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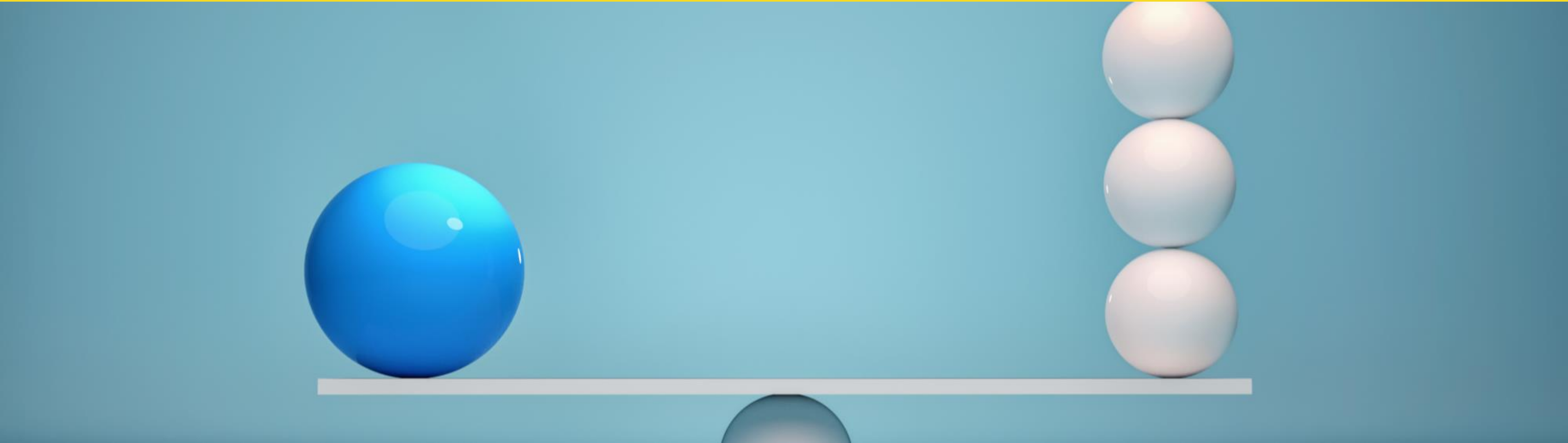
2024-34 LTP Amendment

Financial Strategy – Financial Prudence

12 November 2024 Workshop - LTP, Finance, and Performance Committee



Context

- Our Auditor did not raise any concerns regarding financial prudence for the 2024-34 LTP.
- S & P commented on significant capital programme
- The 2024-34 LTP highlighted two financial challenges:
  - Underinsurance gap of approximately $2.6b
  - Undiversified investment portfolio
- Decision on 10 October to amend the LTP with the preferred option being No Sale of the WIAL shares.
- Need to update financial strategy to help address highlighted financial challenges.
- Financial prudence considerations for insurance headroom & debt capacity.

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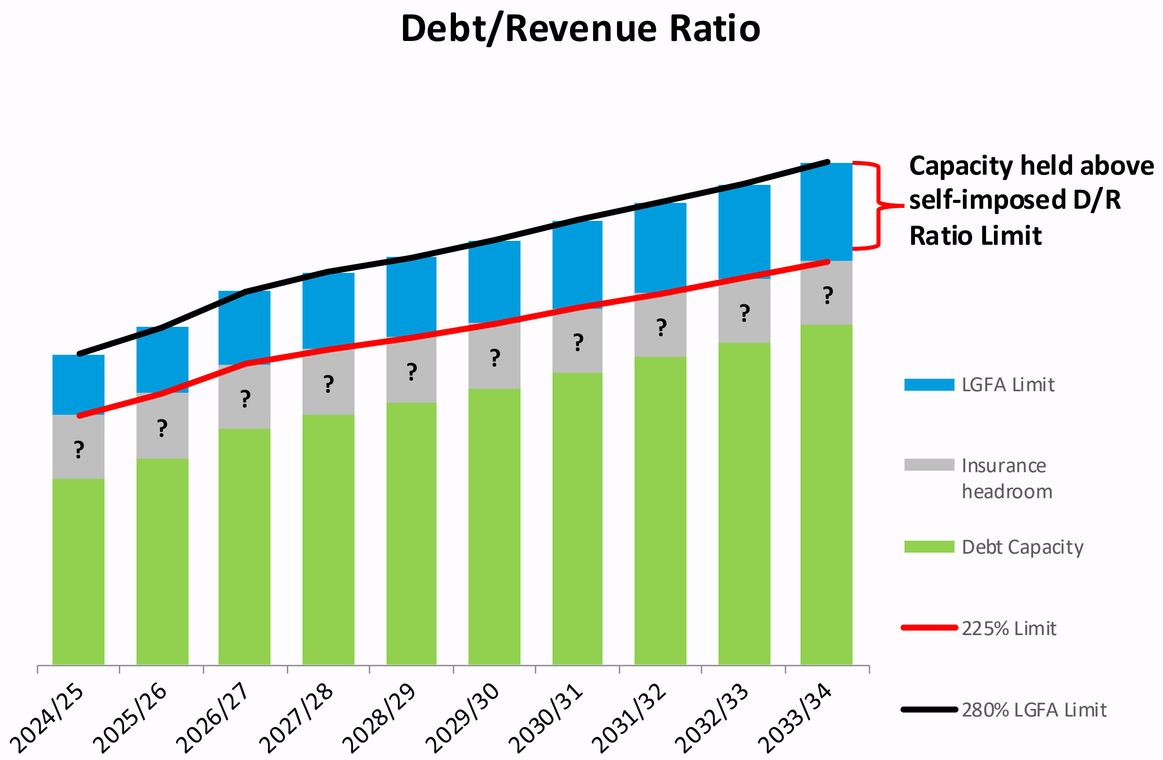
Financial Strategy



Lifting the 225% self-imposed Debt/Revenue Ratio and increasing our borrowings would have implications for rates as we need to fund the cost of debt. The self-imposed ratio also ensures WCC has debt capacity and mitigates risks for unexpected events.

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Local Government Act 2002

Section 101 Financial management

A local authority must manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

The 2024-34 LTP struck the necessary balance providing a reasonable basis for long-term integrated decision making and coordination of the Council's resources.

Need to ensure the LTP amendment strikes the same balance while considering both current and future interests of the community.

Local Government Act 2002 (continued)

Need to have regard to:

Section 102 Funding and financial policies

A local authority must, in order to provide predictability and certainty about sources and levels of funding, adopt the funding and financial policies.

Section 100 Balanced budget requirement

A local authority must ensure that each year's projected operating revenues are set at a level sufficient to meet that year's projected operating expenses. A local authority may set projected operating revenues at a different level from that required by that subsection if the local authority resolves that it is financially prudent to do so.

In considering financial prudence, the local authority must have regard to:

- maintaining levels of service;
- maintaining service capacity and integrity of assets;
- intergenerational equity; and
- compliance with local authority funding and financing policies (established under Section 102).

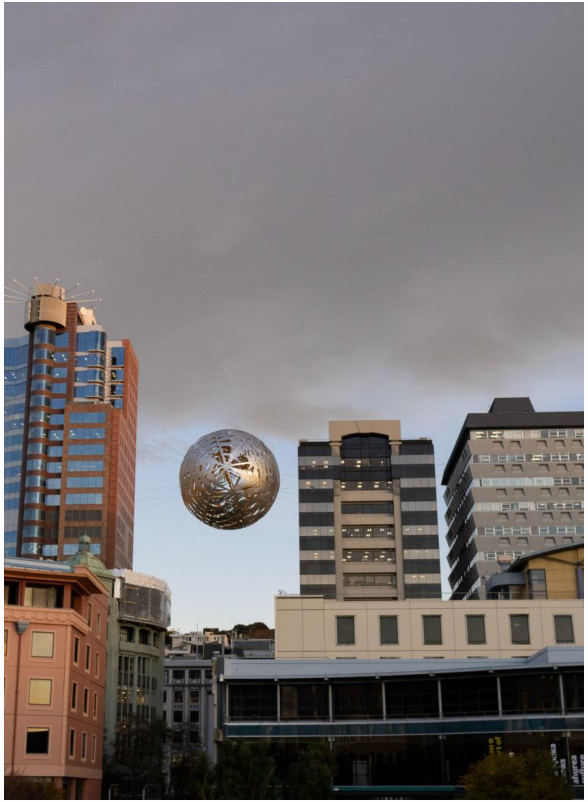
Assessing Financial Prudence

Financial prudence has no clear legal definition and will depend on circumstances.

Considerations/Parameters:

- Statutory interests that the Local Authority must have regard to (previous slide)
- Condition and performance of assets – ensuring we have balance sheet resilience (including deferral of works such as mitigations for climate change).
- Balanced budget
- Depreciation funding
- Debt and credit rating
- Insurance risks
- Climate change
- Unplanned events
- Rates affordability

Condition and performance of assets



- Need to ensure there is sufficient debt capacity in the future for assets where we don’t have sufficient condition data e.g. earthquake prone buildings. We need to be able to take action on critical asset failures.

- 2024-34 LTP funded renewals at 75% of the AMP’s (excluding water infrastructure). This was an emphasis of matter in the Audit Report.

Balanced Budget/Depreciation Funding

- Projected operating revenue sufficient to meet operating expenditure.

- Not currently fully funding water depreciation, full funding by 2028/29.

- Still collecting sufficient revenue to fund planned renewals but not building capacity for the future.

- If fully funded in 2025/26, this would increase rates by a further 6.7%.

Debt and Credit Ratings

- 2024-34 LTP debt/revenue ratio self-imposed limit of 225%, including insurance headroom of $272m.

- LGFA limit 280% - any increase in our current self-imposed ration needs to give regard to:
  - Rates affordability
  - Ensuring balance sheet resilience
  - Responding to unknown events

- Need to consider Investment and Liability Management Policy.

- Standard & Poor's credit rating AA, downgraded from AA+. Still on negative outlook. Further downgrades will increase cost of borrowing (interest costs) and reduce confidence in the Council's financial prudence.

  "Wellington City Council's financial outcomes will be very weak over the next three years due to rising operating and capital expenditures (capex). The Council's additions to its capex program in its 2024-2034 long-term plan (LTP) will weigh on its fiscal performance over the next three years"

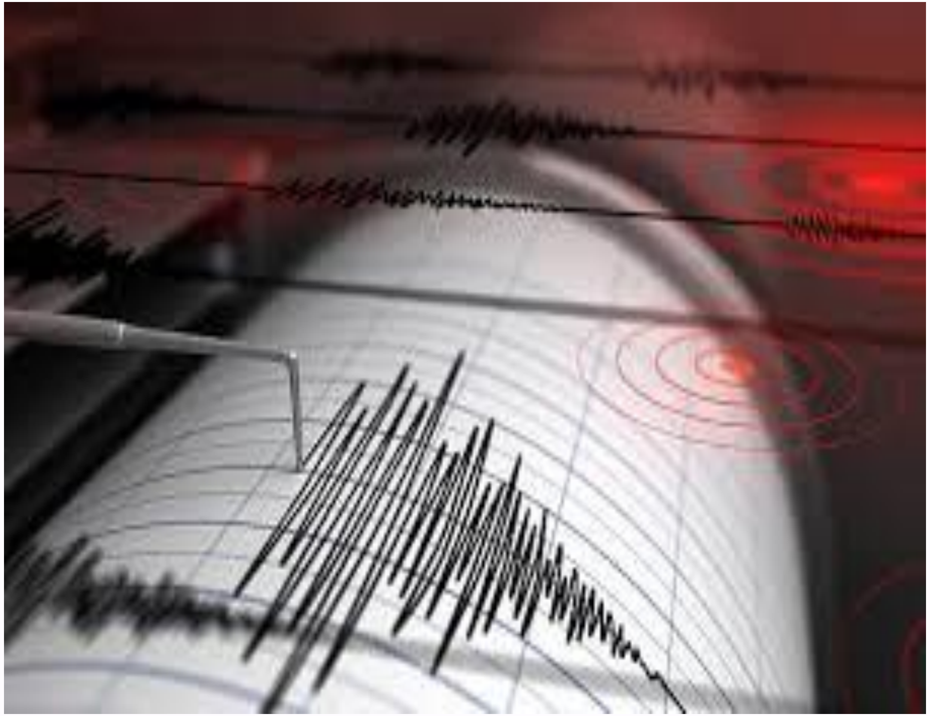
Insurance Risks

- The expected shaking for Wellington under the new NSHM 2022 (10% chance in 50 years) is the highest in the country.

- Based on modelling currently being completed (based on NSHM2022) a 1-1000 year seismic event underinsurance equates to approx. $2.6B, with a 1-500 year event approx. $2.1B

- Cost of insurance has increased significantly and accessing additional traditional capacity to close this gap is challenging.

- Traditional insurance options are no longer sufficient to meet all of Council's needs based on the asset base we are holding, alternative options need to be considered.



Climate change

- Infrastructure was planned and built before we considered the impact on carbon emissions.
- To reach our goal of a 57% reduction in emissions by 2030 and achieve net-zero carbon by 2050, we must rethink and redesign our infrastructure.
- Without proactive adaptation, further climate-related changes are expected to significantly impact our infrastructure.
- Future costs to the Council for making infrastructure more resilient will be material.

Unplanned events

- Aotearoa has had some significant weather events over the past few years, including large rainfall causing significant slips.

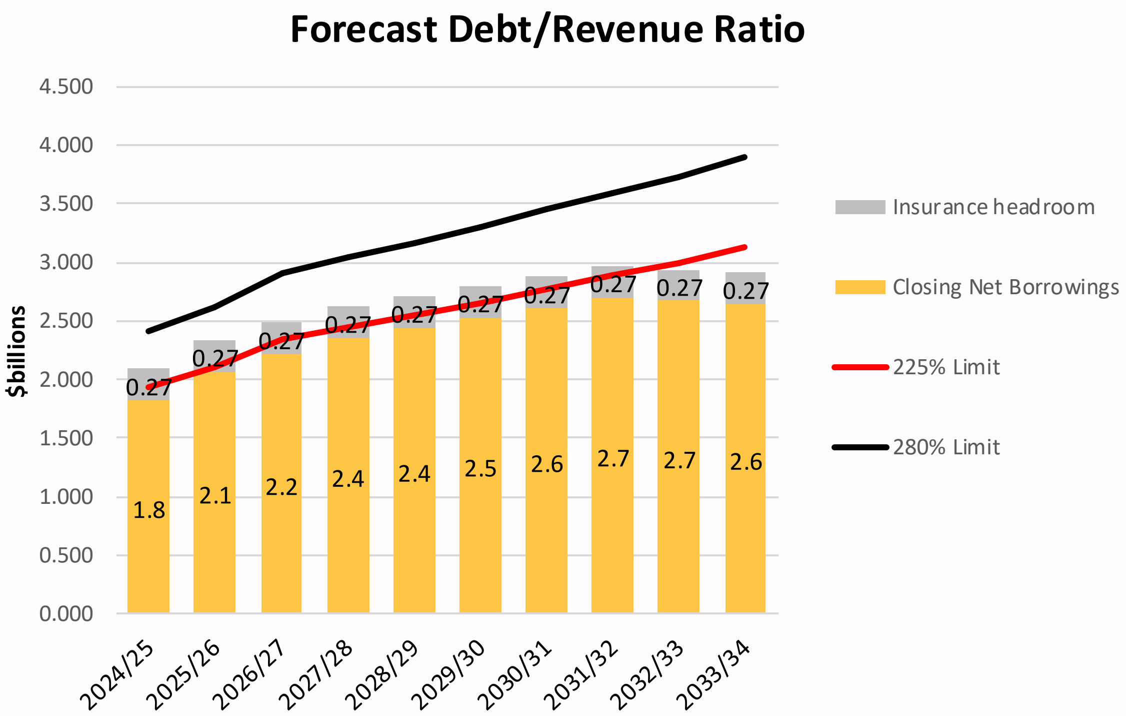
- The Covid-19 pandemic reduced the Council's revenue and required debt capacity to fund this shortfall.

- The Council needs to maintain debt capacity in the case of unplanned events.

Rates affordability

- High reliance on revenue from rates - 57% of total revenue in 2024/25.
- 2007 Shand Report benchmark of 5% of household income being affordable.
- Rates increase limit is to balance affordability with increased investment required in infrastructure.
- On average, Wellington residents pay a lower share of household income on rates compared to surrounding areas.
- Significant commercial sector contributing to rates revenue.
- Need to make prudent financial decisions to remain within limit (average 5-8% over 10 years).

A reminder…



Previously the establishment of a large PIF could have enabled the Council to reduce its insurance headroom, as the fund grew. However, regardless of the size of the fund, the Council can retain the choice about headroom size as part of its consideration of its financial strategy.

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Financial Challenges

- Following the decision to change the preferred option to No sale of the WIAL shares, need to update the financial strategy to address financial challenges and set a financially prudent budget.

- 2024-34 LTP financial strategy addressed both challenges:
    - Created a PIF to mitigate underinsurance risk
    - Diversified the investment portfolio

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Mitigating financial challenges

Proposed mitigations for underinsurance:

- Increased insurance headroom to manage insurance risk
- Insurance roadmap
- Disaster resilience fund/PIF – a small fund will likely not make a meaningful contribution to the underinsurance issue.

Proposed mitigation for undiversified investment portfolio:

- Disaster resilience fund/PIF

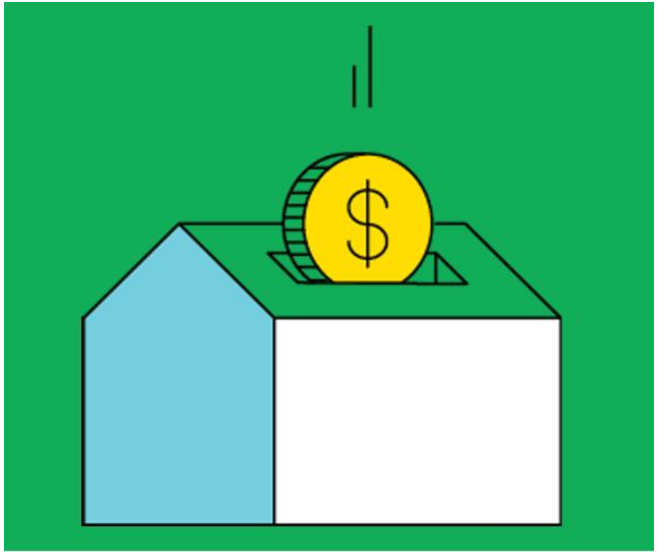
Proposed Financial Strategy

- Maintain Debt/Revenue ratio limit @ 225% over the ten years:
    - Rates affordability

- Increase insurance headroom to $500m based on:
    - 2021/31 LTP $272m headroom was based on actual shortfall
    - Risk has increased x14
    - Significant change to mitigation required – similar approach from 2021/31 LTP not available
    - Similar to other Councils
    - Combined headroom + capacity up to 280% = $1b
    - Forecasted sale proceeds from WIAL shares

- Recommend that to address our increased risk we reduce borrowings to ensure under D/R ratio including $500m insurance headroom by years 5-6. To do this, the capital programme needs to be reduced by $400-$600m.

- Note the reduced NLTP revenue equates to a required reduction of $130m to mitigate impact on D/R ratio.



LTP Amendment

Financial Prudence Consideration/Parameter	Sale of WIAL Shares/PIF	Proposed Financial Strategy - $400m-$600m capital programme reduction, $500m insurance headroom, small PIF/disaster resilience fund
Balance Sheet Resilience	✓	? Some investment portfolio diversification
Condition & Performance of Assets	✓	✓ assume no change to renewals
Balanced budget/Depreciation Funding	Fully funded from 2028/29	Fully funded from 2028/29
Debt & Credit Rating	✓	↓ Reduced debt ? Credit Rating
Insurance Risk	✓	✗ Doesn’t mitigate underinsurance but helps to mitigate
Climate change	✓	? Potential impact from capital programme changes
Unplanned events	✓	✓ assume no change to D/R ratio limit
Rates affordability	✓	↓ Reduced debt/capex = lower interest & depreciation

Disaster Resilience Fund/PIF

- On 29 October the Council agreed to continue to progress work on a Disaster Resilience Fund/PIF with the broad purpose of the fund being to provide a form of self-insurance for a disaster.

- The Council has asked for advice on the fund in December on the following:
  - Objectives and structure of the fund, including anticipated management costs
  - Options for capitalising the fund (e.g. ground leases)
  - How the fund would/could work alongside other insurance roadmap work (e.g. how would a fund and a captive insurer work together)

- A small fund (e.g. $50-70m) would be included in the LTP amendment consultation as part of the option that also includes reductions to the capital programme to increase debt headroom.

So what?

- Need to consider ALL parameters and balance the level of investment required.
- Still need to ensure we are investing in our infrastructure.
- Need to find the “safe-zone”.
- Resilient Balance Sheet

Next steps

13 November Workshop – Capital Programme Review

21 November LTP, Finance & Performance committee – Capital Programme

11 December LTP Finance & Performance committee – Approve draft budget

He Patai?

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