BALANCE SHEET REVIEW - INVESTMENTS

PUBLIC EXCLUDED

Grounds: **Section s48(1)(a) - That the public conduct of this item would be likely to result in the disclosure of information for which good reason for withholding would exist under Section 7.**

Reason: **Section 7(2)(b)(ii) - The withholding of the information is necessary to protect information where the making available of the information would be likely unreasonably to prejudice the commercial position of the person who supplied or who is the subject of the information.**

Kōrero taunaki

Summary of considerations

Purpose

This report discusses the risks associated with existing Council-owned income-generating assets and recommends diversifying the portfolio to reduce risk and better align investment with Council's strategic objectives.

Strategic alignment with community wellbeing outcomes and priority areas

	Aligns with the following strategies and priority areas: ☒ Sustainable, natural eco city ☐ People friendly, compact, safe and accessible capital city ☐ Innovative, inclusive and creative city ☒ Dynamic and sustainable economy
Strategic alignment with priority objective areas from Long-term Plan 2021–2031	☐ Functioning, resilient and reliable three waters infrastructure ☒ Affordable, resilient and safe place to live ☒ Safe, resilient and reliable core transport infrastructure network ☐ Fit-for-purpose community, creative and cultural spaces ☒ Accelerating zero-carbon and waste-free transition ☐ Strong partnerships with mana whenua
Relevant Previous decisions	Finance and Infrastructure Strategy (included in the Long-term Plan 2021-31) policy objectives. Council's consultation on the LTP re: asset sales. Approach to ground lease sales agreed by full Council 30 April 1999
Significance	The decision is **rated high significance** in accordance with schedule 1 of the Council's Significance and Engagement Policy as WIAL is a strategic asset under section 5 of the Local Government Act 2002.

Financial considerations

☐ Nil | ☐ Budgetary provision in Annual Plan / Long-term Plan | ☒ Unbudgeted $X

Risk

☐ Low | ☒ Medium | ☐ High | ☐ Extreme

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Authoriser	Barbara McKerrow, Chief Executive Officer

Taunakitanga

Officers' Recommendations

Officers recommend that Pūroro Tahua - Finance and Performance Committee:

1) Receive the information
2) Note that, in accordance with the Finance and Infrastructure Strategy agreed through the LTP, officers have reviewed the Council's portfolio of assets to determine whether they remain fit-for-purpose in light of the Council's strategic priorities and financial objectives.
3) Note the review has identified the following risks associated with the Council's current portfolio of non-service income generating assets, including:
    a. The lack of diversification;
    b. Geographic concentration;
    c. Exposure to climate change and natural hazards;
    d. Relatively illiquid nature; and
    e. Poor alignment in some cases with the Council's strategic objectives.
4) Note that the Council holds headroom of $272m on the balance sheet to cover uninsured risks and the need for this headroom could be reduced or eliminated through suitably diversified and liquid investments, freeing up funding for other Council priorities.
5) Agree to establish a diversified investment portfolio aligned with Council's strategic objectives, funded through the divestment of existing non-service income generating assets.
6) Agree that the proceeds from the sale of assets are reinvested in other income-generating assets rather than being used to pay down debt (as would otherwise be required by the Investment and Liability Management policy (included in the Long-term Plan 2021-31)).
7) Agree to the development of a Statement of Investment Policy and Objectives (SIPO) and an appropriate asset allocation for the diversified investment portfolio. Officers will develop this by May 2022 for review and approval by Council.
8) Agree to consult with the public on the sale of Council's 34% holding in Wellington International Airport Limited through an LTP amendment progressed alongside the 2022/23 Annual Plan.
9) Direct officers to report back to the AP/LTP Committee by March 2022 with a Consultation document, Statement of Proposal (and corresponding LTP amendment) and engagement programme for review, prior to audit of the consultation material.

10) Note the ground lease portfolio provides a source of long-term, secure, and relatively predictable income and opportunities to influence city-shaping outcomes so is not recommended for divestment at a portfolio level.

11) Agree to update the approach to ground lease sales to provide greater clarity on the circumstances in which any changes to the ground lease portfolio would be made, in accordance with paragraph 87.

Whakarāpopoto

Executive Summary

12) The Finance and Infrastructure Strategy (included in the Long-term Plan 2021-31) includes the following policy objectives:

    a. Minimise the Council's overall costs and risks associated with its borrowing activities and the general management of its other liabilities.

    b. Optimise the return on its investment portfolio and other financial assets.

    c. Regularly review and consider the performance of the Council's financial assets and investments. Where appropriate, the Council will dispose of underperforming assets or those assets and investments that are not essential to the delivery of services and activities set out in the Council's Long-Term Plan.

13) This paper reviews the performance of the Council's non-service income-generating assets and recommends consulting on changes through an LTP amendment in next year's Annual Plan, specifically on the sale of the Council's 34% holding in Wellington International Airport Limited (WIAL). These changes (including the proceeds from the sale of WIAL shares) would seek to diversify the portfolio and make it more fit-for-purpose to support Council's financial objectives and to better manage risk.

14) The Investment and Liability Management policy at p158 provides that "Proceeds from the sale of investments will be used to repay existing borrowings, unless the Council specifically directs that the funds be put to another use." Given the current low-interest rate environment, officers recommend that proceeds from the WIAL shareholding sale are used to begin to establish a new diversified investment fund.

15) Council's non-service income-generating asset base (WIAL shareholding, and a portfolio of ground leases) is geographically concentrated, and relatively illiquid. It is susceptible to climate change, natural hazard risk, and potentially the longer lasting implications of Covid-19. Therefore, it is prudent to explore potential changes to manage financial exposure and ensure the portfolio better supports the Council to deliver on its strategic priorities and manage risks.

16) By divesting a portion of the asset base, an opportunity emerges to reinvest the proceeds into a diversified investment portfolio aligned with Council's strategic objectives. Reshaping the portfolio would also mean the Council would hold a more liquid portfolio of assets that could be used to manage the costs of unforeseen events (e.g., natural disasters) rather than buying insurance or holding debt headroom. This could free up to $272m of debt headroom which could be used to fund other Council priorities.

17) Investing in a growth focused diversified investment portfolio would allow the Council to achieve comparable financial returns while:

a. Tailoring holdings to reflect the Council's risk tolerance;

b. Aligning investment with strategic objectives such as climate change, housing, and infrastructure;

c. Spreading risk over a range of asset classes to mitigate current geographic and concentration risks;

d. Exerting more control than over existing investments (in particular WIAL);

e. Having greater predictability of returns as assets in a diversified portfolio are more liquid than existing assets, allowing for example shares to be sold to return capital gains (not currently easily possible with WIAL);

f. Decoupling returns from the economic performance of Wellington CBD; and

g. Providing greater liquidity in the event that Council requires significant funding at relatively short notice, e.g. following a severe seismic event

18) This paper presents options for the Committee's consideration in relation to the Council's current WIAL shareholding and the ground lease portfolio. Officers recommend that the Council consults on a proposal to sell its WIAL shareholding as part of next year's Annual Plan process, with a view to using the proceeds to build up the new diversified fund. Officers recommend retaining the ground lease portfolio, but to enable future consideration to be given to site-specific divestment of ground leases, where this would achieve Council strategic and financial objectives. Again, the intention would be to invest the proceeds of any future sales into the investment fund.

Takenga mai

Background

19) The Finance and Infrastructure Strategy (included in the Long-term Plan 2021-31) includes the following policy objectives:

a. Minimise the Council's overall costs and risks associated with its borrowing activities and the general management of its other liabilities.

b. Optimise the return on its investment portfolio and other financial assets.

c. Regularly review and consider the performance of the Council's financial assets and investments. Where appropriate, the Council will dispose of underperforming assets or those assets and investments that are not essential to the delivery of services and activities set out in the Council's Long Term Plan.

20) Consistent with the Finance and Infrastructure strategy, officers have undertaken a review of the portfolio, particularly the non-service income-generating assets to determine whether they remain fit-for-purpose given the Council's strategic objectives and current financial position, and the need to manage to better manage risk (particularly insurance risk).

21) Council has a number of non-service income generating assets which help fund its activities and offset ratepayer contributions. Ownership of these assets is largely due to historical reasons.

a. Wellington Airport dates from 1928, with WIAL established in 1990 with 66% Crown ownership (sold to Infratil in 1997) and 34% Council ownership.

b. Ground leases date from the 19th century, with land reclaimed from the Harbour foreshore (Wellington Reclaimed Land Act 1871).

22) A largely passive approach has been taken to date on the management of these holdings.

23) These assets are geographically concentrated, and are susceptible to climate change, natural hazard risk, and potentially the longer lasting implications of Covid-19.

24) Council's investment holdings are sizable but lack diversification and are relatively illiquid. In the event of a major disruption Council would be unable to release equity from these investments quickly, and the value of the assets could be significantly impaired.

25) WIAL returns have been relatively volatile in recent years and there are risks to shareholding value. [redacted]

26) The Council holds $272m headroom to cover risks that are either unable or uneconomical to cover via insurance. A more diversified and liquid investment portfolio would allow the Council to reduce or potentially eliminate the need for the reserve, allowing this to be used for other purposes.

27) Through the LTP consultation, the Council signalled future consultation and decisions on divestment (sale) of these assets, with the objective of using proceeds to off-set future borrowings or reinvest in assets with a better financial return. This can help keep rates at an affordable level. Assets that may represent an opportunity for Council include our shares in WIAL, our portfolio of ground leases, encroachments, road reserve, and some of our buildings.

28) The Local Government Act 2002 (section 14) also contains principles in relation to local authorities and its investments, including principles to assess the returns and risks associated with investments, to ensure prudent stewardship, and to take into account the reasonably foreseeable needs of future generations in a sustainable development approach.

29) There is an intergenerational objective to protect and maintain long term gains in the real capital value of Council's investments for the benefit of future as well as current generations of ratepayers.

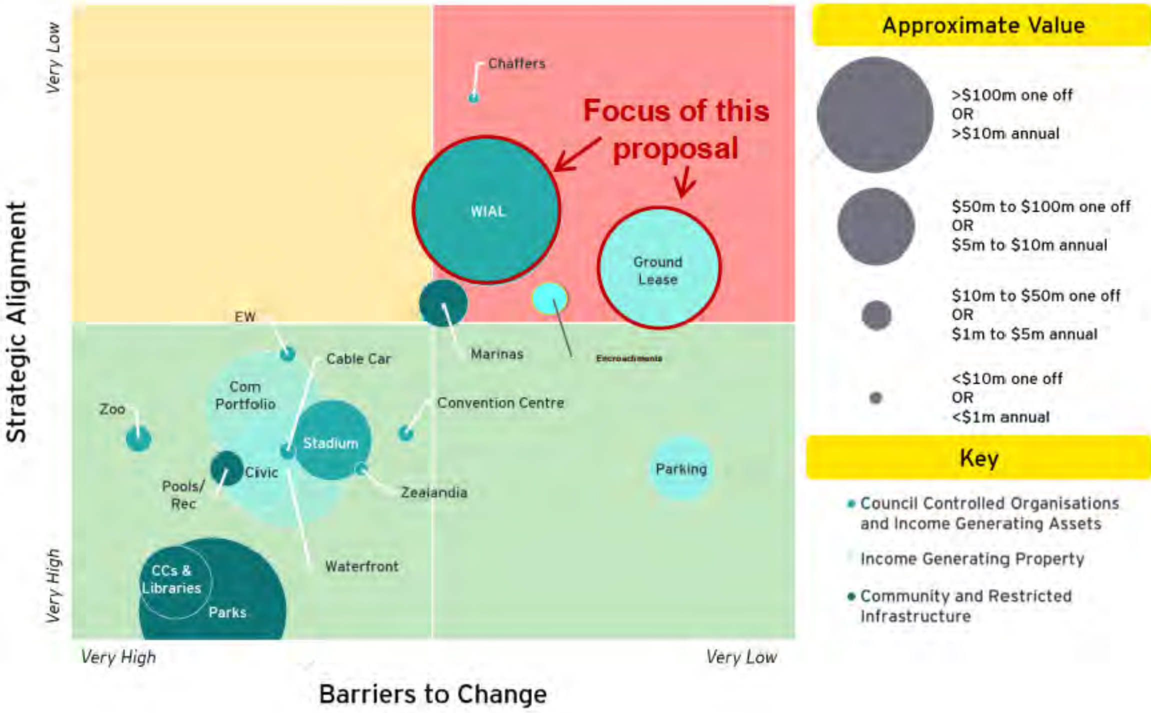
30) The Investment and Liability Management policy (included in the Long-term Plan 2021-31) states that "Proceeds from the sale of investments will be used to repay existing borrowings, unless the Council specifically directs that the funds be put to another use."

31) Given historically low interest rates there would be greater returns from reinvesting the proceeds of asset divestments into other income generating assets, rather than paying down debt.

32) Officers undertook a review of the Council's overall balance sheet. Through this review assets were classified according to their strategic alignment, and the ability of the Council to divest in order to reinvest in other areas. An opportunity assessment identified WIAL and Ground Leases as priority areas to review given their relative size, low strategic alignment, and low barriers to change. On this basis, the WIAL shareholding and ground leases are the focus of the remainder of this paper.

33) Figure 1 below shows the value of assets (size of the circles), how hard they would be to divest (easier to the right), and how strategically core they are (more core at the bottom). For example parks and libraries are core to Council and would be hard to divest so are placed bottom left.

Figure 1: Map of Council assets by size, strategic alignment and ease of divestment



Kōrerorero

Discussion

Diversifying Council's investment portfolio

35) Council's share in WIAL and its ground lease portfolio provide a return made up of capital gains (only realisable upon sale of the assets) and cash yields (in the form of rent or dividends). Capital gains are important only if the assets would be potentially be sold, while cash yields play an important role in reducing ratepayer contributions required.

36) Between FY10 and FY20 Council's share in WIAL returned an average annual return of 12.2%, made up of capital gains of 7.3% and cash yields of 4.9%. Between FY15 and FY20 capital gains increased significantly, while cash yields (dividends) remained largely flat.

37) WIAL paid no dividend in FY21 and have confirmed that no dividend will be paid in FY22. [redacted]

38) Between FY10 and FY20 Council's ground lease portfolio returned an average annual return of 8.2%, made up of capital gains of 2.5% and cash yields of 5.7%.

39) The chart below shows the cash yields (rent and dividend) since FY10, including a forecast for FY22.

Figure 2: Annual cash yields from WIAL and ground lease portfolio

41) Total returns (capital and cash) for WIAL and the ground lease portfolio are higher than a medium risk diversified fund and comparable to those returned by high growth portfolios (refer table 1 below). However, the Council's current investment portfolio has effectively two assets (WIAL shareholding and ground leases), compared with upwards of more than 100 investments in a typical diversified investment portfolio. This means, while its returns have been positive, it is not well diversified and therefore is highly exposed to situations like the current Covid context.

42) A growth fund is a diversified portfolio of stocks that has capital appreciation as its primary goal, rather than income generation through dividends. The portfolio mainly consists of companies with above-average growth that reinvest their earnings into expansion, acquisitions, and / or research and development. Most growth funds offer higher potential capital appreciation but usually at above-average risk. Investors need a tolerance for risk and a holding period with a time horizon of at least five to 10 years.

Overview of Returns	1 year	3 year	5 year
Council's Portfolio	10.2%	11.5%	12.1%
Diversified Portfolio 1	7.7%	10.2%	7.6%
Diversified Portfolio 2	7.9%	11.2%	8.8%
Booster Socially Responsible Balanced Fund	11.1%	8.0%	6.8%
Booster Socially Responsible High Growth Fund	15.8%	12.7%	10.8%

Note: Returns shown are total returns before fees and taxes.

43) Investing in a growth focused diversified investment portfolio would allow the Council to achieve comparable financial returns while:

a. Tailoring holdings to reflect the Council's risk tolerance;

b. Aligning investment with strategic objectives such as climate change, housing, and infrastructure;

c. Spreading risk over a range of asset classes to mitigate current geographic and concentration risks;

d. Exerting more control than over existing investments (in particular WIAL);

e. Having greater predictability of returns as assets in a diversified portfolio are more liquid than existing assets, allowing for example shares to be sold to return capital gains (not currently easily possible with WIAL);

f. Decoupling returns from the economic performance of Wellington CBD; and

g. Providing greater liquidity in the event that Council requires significant funding at relatively short notice.

44) If the Council decides to invest in an investment portfolio, it should establish a Statement of Investment Policy and Objectives (SIPO) and determine an appropriate asset allocation (i.e., set its target level of risk and appropriate composition of the portfolio). This provides guidance on how and where funds should be invested, in line with Council policy and objectives.

45) A professional investment manager should be engaged to manage Council's investment portfolio in line with the SIPO and agreed asset allocation. This would be an efficient approach and ensure that investments are managed at an arm's length. Council would not be involved in the day-to-day management of the fund or choice of specific investments.

46) A diversified investment portfolio approach aligns with Council objectives:

Key Council objectives	Diversified investment portfolio	Rationale
Infrastructure	✓	Allows up to $272m of balance sheet headroom (from insurance risk) to be reprioritised
Resilience	✓	More liquid assets that can be accessed in an emergency
Climate change	✓	Can target investment in funds that support climate change goals. The Council currently has limited influence over WIAL and its emissions, but could reinvest in green funds, and as an independent regulator may have greater influence over WIAL
Housing	✓	Can target investment in funds that support housing goals

Examples of other Councils' approaches to investment

47) A number of other councils have established diversified investment funds:

a. In 2019 Hawke's Bay Regional Council sold 45% of Napier Port for $234m and invested ~$108m in managed investment funds. The purpose was to increase investment diversification and liquidity.

b. In 2004 New Plymouth District Council sold its share in Powerco and used the proceeds to establish a Perpetual Investment Fund (PIF). The purpose was to spread their investments, reduce risk, and seek annual returns the same or higher than dividends received from Powerco. The PIF was managed by Taranaki Investment Management Limited, a Council-Controlled Organisation. In 2017 the management of the PIF was fully outsourced to Mercer (NZ) Limited. Investments are now worth ~$292m.

c. In 1995 Taupō Electricity Limited (TEL) and Taupō Generation Limited (TGL) were sold and the proceeds invested in the TEL Fund, which is now worth ~$64m. The fund has improved Taupo District Council's Standard and Poor's (S&P) credit rating by the high level of liquidity that the fund offers. In the event of a natural disaster the TEL fund means that Council can fund its share without having to pay a significant insurance premium.

d. In 1994 Thames Coromandel District Council created the Power New Zealand Reserve using proceeds from the sale of its Power NZ shares. In 2019 the fund was worth ~$25m. The reserve is an asset that Council has a responsibility to maintain for the benefit of both current and future ratepayers.

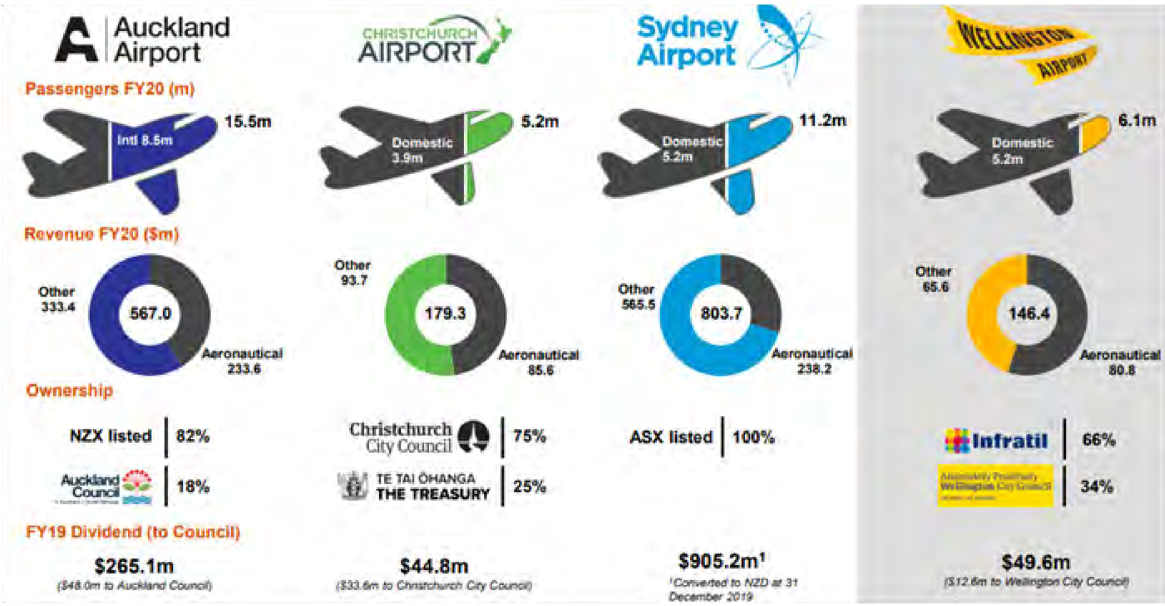
Wellington International Airport Limited (WIAL) ownership

48) Council's shareholding in WIAL is where officers recommend that Council considers its ongoing ownership, with a view to releasing funds to begin investing in a diversified fund.

49) The Council owns 34% of WIAL and has two WIAL Board positions. WIAL paid Council an average dividend of $13.1m between FY10 and FY20. Dividends to Council from WIAL have plateaued from FY16, despite EBITDA increasing by 23% over the same period. No dividend was paid in FY21 and none is expected in FY22. [redacted] Council has terminated a ~$76m loan agreement for seawall strengthening to support the WIAL capex programme post FY26. [redacted]

50) Although impacted by Covid-19, WIAL is in a stronger position than its peers given its domestic and trans-Tasman focus. At the start of 2020 its passenger mix was 82% domestic, 12% Australia & Pacific, and 6% international. (refer figure 3 below).

Figure 3: New Zealand and Australian airport performance



52) To inform this review of the balance sheet, a PwC market assessment [redacted]

Table 2: [redacted]

[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]
[redacted]	[redacted]	[redacted]

53) EV / EBITDA is a popular valuation multiple used to determine the fair market value of a company. It measures enterprise value (EV) to earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA measures a firm's overall financial performance, while EV determines the firm's total value. EV / EBITDA multiples are at historically high levels, suggesting the market is expecting a strong rebound in the near to medium term. Other airports (e.g., Auckland and Sydney have similarly strong results which suggests the underlying value of the asset remains and represents a good investment proposition for a potential buyer.

[redacted] if you look at the Weighted Average Cost of Capital (WACC) as a measure of potential investor returns on an investment in a company, WIAL looks like a positive investment. WIAL's regulated pricing WACC until 2024 is 4.94%. Should interest rates remain low through this pricing period, this regulated return will be particularly attractive to infrastructure investors seeking target returns in a low interest rate environment.

55) The low interest rate environment has also increased demand for higher yielding infrastructure assets. Airport market capitalisations have broadly returned to pre pandemic levels. Given the strong rebound in domestic travel, WIAL's valuation is expected to have done the same.

56) [redacted]

57) It would be Council's choice as to which offer to accept on the basis of financial benefit and non-financial considerations, [redacted]

__Ground lease ownership__

58) The ground lease portfolio provides a source of long-term, secure, and relatively predictable income, and opportunities to influence city-shaping outcomes so is not recommended for divestment at a portfolio level.

59) The leasehold portfolio is a unique and highly sought-after asset class. Any decision to sell all or part of the portfolio should be considered carefully, noting that the portfolio provides Council with leverage to influence wider City outcomes.

60) Note that some ground leases were obtained by Council through the Wellington Reclaimed Land Act 1871 are held in trust for the purposes of public utility and there is a particular process (notification to certain Ministers) that needs to be followed for their sale.

61) Council owns 63 ground leases predominantly located within the Wellington CBD. Of the 63, 53 are perpetually renewable typically 21-year (“Glasgow” or perpetual) leasehold interests. Of the 10 remaining interests, two are vacant and eight are terminating (not perpetual) leases. This report focuses on the 53 perpetual leasehold interests. The map below (figure 4) shows the majority of the ground leases in the portfolio, but excludes some, for example in Miramar.

Figure 4: Current Council ground leases in CBD

As at June 2021, the total ground lease portfolio has a total asset value of $234m and provides Council with an annual revenue of $9.7m. The perpetually renewable proportion of the portfolio has a value of $208m with forecast revenue of $9.3m in the 2021/22 financial year.

Ground lease portfolio performance

63) The perpetual portfolio provides reasonably stable returns, with annual income returns since FY10 ranging between 4.4% and 6.4%, while capital returns are more volatile, ranging from -3.9% (post GFC in FY10) to 9.7% (in FY17).

64) For comparison, the MSCI / Property Council NZ All NZ Property Index (industry standard index) indicates that property funds achieved a total return of 10.7% p.a. and the NZX50 achieved average returns of 14.2% p.a. The ground lease portfolio average annual return of 9.7% is lower than these indexes but it is a lower risk passive income stream compared to improved assets such as office, retail or industrial.

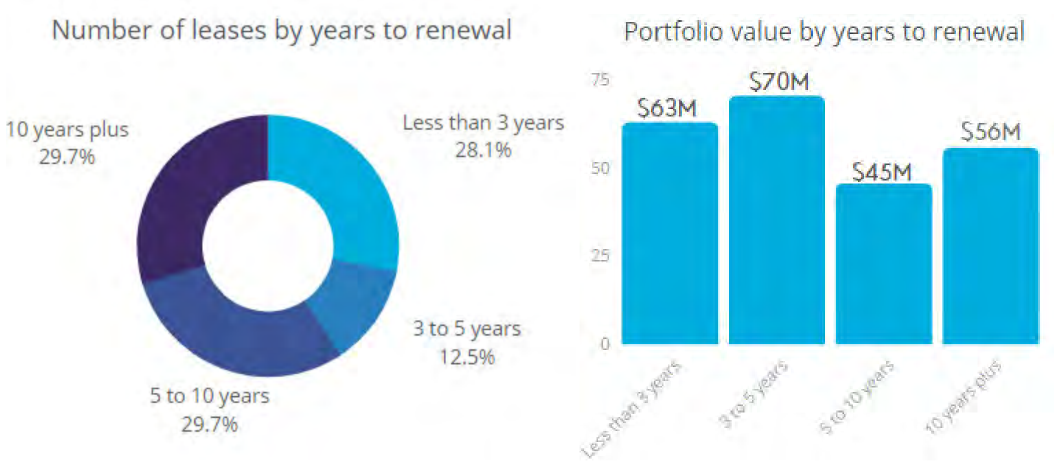
65) The 21-year lease model helps insulate the portfolio from property market shocks.

66) Based on valuation assumptions from CBRE Valuations, the portfolio is forecast to provide Council with a return of ~7.0% per annum over the next 10 years. This is an average return predominantly driven by a long-term land growth assumption of 2.0% p.a.

Ground lease portfolio risks and opportunities

67) Nonetheless after a long period of sustained growth economists are predicting a market slow down which may negatively impact the future performance of the portfolio. Around 25% of the perpetual portfolio (by value) has a rent review in the next three years and 45% of the portfolio is due for review in the next five years. Rent reviews are done infrequently (every 21 years) so have a significant impact on the portfolio's returns over a reasonably long period of time. If a downturn eventuates, this could flow through to lower returns from at least a quarter of the sites in the portfolio.

Figure 5: Number and value of leases by timeframe for renewal



68) The portfolio is also highly concentrated geographically (i.e. unimproved land predominantly situated in the Wellington CBD and surrounds) which means it is highly exposed from a resilience perspective, to seismic events, flooding and sea level rise which may significantly impair value in the future. Figure 5 shows the image of a 1m rise in sea levels (forecast to occur over the next 100 years).

69) However, Council ownership of this land provides Council with a degree of control in the event of a natural disaster or rising sea levels around (re)development of the area and continued Council ownership and retention of the portfolio demonstrates confidence in Wellington City.

Figure 5: Impact of 1m sea level rise on CBD ground lease portfolio

70) The leasehold portfolio on balance is not holding back the growth of the City but may be affecting some sites, especially where the underlying highest and best use of the land is owner occupied residential apartments or other forms of medium to high density housing (such as co-housing).

71) It is recommended that the overall portfolio is retained as a source of long-term, secure, and relatively predictable income, and as leverage to influence city-shaping outcomes. However, there may be specific sites where divestment may be worth exploring to influence wider City outcomes, although there are some important process considerations.

Ground lease sales approach

72) The current approach agreed by full Council 30 April 1999 states:

   a. *Not proceed with the sale of any of its interests in ground leases except where:*

i. *the city holds a minority interest in any sites; or*

ii. *the lease is a significant impediment to immediate and planned development; or*

iii. *there are clear financial advantages which would accrue to Council from the sale.*

b. *Note that in determining whether to sell Council's interest the following criteria are to be considered:*

i. *The price to be the highest possible but not less than the current market value*

ii. *The Heritage opportunities to the city are fully explored – and the heritage values of the building on the site to be dealt with as a transparent separate issue*

iii. *The age and character of the building and the suitability for redevelopment. Redevelopment proposals may be requested.*

iv. *Existing Council policy in regard to other strategies is also to be taken into account, e.g. Urban Design, Retail, Cultural, Heritage and Economic development.*

73) A 2008 Review of the Ground Lease Portfolio confirmed the Financial Advantage calculation was found to be "flawed, complex and open to challenge". It effectively meant that Council's default position would be to sell ground leases where the lessee is prepared to pay the 'financial advantage' amount calculated. It was recommended that its use cease and a new method be adopted. No further sales have been concluded since the review and the financial advantage calculation has not been updated.

74) It is recommended that Council update the approach to provide clarity on the circumstances under which any sales would be allowed, with an emphasis on retaining the integrity of the existing investment portfolio. Holding a large number of sites on long-term leases provides stable returns over the economic cycle and provides Council with leverage to influence wider City outcomes.

Kōwhiringa

Options

Use of proceeds from divestments

75) The Council has a number of choices to consider as a result of the proposals in this paper. These include:

a. Whether to establish a diversified investment fund to enable the Council to more effecitvely manage financial risk and free up balance sheet headroom

b. Whether to sell all / part of the Council's shareholding in WIAL in order to establish the investment fund

c. Whether to sell all / some of the Council's ground leases in order to contribute to the investment fund

76) It is important to note that while the Council's Investment and Liability Management policy emphasises that proceeds from any sales are used to pay down debt, this is subject to Council direction. Given the current low-interest rate environment officers recommend that proceeds could be used to begin to establish a new diversified

investment fund due to the risk management benefits detailed in this paper and supported by the Local Government principles referred to in paragraph 28.

77) Officers recommend that the Council establishes a diversified fund on the basis that it will help the Council more effectively manage future financial risk and free up debt headroom capacity for other Council priorities. The Investment and Liability Management policy (included in the Long-term Plan 2021-31) allows Council to specify that funds are directed to uses other than repayment of debt, but officers recommend that we include this as part of the consultation on the sale of WIAL. The potential for targeted divestment of assets to build a higher-performing overall portfolio was signalled by the Council through the LTP process.

Wellington International Airport Limited (WIAL) ownership

78) There are three options regarding Council's ownership of WIAL. It is recommended that Council sell its 34% share in WIAL to reinvest in more liquid, and strategically aligned investments. Selling the Council's full shareholding would remove the current potential perceived conflict between the Council as both shareholder and regulator of WIAL. [redacted]

79) Officers recommend that all options are included for public consultation as part of next year's Annual Plan process, with the Council preference indicated for option 3. This consultation would need to be accompanied by an LTP amendment showing the impact of the preferred option on the Council's long-term financial position.

Table 3: WIAL sale options

	Advantages	**Disadvantages**
Option 1: Retain 34% holding (not officer preferred)	- Retain future dividend payments - Retain option to sell in the future	- Relatively illiquid asset with significant risks relating to natural hazards, climate change, and Covid 19 - Council unable to realise opportunities from divesting and reinvesting proceeds from sale - [redacted]
Option 2: Sell 17% stake (not officer preferred)	- [redacted] - Council retains some control over WIAL - Council continues to receive dividend payments	- Same issues as retaining 34% holding plus additional below - [redacted] - [redacted] - [redacted]
Option 3: Sell 34% stake (officer preferred)	- [redacted] - [redacted]	- [redacted]

	[redacted]	

Ground lease ownership

80) There are four options regarding Council's ownership of ground leases:

   a. Option 1: Retain the status quo, preserving the integrity of the portfolio with sales only allowed in exceptional circumstances as allowed by the proposed revised ground lease sales approach

   b. Option 2: Sell the portfolio as individual ground leases

   c. Option 3: Sell the full ground lease portfolio in a single sale

   d. Option 4: Securitise the portfolio (creating a financial instrument from the assets in which people can invest)

81) Officers recommend that the overall portfolio integrity is retained (option 1) as a source of long-term, secure, and relatively predictable income, and as leverage to influence city-shaping outcomes.

82) This recommendation is consistent with a 2008 review of the portfolio which stated, “it is in the Council’s best financial interests to continue to hold its ground leases in a managed investment portfolio within Council control and not to divest them in part or in whole”.

Table 4: Ground lease sale options

	Advantages	**Disadvantages**
Option 1: Retain full portfolio (officer preferred)	- Provides long-term, secure and relatively predictable income stream - Performance is not necessarily impacted by short-term market shocks - Requires relatively little management - Should the lessee fail to pay rent the land will revert to the lessor (subject to any mortgage priority from lenders) - Revenue is predominantly driven by land value which generally appreciates in the long-term - The portfolio provides Council with leverage to influence city-shaping outcomes	- Ownership of leasehold land can create animosity between ground lessees and Council - Lower investment liquidity - The portfolio is not diversified either from a geographic or asset class perspective - A large proportion of the portfolio has 21 year rent reviews – limiting the ability for the lessor to realign ground rentals to market - In some circumstances, the leasehold interest can contribute to under-development of some sites to the extent that it can result in poor outcomes for the City - If the tenant fails, the lessor may be left with economically obsolete buildings

		which may be costly to rectify (e.g. contamination issues)
Option 2: Sell the portfolio as individual sales (not officer preferred)	- Unlock / catalyse development opportunities + Unlock equity for other needs / alternative investments - Provides Council with additional tools to influence outcomes - Potential to unlock additional value if sold to ground lessees - Enable building up of diversified investment fund to manage future Council financial risks	- Selling individually needs to be carefully managed and can be timely and costly - Potential to erode portfolio diversification benefits - Approval heavy - Risk that ground lessees ‘game’ market cycles (depending on sales strategy) - Any sale of assets will require a clear strategy in relation to reinvestment
Option 3: Sell full portfolio (not officer preferred)	- Unlock over $200m in equity - Simple transaction (as opposed to selling individual sites) - Utilise capital for other needs / alternative investments	- Potentially undermine Wellington market confidence - Removes ability to influence city-shaping outcomes from key sites - Cannot unlock additional value
Option 4: Securitise portfolio (not officer preferred)	- Upfront payment to fund other needs / alternative investments - Retain portfolio - Transfer of risk for defined period	- Forego revenue upside - 64% of Portfolio (by value) has a rent review in the next five years - Any sale of assets will require a clear strategy in relation to redeployment of revenue - Limits ability to influence city-shaping outcomes from key sites - Cannot unlock additional value

Proposed update to ground lease sales approach

83) Is it recommended that the following update (changes in italic and strikethrough) is made to the approach to ground lease sales determined by full Council 30 April 1999. This is in line with the 2007 Review of the Ground Lease Portfolio and recommendation in this paper to retain the overall portfolio and minimise erosion of portfolio diversification benefits unless there is a clear and compelling benefit to Council to do so.

84) Not proceed with the sale of any of its interests in ground leases except where:

~~a. the city holds a minority interest in any sites; or~~

b. the lease is a significant impediment to ~~immediate and~~ planned development *that aligns with Council’s objectives and policies*; ~~or~~ *and*

c. there are *significant* ~~clear~~ ~~financial~~ advantages, which would accrue to ~~Council~~ *Wellington* from the sale; ~~or~~ *and*

d. the sale will not materially impact the integrity of the ground lease portfolio unless there is a compelling opportunity to leverage wider outcomes for the city.

Noting that any sale is solely at Council's discretion.

~~Note that in determining whether to sell Council's interest the following criteria are to be considered:~~

~~(i) The price to be the highest possible but not less than less than the current market value~~

~~(ii) The Heritage opportunities to the city are fully explored – and the heritage values of the building on the site to be dealt with as a transparent separate issue~~

~~(iii) The age and character of the building and the suitability for redevelopment. Redevelopment proposals may be requested.~~

~~(iv) Existing Council policy in regard to other strategies is also to be taken into account, e.g. Urban Design, Retail, Cultural, Heritage and Economic development.~~

85) The rationale for these proposed changes is to make it clearer that the default position of Council is not to sell ground leases unless they would deliver significant outcomes aligned with Council's strategy and policies. The revised wording provides a stronger link to Council's priorities, and greater flexibility to future proof the policy.

86) Below is a clean version of the recommended updated wording:

87) Not proceed with the sale of any of its interests in ground leases except where:

a. the lease is a significant impediment to planned development that aligns with Council's objectives and policies; and

b. there are significant advantages, which would accrue to Wellington from the sale; and

c. the sale will not materially impact the integrity of the ground lease portfolio, unless there is a compelling opportunity to leverage wider outcomes for the city.

Noting that any sale is solely at Council's discretion.

Whai whakaaro ki ngā whakataunga

Considerations for decision-making

Alignment with Council's strategies and policies

88) In Council's consultation on the LTP it was signalled under decisions coming up in the future that "Where we have assets that could realise more value we can look at divesting (selling) these assets and use the proceeds to off-set our borrowings or reinvest in assets with a better financial return. This can help keep rates at an affordable level. Assets that may represent an opportunity for Council include our shares in WIAL, our portfolio of ground leases, encroachments, road reserve, and some of our buildings."

89) Opportunities to reinvest proceeds of sale of assets referenced in the Pre-election Report 2019. Specific policy objectives (from Long-term Plan 2021-31 – Volume 2 – Investment and Liability Management Policies) supported by this paper include:

a. Minimise the Council's overall costs and risks associated with its borrowing activities and the general management of its other liabilities.

b. Optimise the return on its investment portfolio and other financial assets.

c. Regularly review and consider the performance of the Council's financial assets and investments. Where appropriate, the Council will dispose of under performing assets or those assets and investments that are not essential to the delivery of services and activities set out in the Council's Long Term Plan.

Engagement and Consultation

90) This report seeks approval to consult with the public on the sale of Council's 34% holding in WIAL through an LTP amendment progressed alongside the 2022/23 Annual Plan. The options we will consult on is not to sell, sell 17%, or sell 34% of Council's WIAL shareholding.

91) We will also consult on whether to use funds from the proposed sale of Council's WIAL shareholding to pay down debt or establish a diversified investment portfolio.

Implications for Māori

92) The sale of ground leases may be subject to Right of First Refusal (RFR) in favour of iwi. This would be reviewed as part of any proposed sale of ground leases. No sales are proposed in this paper.

Financial implications

93) Recommended sale of Council's 34% shareholding in WIAL to reinvest in a diversified portfolio of income generating assets of the same current value. Opportunity to reduce or potentially eliminate the need for headroom of $272m to cover uninsured risk, allowing this to be used for other purposes at Council's discretion.

Legal considerations

94) [redacted]

Risks and mitigations

95) Overall, this proposal is rated as high risk on the Council's risk framework given the financial significance and recommendation to sell a strategic investment (WIAL shareholding).

96) The current portfolio of non-service income generating assets is exposed to a large number of risks, including:

a. Geographic concentration

b. Minimal diversification (an airport and ground leases primarily within the CBD)

c. Heavy dependency on performance of Wellington CBD

d. Susceptibility to climate change and natural hazards

e. Relative illiquidity, in a major disruption the Council would be unable to release equity from investments quickly, and the value of the assets would be significantly impaired

f. Volatile returns from WIAL shareholding since Covid-19, [redacted]

97) This paper proposes to address these risks through the sale of Council's 34% shareholding in WIAL and reinvestment of the proceeds into a diversified portfolio of income generating assets.

98) Risks and mitigations associated with this proposal include:

a. Offers for Council's WIAL shareholding are lower than either financial or non-financial expectations – the sale is at Council's discretion and it can decline to sell if offers are insufficient.

b. Returns from the diversified portfolio of income generating assets are lower than current returns – WIAL has returned no dividend in FY21 and is not expected to in FY22. There is a small risk that over the long-term WIAL shares will outperform the diversified portfolio, but there are significant risks noted above associated with significant investment in a single shareholding.

c. May not be public support for either selling Council's shareholding in WIAL or reinvesting the proceeds into a diversified fund (rather than using to mitigate expected rates increases) – to be addressed through engagement and consultation process, with a focus on there being an intergenerational objective to protect and maintain long term gains in the real capital value of Council's investments for the benefit of future as well as current generations of ratepayers.

d. Perception that the Council is not supporting the region through divestment of its shareholding in WIAL – emphasis that divestment is not related to any loss in confidence in WIAL but a rebalancing of Council's investment portfolio to reduce risk exposure and better meet Council strategic objectives.

e. An economic downturn could lock in lower ground lease rates for 21 years – accepted risk as part of the approach toward ground leases that has delivered steady returns, smoothed over the economic cycle, adopted since the 19th century.

f. Continued ownership of assets (ground leases) which are susceptible to climate change and natural hazards – accepted risk, providing Council with a degree of control around (re)development of the area. Council ownership and retention of the portfolio demonstrates confidence in Wellington City.

Disability and accessibility impact

99) None identified.

Climate Change impact and considerations

100) Considered as part of proposals to diversify the Council's investments from assets that are vulnerable to sea level rise (ground leases and WIAL) and support carbon intensive activity (WIAL), to investments aligned with climate change objectives.

101) The level of influence Council has over WIAL's activities will not change materially through not retaining a shareholding in WIAL and may increase as a result of removing any potential conflict with Council's role as a regulator.

102) Retaining the integrity of the ground lease portfolio provides Council with leverage to support developments in the City that address climate change.

103) Proceeds from the divestment of WIAL may be directed toward investments that help address climate change, to be confirmed during development of the Statement of Investment Policy and Objectives (SIPO) and asset allocation.

Communications Plan

104) To be covered through the engagement and consultation process outlined.

Health and Safety Impact considered

105) Not applicable.

Ngā mahinga e whai ake nei

Next actions

106) Next steps are to:

a. Consult through an LTP amendment progressed alongside the 2022/23 Annual Plan on selling Council's 34% share in WIAL

b. Subject to the outcome of consultation future next steps may include:

    i. Develop a Statement of Investment Policy and Objectives (SIPO) and determine an appropriate asset allocation for approval by Council

    ii. Establish a diversified investment portfolio

    iii. [redacted]

c. Update the wording of the approach to ground lease sales

Attachments

Nil