
CAPACITY OUTCOME BASED BUSINESS MODEL

1. Purpose of report

The purpose of this report is to outline the detail of the Capacity Outcome Based Business Model (OBBM) and update Council on the progress of the transition plans and capability reviews.

2. Executive summary

In 2012 Hutt City Council (HCC) agreed to allow Capacity Infrastructure Services Ltd (Capacity) to transform to an OBBM (as set out in this report) and to bring Upper Hutt City Council (UHCC) and Porirua City Council (PCC) on as shareholders. Wellington City Council (the Council) agreed to the addition of UHCC and PCC as shareholders and agreed to the OBBM in principle. UHCC agreed to become a shareholder and PCC agreed that documentation be prepared for public consultation on the Capacity proposal.

Capacity will remain committed to managing the water supply, wastewater and stormwater (collectively known as the “three waters”) assets on behalf of its shareholder and client councils. Ownership of the three water assets is retained by each individual council and Capacity will be paid a fee through an agreed mechanism to manage the three water assets on the shareholder’s behalf.

Capacity’s performance will be measured via common (and agreed) Key Performance Indicator (KPI) metrics, with individual councils agreeing on the level for each measure as part of agreed Service Level Agreements (SLAs).

3. Recommendations

Officers recommend that the Strategy and Policy Committee:

- 1. Receive the information.*
- 2. Recommend that Council note work is continuing to finalise the 2013/14 Service Level Agreement between Council and Capacity.*
- 3. Recommend that Council note work is continuing to develop the Capacity Shareholder Memorandum of Understanding.*

4. *Recommend that Council note that Capacity's other current shareholder, Hutt City Council, has already unanimously voted to support Capacity to move to the outcomes based business model as set out in this report.*
5. *Recommend that Council agree the Capacity outcome based business model (already approved in principle) will now be implemented commencing the 2013/14 financial year, subject to the agreed transition plan and the capability review being reported back to the Council.*
6. *Recommend that Council note the current authority for the Council Chief Executive Officer to approve and execute all final documentation to move Capacity to an outcome based business model is subject to the Council Chief Executive Officer reporting back to the Council on the capability review by the end of May.*

4. Background

At the 26 April 2012 meeting, the Council received a report on proposed governance changes to Capacity. Among the recommendations, the Council:

- Agreed in principle to support Capacity moving to an OBBM; and
- Delegated to the Chief Executive responsibility for negotiating and approving a shareholders' Memorandum of Understanding on behalf of the Council and approving changes to Capacity's constitution and any other consequential documentation on behalf of the Council to put these proposals into effect.

At the 29 November 2012 meeting, the Council received a report on the review of Council's Council Controlled Organisations (CCOs) and directed the Chief Executive Officer (CEO) to agree with the other shareholders of Capacity, the detail of the OBBM, on the basis that the following are retained by the Council:

- Ownership of the three waters assets;
- Ownership of the three waters information and asset management info system (AMS);
- Responsibility for policy and strategic direction;
- Approval of asset management plans;
- Approval of the SLA and KPI's; and
- Approval of budgets (and funding) for operating and capital expenditure related to Council's three water activities.

At this meeting the Council also instructed the Council Chief Executive, in consultation with the Board of Capacity, to review and report back on their capabilities to deliver on the objectives of a regional water management unit and the transition plan to an outcomes model, by 31 March 2013.

Capacity officers have been working with the Capacity Board and client council officers to finalise the details of the OBBM, as well as developing a draft SLA which will support its delivery. This report sets out the key features that are being embedded into the SLA contractual arrangements. The capability review, and subsequent report back to the Council, can be undertaken now that this

work is agreed. As a result, while the original date was 31 March, officers will report back to the Council on the capability review by the end of May.

5. Discussion

In 2012 a number of reports were produced regarding Capacity's move to an OBBM, along with the benefits, efficiencies and risks of moving to an OBBM. This report draws on details of these papers in order to explain the key features of the OBBM.

As noted, in 2012, approval was sought from the Council for Capacity to move to an OBBM and bring UHCC and PCC into the business as shareholders and clients. As noted, the Council agreed to the additional shareholders and approved the OBBM in principle.

In 2012 HCC agreed to allow Capacity to transform to an OBBM (as set out in this report) and to bring UHCC and PCC on as shareholders. UHCC agreed to become a shareholder and PCC agreed that documentation be prepared for public consultation on the Capacity proposal (this consultation is currently being prepared).

The move to an OBBM is consistent with the work currently being carried out by the Local Government Infrastructure Efficiency Expert Advisory Group (due to report back shortly). It is likely that the recommendations of the expert advisory group will be consistent with the changes outlined in this report. Council and Capacity officers will continue to closely monitor the findings of the expert advisory group and will report back to Council if there are any material changes that need to be considered.

It is noted that the Council agreed in 2012 that the relevant voting and income share percentages should be reviewed for reasonableness in the event of regional governance changes.

5.1 Outcome based Business Model

The new Capacity OBBM will operate across the enlarged organisation incorporating up to two new shareholders and clients and has the following features that will allow the new model to operate effectively:

- (a) The client councils will retain ownership of their water networks and associated assets, but they will provide Capacity with operational control of the assets.
- (b) Each council sets policy and the outcomes they require in relation to the delivery of water services in their area. Capacity needs to deliver in accordance with the required outcomes. Capacity will assist in drafting council policy (as required) with overarching decision making remaining with each individual council.

- (c) Where the opportunity for gains in efficiency or effectiveness exists Capacity will proactively lead the development of a common policy framework across some or all councils.
- (d) No further equity finance is required from the Council to move to the OBBM beyond that which has been budgeted for in the 2012 LTP through the continuation of the 'no liability' system embedded into the current SLAs. The no liability system takes account of the fact that as a Council Controlled Trading Organisation (CCTO), it is not possible for shareholder councils to guarantee or indemnify Capacity.
- (e) A continuation of the 'no liability' structure will ensure a council's funding will only be applied to assets in that council's jurisdiction without cross-subsidy.
- (f) Capacity will continue developing its capabilities to ensure it is at the leading edge of strategic infrastructure advice within New Zealand and around the world.
- (g) The Capacity board will be appointed by the shareholding councils and should consist of appointees best qualified to govern the business affairs of the company.
- (h) Capacity will work with client councils on LTP and Annual Plan budgets to identify an agreed schedule and value of works and services.
- (i) Capacity is paid on agreed intervals for the schedule of works and services delivered over the period.
- (j) The OBBM contract is designed to enable Capacity to minimise whole of life costs, and not compromise short term water services outcomes. This will be achieved through a contract of sufficient length (to coincide with LTP years), giving Capacity the flexibility to plan over several years.
- (k) Capacity will only be required to consult or gain approval from the councils in relation to issues beyond approved programmes or budgets.
- (l) In order to facilitate innovation and continuous improvement, which, ultimately will provide better value for money for the councils and help ensure that Capacity is at the leading edge of strategic advice and management in the three waters industry, Capacity will be incentivised to earn a performance bonus in the form of retained earnings. The retained earnings will be available to Capacity to invest back into the business.
- (m) The Capacity Board will have complete oversight of Capacity's performance and report back to the client councils on an agreed schedule, based on the SLA, including an agreed suite of KPIs (please see section below for more information on the proposed OBBM KPIs).

- (n) The Capacity board will have oversight of the delivery of water services and the authority to delegate such authorities to Capacity's CEO.
- (o) By being responsible for water services outcomes as opposed to asset management inputs, Capacity will have accountability for managing a range of cost and reputation risks that currently reside in the councils.
- (p) Capacity will manage a number of legacy IT issues as it moves to the OBBM. These include the management and interface to shareholder AMSs (discussed in further detail below) and the potential consolidation of the various requests for service systems. Capacity is looking to consolidate these within one of Capacity's shareholder councils (i.e. in a shared services environment), if possible.
- (q) Capacity will at all times provide financial and professional advice that meets council budget and reporting deadlines.
- (r) Capacity will provide Asset Management Plans (AMPs) to councils (in accordance with each council's requirements and following discussion and agreement) for formal approval by councils.
- (s) Capacity will advise and negotiate with councils the annual charge being a combination of direct organisational costs and consultancy costs for agreed service delivery of operation and maintenance management, asset renewal implementation, preparation of reports and policy advice, and the management costs associated with estimated upgrade asset expenditures.
- (t) Capacity will take the risk on the fixed annual charge being sufficient. In the event of efficiencies (with consequential savings) being achieved, the later period fees will be adjusted accordingly.
- (u) The councils will continue to take the budget risk on activities managed by Capacity on the councils' behalf on agreed costs (such as reactive maintenance, charges and projects which incur non-budgeted costs such as arising from unforeseen ground conditions etc), managed by Capacity on the councils' behalf.
- (v) Capacity will advise and negotiate with councils the value of renewal capital expenditure to be expended derived from the AMSs, AMPs and LTPs.
- (w) Capacity will tender and award operation, maintenance and capital work contracts in its own name in accordance with approved procurement policies and the above agreed annual charges. This in turn, will allow Capacity to aggregate works, leading to further efficiency gains.

- (x) Where Capacity is required to tender and award contracts in the Council's name, in accordance with approved procurement policies, appropriate delegations will be provided to Capacity to undertake such functions.
- (y) Capacity will provide expert advice in respect to asset upgrade expenditure, with the final decision remaining with councils.
- (z) Delivery of services with appropriate reporting and the achievement of associated KPIs will give rise to an achievement payment mechanism (to be reinvested into the business if achieved) as per point m, above.

To summarise, the key features of what Capacity's OBBM will 'look like' and how this differs from the existing business model are outlined in the following table:

Element	Current Model	Outcome Model
Asset ownership	In public (Council) hands	Council (no change)
LTP/Annual Budget decisions	Council	Council (no change)
Reputational risk	Council	Capacity (over time)
Contract and operational responsibility	Council	Capacity
Reporting to Council	Monthly	Quarterly (although monthly reporting to Capacity Board)
Council policy compliance	Capacity abides by all Council policies or region-wide policies approved by Council.	No change
Delegation authorities	Council officers	Capacity Board/Capacity
Cross-subsidisation of other client Councils	The Council's 3 water networks are managed on a co-ordinated basis, without cross-subsidy to other client Councils	No change
Regional network overview	Limited regional overview	Development of regional network policies and practices
Principal to contracts	Council/Capacity	Capacity continuing as principal with operations and maintenance contracts and expanding role to be principal of capital works contracts
Principal to resource consents	Council	Capacity

Customer Interface	Council/Capacity	Capacity
Asset Management Plan approval	Council	Council (no change)
Asset Management Systems	Council	Capacity (co-ordinated across shareholder councils)

Transition Plan

The Council and Capacity officers are currently developing a transition plan to start to move Capacity to the OBBM by 1 July 2013. The transition plan covers off key areas such as the new SLA and reflecting the new OBBM in the Statement of Intent. Formal approval by the Council's CEO for this will be sought prior to 30 June 2013.

The key transition steps and timing will be as follows:

Transition Step	Timing
Agree details of the OBBM with other shareholder	March 2013
Agreement of Memorandum of Understanding	April/May 2013
New constitution	April/May 2013
PCC consultation and decision	May 2013
Capacity capability review completed and reported back to Council	By 31 May 2013
Agreement of operational transition plan, including AMS	April/May 2013
Agree updated SLA	April/May 2013
Agreement on new KPIs (and weightings)	April/May 2013
Approval of Statement of Intent, with OBBM reflected as much as possible	By 30 June 2013
Appointment of new Capacity Board	1 July 2013

Capability Review

In consultation with the Council CEO, the Capacity Board will commence a review on Capacity's capabilities to deliver on the objectives of the OBBM. Now that the details of the OBBM are finalised, this review, and the subsequent report back to the Council, can be undertaken. As a result, officers will report back to the Council on this by the end of May.

Memorandum of Understanding

A draft Memorandum of Understanding (MoU) is being drafted by the Capacity Board and Capacity shareholders to provide structure for shareholder consultation, appointment of directors and to give consistent feedback to Capacity.

The principles underpinning the MoU are to ensure that:

- the shareholders of Capacity are kept well informed in a timely way on any shareholder or governance related matters;
- the Company, including the Board, have a clear mechanism to obtain shareholder feedback as required;
- shareholders have a clear mechanism to relay any governance concerns to the Company and/or fellow shareholders;
- there is a forum to consider the Company's governance from a holistic perspective and assist in co-ordinating decisions among shareholders; and
- Shareholders have an agreed process for the appointment of directors.

Proposed Outcome Based Business Model Key Performance Indicators (KPIs)

Under the new OBBM, Capacity will be paid a fee through an agreed mechanism to manage the three water activities on behalf of shareholders. Capacity's performance would then be measured via common (and agreed) KPI metrics, with individual councils agreeing on the level for each measure.

After researching and reviewing the performance measures used in New Zealand (WaterNZ, Treasury, Watercare and other TAs), Australia (WSAA) and the United Kingdom (OFWAT), a set of indicators were prepared. Capacity then undertook a process of consultation with Wellington, Hutt and Upper Hutt City Councils (and Porirua City Council as a likely future shareholder).

While the bulk of the indicators are well known to those working in public infrastructure management in New Zealand, stakeholders need to be assured that the future of their networks are not being adversely affected by decisions made today. Conversely Capacity needed to demonstrate that the work done today will deliver future benefits for the community.

A new indicator called "serviceability" has been proposed to be introduced. Serviceability is defined as "the capability of a system of assets to deliver a reference level of service to customers and to the environment now and in the future." (OFWAT).

In practice the "serviceability" of the network is measured by trending over time a "basket" of indicators and measuring the slope of the line. The measures and the trended serviceability indicators are shown in the table over.

The Department of Internal Affairs (as part of the Local Government transparency, accountability and financial management work area) is currently consulting on proposed mandatory national KPIs for three water infrastructure. Once these KPIs are finalised it may be necessary to modify and/or add to the indicators to satisfy compliance with any relevant legislation.

Please note that the Council's CEO will approve the final KPIs as part of the final SLA. The proposed measures are outlined in the table, over:

Service Category	Key Performance Indicator	Service Outcome
Service Quality	Maintain grading from Ministry of Health for the local water supply distribution	<i>To maintain a high and consistent quality and value of the service, to the level defined in the LTP and SLA</i>
	Compliance with New Zealand Drinking Water Standards	
	Fewer than four unplanned supply cuts (pipe bursts) per 1000 connections	
	Fewer than 1.2 wastewater incidents reported per kilometre of wastewater reticulation pipeline	
	Completion of annual opex programme within budget	
	Completion of annual capex programme within budget	
	Completion of annual opex programmes within the financial year	
	Completion of annual capex programmes within the financial year	
	Networks operated and maintained to deliver network capability	
	Maintaining 'serviceability' in the level of service (Water and Wastewater)	
	Customer Focus	
Achievement of Council's own Customer Satisfaction Survey Targets		
To meet all Response A & B times for Priority One (P1) activities ("Onsite within one hour")		
Cost - Effectiveness	Operating Cost per Connection	<i>To provide a cost-effective water management service</i>
	Total labour and consultancy charges as a % of total expenditure (inflation adjusted)	
	Design and supervision labour and consultancy charges measured against industry guidelines.	
Environmental Performance	Management of unaccounted for water	<i>To provide an environmentally sustainable water management service.</i>
	Maintain the average unmetered water consumption (normal year)	
	No resource consent-related infringement notices received from GWRC	
Legislative Compliance	Full compliance with the Health and Safety in Employment Act 1992	<i>To operate a safe workplace and comply with relevant legislation.</i>
	Full compliance with all other relevant legislation	
Process	Achievement of key milestones in Emergency Management Planning	<i>To build a resilient network and provide continuous improvement in management and delivery of the Water Services</i>
	Achievement of key milestones in AMP Improvement Project Planning and Production	
	AMPs rated ("Good" to "Very Good") by Audit NZ or Peer Review	
	Achievement of key milestones in Activity Risk Management Planning	
	Delivery of AMPs, SOI and Annual Report and other agreed documents on time	
	Maintenance of ISO Accreditation	

Asset Management Systems (AMS):

To drive efficiencies a single regional three water AMS interface, linking to existing council AMSs, will underpin the OBBM. The preferred AMS (selected through a Council led IT procurement in 2012) is InfoNet, which will continue to be housed and supported at the Council in a shared services environment. This is consistent with the Council acquisition in 2012 and will enable councils to retain and maintain all the data in their existing AMS, thus addressing the issue over the ability to access the data at any point in time. The preferred AMS will also allow Capacity's strict adherence to the Archives Act 2011 to continue.

The advantages/benefits of this approach include:

- From a technology perspective, Capacity will be able to utilise the existing systems within minimal impact to councils.
- Capacity will have greater levels of access to data, and ability to utilise the data.
- The ability for councils to maintain ownership of asset data, while access to asset data is available to Capacity.
- Ability to streamline and/or move from shareholder client centric teams, to a single team model regardless of the shareholder client.
- Enables Capacity to take a wider regional perspective to the current Capacity services.

By adopting the InfoNet solution as the regional three water AMS, the risk of waste is mitigated. This option enables Capacity and councils to demonstrate prudent financial management decision making and use existing expenditure. It also benefits Capacity, and its council shareholders in other ways:

- Capacity will be able to avoid the time and cost associated with a tender and evaluation process and proceed direct to the interface development phase;
- Capacity will realise the objectives and benefits outlined in this business case earlier than otherwise possible;
- The Council InfoNet project momentum will have minimal disruption;
- The objectives and benefits of the Council InfoNet project will still be realised;
- Capacity will be able to utilise the Council InfoNet project resources, people, tools, frameworks and learning's, thus avoiding project establishment costs and delays; and
- Provides a technology platform that has the ability to interface with existing and potential client AMS (Confirm, Hansen and SAP).

5.2 Consultation and Engagement

As Capacity is an existing CCTO of which the Council is a shareholder, there is no requirement for specific community consultation on the matters outlined in this report.

5.3 Financial considerations

A shift to the OBBM is initially estimated to involve a capital investment of approximately \$24k arising from the implementation of the new capital structures. This has been budgeted for in the 2012 LTP. Over time, it is highly likely that the Council will benefit from efficiency benefits falling into four key areas:

- Planning and operation efficiencies
- Integration of Asset Management Systems to the current Council InfoNet system
- Potential for realigned council overhead costs
- Consolidation of call centre costs

5.4 Climate change impacts and considerations

Capacity's work programme considers issues such as sea level rise, higher rainfall intensity and increased temperatures. Capacity's role in this area will be significant regardless of the move to the OBBM outlined in this paper.

5.5 Long-term plan considerations

As discussed in the referenced previous reports, at the proposed levels of investment outlined in the PwC report, Capacity's move to the OBBM is likely to result in an additional capital investment of \$24k for Council in the year it takes place. There was generic commentary on this issue as part of the 2012 LTP consultation documentation. Going forward, annual budgets for Capacity will be considered as part of the Annual Plan process.

6. Conclusion

The Capacity Board and Capacity shareholders are now finalising the details to transition to the new OBBM in order to allow the Capacity OBBM to start to commence from 1 July 2013.

Contact Officers: *Anthony Wilson, Chief Asset Officer, Peter Garty, Chief Financial Officer, David Hill, Chief Executive Officer, Capacity and Gunther Wild, Senior Analyst, Capacity*

SUPPORTING INFORMATION

1) Strategic fit / Strategic outcome

This report supports Council's overall vision of Towards 2040: Smart Capital. It supports the Council's regional aspirations to develop shared water services and encourage connectedness and regional asset planning opportunities.

2) LTP/Annual Plan reference and long term financial impact

This report highlights some high level potential long term efficiencies. The magnitude of these efficiencies is still to be determined.

3) Treaty of Waitangi considerations

The Mana Whenua were a party to the decision to set up a CCTO.

4) Decision-making

The decision to move to the OBBM was already made by Council in 2012. The decision is significant but is in alignment with Council policies and intentions. It also is in alignment with regional aspirations.

5) Consultation

a) General consultation

Council is not required under legislation to consult on this matter, but included some generic comments in the 2012 Long Term Plan.

b) Consultation with Maori

N/A

6) Legal implications

Council's lawyers have not been consulted during the development of this report.

7) Consistency with existing policy

This report recommends measures that are consistent with Council policy.