# Sludge Minimisation Facility Project Funding

Absolutely Positively **Wellington** City Council
Me Heke Ki Pōneke

## Purpose

On 25 August 2022, Council agreed in principle to progress the Sludge Minimisation Facility (SMF) project under the Infrastructure Funding and Finance Act (IFFA). This included in principle agreement of how an IFFA levy may be set and other associated commercial arrangements. This paper provides further background and information on the Council's intended IFFA levy proposal.

## Background

The SMF project is an investment in a facility at Moa Point, adjacent to the existing wastewater treatment plant. It aims to decouple the disposal of sewage sludge from the Southern Landfill ahead of the existing resource consent lapsing. The project objectives strongly align with Wellington City Council's strategic community wellbeing and Long-Term Plan objectives.

On 30 June 2022 Council approved the SMF business case with a Lysis-Digestion and Thermal Drying plant as the preferred option for progressing through detailed design. It was noted that the SMF project would come back to the Council in December 2022 for formal approval of the total cost including the funding and financing mechanism.

*Infrastructure Funding and Finance Act 2020*

The IFFA is a new funding and financing mechanism for infrastructure established under legislation in 2020.

Under the IFFA legislation, a long-term levy, paid alongside Council rates is set on properties that are expected to benefit from eligible infrastructure (i.e., properties that benefit from the SMF). A Special Purpose Vehicle (SPV) borrows money from the private sector and makes the proceeds available to Wellington City Council to meet the costs of constructing eligible infrastructure such as the SMF. The borrowings are then repaid by the SPV using proceeds from the levy.

The overall effect is the IFFA avoids Wellington City Council having to borrow to meet the costs of eligible infrastructure using its own balance sheet, providing additional capacity to deliver on other projects set out in the Long-Term Plan, most notably Let's Get Wellington Moving.

Before an IFFA levy can be put in place, the Council must submit a levy proposal to the Ministry for Housing and Urban Development (MHUD). MHUD will assess the levy proposal against the criteria listed in the IFFA and may make a recommendation to the Minister for Housing to approve the proposal with final authorisation of the levy subject to Cabinet approval.

## Options for funding the SMF Project

There are two options available to fund and finance the SMF project:

- The traditional rates and debt funding model with financing 'on the Council's balance sheet', or
- Utilising the new IFFA legislation to implement an infrastructure levy and financing via an SPV, treated as 'off balance sheet' from Wellington City Council's perspective.

The pros and cons of these options are set out in the table below. Officers recommended, and Council agreed, to proceed with the SMF project under the IFFA model, on the basis that it is the only option that allows delivery of the project without exceeding Council debt limits or requiring reprioritisation of the existing Long-Term Plan.

Table One: SMF funding options

| Option | Pros | Cons |
|---|---|---|
| Infrastructure Funding and Financing Act model | • Allows the project to proceed without impact on the Council balance sheet, including (but not limited to) exceeding debt to revenue limits, and supporting the Council's credit rating.<br>• Allows capital projects in the existing LTP to proceed without reprioritisation while progressing with the SMF project.<br>• Proving IFF as a viable tool to provide additional infrastructure and fill New Zealand's infrastructure gap.<br>• Allocation of costs aligned to a beneficiary pays approach, whilst allowing for affordability considerations to be managed.<br>• Spreads the cost of project over a long time period (e.g., 30 years) at a known capped cost of debt. | • More complex, and new, transaction mechanism.<br>• Financing costs under IFF are expected to be slightly higher than traditional Council financing primarily reflecting the longer-term debt structure that it provides. |
| Traditional rates and debt funding model | • Lower overall cost.<br>• Known and well-established funding and financing tools allow simpler transaction. | • Projected debt to revenue thresholds will rise above both Council and LGFA covenant limits.<br>• Requires revision of capital plan and reprioritisation of other projects.<br>• No headroom to respond to fiscal risks e.g., significant seismic event.<br>• LGFA borrowing is typically shorter term (<7-10 years), leaving ratepayers to bear the risk that interest rates increase. |

## Commercial principles and setting the IFFA levy structure

Council currently expects to submit the IFFA levy proposal to MHUD in early 2023 ahead of anticipated financial close by 30 June 2023. These timelines enable construction of the SMF ahead of 30 June 2026.

Council has agreed, in principle, the underlying commercial principles that will support development of the levy proposal ahead of submission to MHUD. This includes matters such as the proposed levy area, the expected eligible costs, the proposed levy period, the method of allocating levy and assessing the levy liability for rating units in the levy area. Note the specific details of the levy proposal are still being finalised and are subject to approval by Council and the Crown.

*Proposed levy area*

The proposed levy area is expected to cover the entire Wellington City Council rating area, excluding protected Māori land, on the basis that there are benefits to all Wellington rate payers from the development of this infrastructure (described in further detail below).

*Eligible costs*

The project is currently conducting further design and costing of the preferred option via an Early Contractor Involvement process. This will include testing scope, specification and design to ensure overall value for money. Final costs and baseline project budget will be confirmed as part of the final approval paper to Council in December. Levy estimates in this paper are based on IFFA funding of $299 million.

*Levy period*

A levy period of approximately 30 years is proposed noting the maximum permissible period under the IFFA is 50 years. A longer levy period will have higher whole of life costs but lower annual cost for each levy payer. 30 years aligns the period with the expected useful and depreciation life of the SMF, is consistent with common practice for local infrastructure assets, optimises the financing structure and reduces financial risk of longer-term debt.

The levy is currently proposed to commence in July 2024, at 25% of the full levy, ramping up evenly to the full levy over the three following years. This ensures the levy aligns with project construction, lowers whole of life costs and better aligns the incidence of levies with current projections of general rates changes, which (as outlined in the LTP) have relatively greater increases in the near term before reverting to more normal changes post the levy ramp period.

*Levy allocation and assessment*

IFFA legislation requires that the application of the levy should consider (amongst other things) the distribution of expected benefits from the SMF and the extent to which each property causes the need for the SMF, while broadly aligning with each property's ability to pay.

Officers recommended, and Council agreed, that the levy is apportioned to ratepayers in relation to the expected benefits that they will receive from the facility. In practice, this will involve differentiating properties based upon whether they are directly connected to the facility or otherwise.

Properties whose wastewater flows to the SMF cause the need for the facility and directly benefit from having their wastewater treated at a long-term fit for purpose and resilient plant. As noted earlier in the paper, the option to do nothing is not available as the existing resource consent for sludge disposal is due to lapse in 2026. Therefore, the SMF also allows the costs and other negative amenity of alternative disposal to be avoided.

In addition to the use benefits there are a range of broader benefits provided by the facility including environmental and waste reduction benefits, carbon reduction, reduced operating costs or potential revenue generation due to gas and energy capture, a more resilient and efficient overall wastewater network, reduced transport of waste through the city and benefits of growth that the facility supports. These benefits accrue to all ratepayers irrespective of whether their wastewater flows to the SMF.

Although subject to finalisation, it is expected that directly connected properties will contribute most of the levy (greater than 90%). This is on the basis that usage makes up most of the overall benefits and because connected properties 'doubly benefit' by also receiving the broader benefits of the facility. Directly connected properties make up most properties in the Wellington rating area (approximately 78%), meaning these costs are spread over a large number of levy payers.

It is expected those remaining properties that receive just the broader benefits of the facility will meet the remainder of levy costs (less than 10%). Final decisions are yet to be taken on whether any differentiation will apply within the group of properties that are not connected to the SMF.

Within each beneficiary group it is proposed that a 75% allocation to residential properties and a 25% allocation to commercial properties applies. This allocation is based on causal analysis and influenced by feedback from the community engagement process.

Levies will be adjusted based on capital values to reflect ability to pay. It is expected that commercial property levies will be adjusted 100% based on capital value, while residential property levies will include a fixed component proportional to 25% of the residential levy with the remaining 75% adjusted based on a property's capital value. This treatment is consistent with the current ratings approach.

Exact details of the beneficiary group identification and allocation are still being finalised and are subject to change. Council will make final decisions on the design of the proposed levy in December 2022. This will include the final make up and number of beneficiary groups and the proportion of the proposed levy they will meet.

## Expected costs and affordability

Table two shows approximate levies based upon a connected and non-connected split, per $1 million property capital value. Levies range from $61 to $420 per annum per million of CV for unconnected residential properties and directly connected commercial properties respectively. Estimated figures are for the first full year of levy in 2027 and will escalate over time. Specific details of the overall levy proposal are still being finalised and the levy ranges below reflect potential outcomes and are subject to change.

## Risks and contingencies

If authorised, SMF levies will be influenced by the specific terms achieved at financial close. For example, the final interest rate for IFFA borrowing. These terms will not be known until nearer to 30 June 2023. Therefore, the levy proposal submitted to MHUD needs to incorporate a buffer to accommodate possible movements in interest rates. Table two also shows potential levies should a buffer equivalent to a 1% increase in borrowing rates be needed. At this stage, it is not expected that all of this buffer will be required

### Affordability

The proposed levy allocation, including buffer, was assessed by suburb, in combination with forecast rates, as a proportion of total household income. That analysis showed that no suburb exceeded the 5% of gross income, which, as set out in the Shand report (2005), is a commonly used indicator, but not a bright line measure of affordability.

Table two: Indicative levies by beneficiary group and property type

| Total indicative annual levy per $1 million of capital value (as at July 2027) | | |
|---|---|---|
| | Assumed base 30-year interest rate | |
| | 5% | 6% |
| **Directly connected properties** | | |
| Residential | $273-$281 | $311-$321 |
| Commercial | $415-$420 | $473-$479 |
| **Other properties*** | | |
| Residential | $61-$124 | $69-$142 |
| Commercial | $90-$196 | $103-$224 |
| | (Best estimate of levies at publication date) | (Higher levies only if buffer required to be used) |

* - other properties may be further disaggregated into sub-groups in final levy proposal

## Engagement and Consultation

Through the Long-Term Plan (LTP) 2021, we consulted Wellingtonians on a capital investment for the SMF and the option of IFFA funding. At a high level the feedback was closely split between the funding options.

In April 2022 WCC carried out further community engagement, primarily targeted at the commercial sector, seeking feedback on the proposed IFFA funding approach. Forty-two submissions were received. The summary of those submissions can be found by following this link - Sludge minimisation facility rates levy | Kōrero mai | Wellington City Council.

At the August meeting, Council requested WCC provide a public update on potential SMF levies, as per this paper.

## Testing, refinement, and approval

Levy design details are being refined and tested with Crown Infrastructure Partners (CIP) before Council approves its final IFF levy proposal for submission to MHUD. Levy design details are subject to refinement through this process.

## Next steps

Council will make final decisions whether to proceed with the SMF project and submit a levy proposal in December, this will include decisions on the final design of the proposed levy.

Key inputs into these decisions include ongoing refinement of the scope, design and cost of the SMF as part of the Early Contractor Involvement (ECI) phase of the project. This is alongside further development and refinement of the IFF levy proposal in conjunction with CIP.

Once Council approves submission of the levy proposal, MHUD will assess it against the criteria listed in the IFFA and may make a recommendation to the Minister for Housing to approve the proposal with final authorisation of the levy subject to Cabinet approval.