement of water services across New Zealand, with the added benefit of being less disruptive than a structural consolidation of water utilities.
- The arrangement reinforces the Council's position as a good neighbour.

This paper sets out the background to the relationship to date between Watercare and WDC so that the Governing Body may endorse the relationship.

3. The Details

3.1 Why WDC approached Watercare

WDC approached Watercare for the following reasons:

- **Watercare's expertise and ability to scale:** WDC considers Watercare will be able to provide water, wastewater and some stormwater services more efficiently and cost effectively than WDC. WDC has consulted with its ratepayers on an LTP price path which assumed contracting with Watercare would generate \$28m of savings over the LTP period compared to WDC status quo delivery.

- **Watercare already operates in the Waikato:** We provide bulk water and wastewater services to Pokeno and Tuakau in North Waikato. We also take water from the Waikato River. Watercare was therefore a natural choice for an ongoing relationship.

In 2018 the WDC made a recommendation that a contract be negotiated with Watercare for the supply of WDC's water services overseen by a WDC-appointed Waters Governance Board. This recommendation was consulted on during the WDC Long Term Plan consultation process and was the preferred option for the public.

3.2 There are non-financial benefits to Watercare

The contract includes the opportunity for Auckland Council and Watercare to showcase Watercare's leadership in the water industry and provide further development opportunities for Watercare staff. In addition, the contract is aligned with Watercare's Statement of Intent 2018-2021 which includes a commitment to explore alternative revenue sources (refer page 20). This contract will deliver on that commitment.

3.3 The terms of the contract

The draft contract is a full service delivery contract. Watercare will be replicating the services it provides to Aucklanders for the customers within the Waikato District. Watercare may also provide some stormwater services (e.g. services relating to the maintenance and operation of the stormwater pipe network). Watercare is not bound by s57 when providing services to WDC.

- **Revenue:** The commercial contract will generate revenue of \$20 million per year, this represents around 3% of Watercare's revenue. This will assist Auckland Council's debt to revenue ratio.
- **Return:** The contract will also ensure Watercare makes an acceptable return for providing the services.

Key terms of the long term contract are:

- **Term:** 32 years.
- **Asset ownership including strategic resource consents:** will be retained by WDC (in accordance with s137 of the Local Government Act 2002 (LGA)).
- **Watercare's revenue:** approximately \$20 million per annum.
- **Pricing Methodology:** The water and wastewater prices will be based on an International best practice regulated pricing model, similar to that applied by the NZ Commerce Commission and England's water regulator OFWAT. The methodology will allow Watercare to recover costs and make a fair return.
- **Two year transition period (July 2019-July 2021):** This will enable Watercare to fully develop the asset management plan (AMP), a funding plan and a proposed price path which will then be agreed with the WDC Waters Governance Board (WGB). During this 2 year period, WDC will continue to bill the customers and collect the revenue and the prices will remain consistent with the LTP. Watercare will be

compensated for the delivery of the services within the LTP envelope and any capex will be funded by WDC.

- **Operational period (July 2021-June 2051):** Watercare will provide the following services to WDC:
 - o customer billing and revenue collection
 - o customer management
 - o operations and maintenance of all water and wastewater assets
 - o the development and delivery of the asset management plan
 - o fund the costs of the arrangement over the life of the contract from the revenues collected
- **Termination provision:** If the parties cannot agree on an AMP, funding plan or proposed price path in the first two years, either party will have the option to exit the contract. Other exit provisions include if there is legislative change that materially impacts the contract, for example the potential reform of the water sector. In the event of termination, there is a detailed disengagement process to be followed. In either case, Watercare will be kept whole with respect to costs expended.
- **WDC Governance:** WDC has formed a Waters Governance Board (WGB), which will oversee WDC's waters business. The WGB reports directly to WDC but is designed to operate as independently as possible through delegations. The four members include three independent members, namely Rukumoana Schaafhausen (Chair), David Wright and Garth Dibley, and the Chief Executive of WDC, Gavin Ion (to provide a link to Council and retain accountability to the CE for the success of the arrangement). In accordance with s137 of the LGA, WDC remains ultimately responsible for the supply of water services - Watercare will simply be supplying those services under the terms of the contract.

3.4 The Executive has conducted thorough due diligence

Watercare management has been conducting thorough due diligence over the last 6 months.

The Watercare Board has been receiving updates monthly from Management on the status of the due diligence and negotiations. The Board were also involved in a joint workshop with the Waikato District Council executives and the WDC Waters Governance Board in February 2019 to finalise terms of a Memorandum of Understanding that outlines the principals of the relationship between the two parties.

3.5 Risks to Watercare and the wider Council Group

In addition to the due diligence performed, the Watercare Board will be reviewing the final business case including a risk assessment, at the May 2019 Board meeting. The Board will not approve the business case unless the level of risk is acceptable to Watercare and therefore Auckland Council.

Key risks identified to date:

- **Safety condition of existing WDC assets at 1 July 2019:** Any assets identified as safety risks have been highlighted and WDC will be required to remediate these assets to ensure Watercare people are kept safe.

- **Auckland Council balance sheet constraints:** Due to the additional revenue, this contract is expected to improve the Council Group's debt to revenue ratio.
- **Appropriate IRD Ruling:** WSL are awaiting an IRD ruling to ensure there is no tax impact of the proposed "right to use" arrangement proposed in the contract.
- **Watercare's reputation:** Failure to conclude the contract or failure to deliver against the agreed KPIs. The KPI regime will be jointly agreed by WSL and the WGB to ensure they are achievable under the existing asset conditions.

3.6 We have obtained legal advice

WSL has engaged Simpson Grierson to advise on the long term contract as well as to provide guidance and clarification around Local Government Act requirements including consultation with Auckland customers. The consultation process will commence shortly.

3.7 We have considered our obligations to Aucklanders

The three principles of the contract noted in **Section 1** ensure our obligations and service to our Auckland customers are not compromised.

Because the WDC consulted with its residents during its Long Term Plan, we do not anticipate a high level of public interest in the contract from Waikato residents. Given the relatively small revenue earned under the contract, we do not see the contract as being of material interest to Auckland customers. As previously noted, Watercare already has a presence in the Waikato, operating in Tuakau and Pokeno, and also draws approximately 20% of its drinking water from the Waikato River to supply Aucklanders.

Finally, as WSL is offering employment to the WDC Water staff, and assuming most of these staff will transfer to WSL, it is not anticipated that the work to deliver the WDC contract will materially change our existing staff work load.

4. Next steps

1. Council Endorsement of Watercare entering into a commercial arrangement with Waikato District Council for a period of up to 32 years with an average annual value of \$20m. (Governing Body meeting - 2 May 2019)
2. Watercare Board to consider the final business case (Watercare Board meeting - 28 May 2019)
3. Formal signing of contract
4. Services commence (1 July 2019).