
AGREEMENT ON CAPACITY SAVINGS MODEL

1. Purpose of Report

This report outlines the agreement reached between Wellington Water Management Limited (Capacity) and Wellington City Council in respect of the model to be used by Capacity to calculate the operational expenditure savings achieved since the formation of Capacity to deliver water services to Wellington.

2. Executive Summary

Achieving significant targeted cost reductions was one of the key objectives of establishing Capacity in 2004 and is one of more obvious performance indicators for the company. The Service Level Agreement (SLA) specifies a savings target of \$2.505m is to be achieved in the first five years to 30 June 2009 but, instead of directing the parties as to how the savings model would be constructed, it obligates the parties to negotiate and agree a model which Capacity would use to calculate and report the savings.

Through collaboration, several iterations of the model had been developed over the first four years of the SLA without resolution until November 2008. WCC and Capacity had each embraced different scenarios of the model but it was clear that neither scenario would indicate the targeted cost reductions would be achieved. To resolve the impasse, move to a position of being able to report against that performance indicator, and apply staff time and resources more effectively, agreement was reached in November 2008 to adopt the scenario proposed by Capacity.

This scenario indicates that savings of \$0.702m have been achieved to 30 June 2008, which is \$0.843m short of the cumulative four year savings target of \$1.545m. Capacity has also indicated that the five year cumulative savings target of \$2.505m will not be achieved however both parties have agreed to work together to establish a revised annual savings target from 2009/10. This revised target will be loaded into WCC's Long Term Council Community Plan (LTCCP) but is unlikely to be close to the original annual savings target of \$0.960m.

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Upcoming activity for WCC and Capacity includes review of the SLA in the New Year with a view to negotiating and resolving provisions for a second five year term prior to expiry of the current term on 30 June 2009. In addition, WCC and Hutt City Council (HCC) have been asked to respond to a recent request from Upper Hutt City Council (UHCC) to receive from the existing shareholders a proposal for UHCC to take an equity position in the company.

3. Recommendations

Officers recommend that the Subcommittee:

1. *Receive the information.*
2. *Note that when Wellington Water Services Limited (Capacity) was established in 2004 one of the company's objectives was achieving for both Wellington City Council and Hutt City Council total targeted cost reductions of \$4.18 million over the first five years of the Contract for Provision of Services Related to Water Services (Service Level Agreement)*
3. *Note that the Service Level Agreement contains targeted cumulative cost reductions for Wellington City Council of \$2.505 million during the first five years ending 30 June 2009 and \$0.960 million per annum thereafter*
4. *Note that agreement has been reached between Council and Capacity on the model to be used by Capacity to calculate operational expenditure savings for the five years ending 30 June 2009*
5. *Note that the agreed savings model indicates \$0.702 million in cost reductions have been achieved in the four years to 30 June 2008, against a target of \$1.545 million*
6. *Note that Capacity has advised Council that the Company does not consider it will be possible to meet the cumulative cost reduction target of \$2.505 million by the 30 June 2009 expiry date of the Service Level Agreement*
7. *Request Capacity reforecast the cumulative cost reductions to 30 June 2009 and report the results back to the Subcommittee at its meeting in March 2009*
8. *Note that, while Council officers consider it unlikely that the annual cost reduction (savings) target of \$0.960m to apply from 1 July 2009 will be met, Capacity and Council have agreed to work together to establish a revised target.*
9. *Request that the revised target referred to in recommendation 8 be both realistic and measurable, and be reported back to the Subcommittee on a quarterly basis*

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10. *Note that Capacity has secured a two year fixed fee contract for the provision of water services to Upper Hutt City Council commencing 1 July 2008, which contract may either pose some cost risk to WCC if costs of provision exceed the fixed fee or provide potential surplus for WCC if the fixed fee exceeds the costs of service provision*
11. *Note that Upper Hutt City Council has requested Wellington City Council and Hutt City Council, as the existing shareholders of Capacity, develop a proposal under which Upper Hutt City Council would take an equity position in Capacity*
12. *Note that officers will report back to the Subcommittee in March 2009 on the implications of recommendation 11.*
13. *Note that Capacity and Council will commence a review of the Service Level Agreement in the New Year with a view to concluding negotiations prior to expiry of the current term on 30 June 2009, and that strategic (asset) planning is among the many items to be reviewed.*

4. Background

Wellington Water Management Limited (Capacity) was established by Wellington City Council and Hutt City Council in 2004 and commenced operations on 1 July Of that year. The councils established Capacity to a) better assist the achievement of community outcomes or deliverables related to health, safety and development of the community, and environmental sustainability, and b) to provide cost savings in the delivery of water services to their respective communities.

The parties' expectations and obligations in respect of Capacity are detailed in the Contract for Provision of Services relating to Water Services, now referred to as the Service Level Agreement (SLA). The objectives of the parties tends to focus on maintaining levels of service, centralising expertise, asset and infrastructure ownership remaining with the Councils, and realising significant cost reductions over the term of the SLA (five years to 30 June 2009) and annually thereafter.

The SLA required Capacity to construct and present for the approval of both councils by 31 March 2005 a model on which the cost reduction targets were to be measured. Whilst Capacity reached agreement with HCC on the model to apply to that council, negotiations with WCC over what is to be included and excluded have been protracted and final agreement was not reached until 24 November 2008.

Application of the agreed model shows that the targeted cumulative savings of \$1.545m to 30 June 2008 have not been achieved and Capacity has advised the corresponding five year target of \$2.505m to 30 June 2009 could not possibly be met.

The model does however demonstrate that to year-end 2008 Capacity has achieved cumulative savings of \$0.702m. All costs that Capacity cannot directly

control are excluded from the model. Conversely, Capacity asserts that capital expenditure savings it has identified and implemented are not reflected by the model. Despite the parties' best intentions at the time Capacity was established, some four years later it is evident that the targeted cost reductions were ambitious and devising a robust and defensible model a very complex endeavour.

Having agreed the savings model for the balance of the term to 30 June 2009, WCC and Capacity are now focused on establishing a revised annual savings target from 1 July 2009. This revised target will be loaded into WCC's LTCCP but is unlikely to be close to the original annual savings target of \$0.960m.

5. Discussion

5.1 Objectives in Establishing Capacity

WCC and HCC established Capacity to better assist the achievement of their community outcomes or deliverables and performance measures related to the provision of water services, and to provide cost savings. Among the key objectives for the company set out in the SLA are:

- Delivery of water services that are affordable, sustainable, accessible and of high quality
- Services that meet or exceed the standards provided by in-house units, service levels in each Council's Asset Management Plans and Performance Indicators
- A reduction in costs through, amongst other things, rationalising resources, centralising expertise and skills, and optimising economies of scale
- Targeted cost reductions over the first five years of at least \$1.67 millions for HCC and at least \$2.505 million for WCC
- Following the first five years annual savings of at least \$0.960m for WCC and at least \$0.640m for HCC
- Transparency in provision and pricing of the services
- The recovery by Capacity of all its costs of providing the services without making a loss or a material profit
- That each Council retains direct ownership of all assets and infrastructure, including assets and infrastructure built during the term of the SLA (i.e. to 30 June 2009).

5.2 Composition of the Savings Model

The SLA specifically states the targeted cost reductions over the term to 30 June 2009 but does not provide corresponding certainty in respect of what is to be included or excluded. Compounding this is the fact that WCC's costs for 2003/04 (indexed) form the baseline against which Capacity's costs and consequential savings are to be measured. The model's underlying principle is that it includes all operating costs directly controllable by Capacity, or

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conversely any operating costs over which Capacity has no direct control are to be excluded from the model.

Through collaboration several iterations of the model have been developed over the past four years. In November 2007 the parties reached in-principle agreement on a fully substantiated model of the savings position as at 30 June 2007. That model excluded the following:

- Depreciation charges
- Bulk water levy charges
- Contributions to the waste water treatment plant joint venture
- Electricity charges
- WCC organisational allocations
- Interest charges
- Insurance charges
- Tariff charges for operation of the Moa Point and Western Treatment plants

Application of this model, nominally referred to as Scenario A, demonstrated that no savings had been achieved in the first four years to 30 June 2008 and instead expenditure had exceeded the cost reduction target by \$0.930m. This represented a negative variance of \$2.475m against the cumulative savings target of \$1.545m to 30 June 2008.

Capacity subsequently requested the model be adjusted to reflect several Capacity-controlled operating expenditures that had increased significantly between the base year (2003/04) and the first year of operation. These costs included directors' fees, vehicle and plant costs, rent, external IT costs, insurance and equipment leases.

The adjusted model (Scenario B) showed that cumulative savings of \$0.702m had been achieved in the four years to 30 June 2008 although this still fell \$0.843m below the cumulative savings target of \$1.545m.

The parties agreed that further refinement of the model would unacceptably draw a disproportionate amount of Capacity's staff time and resources. Moreover, neither party was willing to compromise the water network in order to meet the targets set prior to Capacity commencing operation.

Consequently the parties agreed on 27 November 2008 to utilise Scenario B as the basis upon which Capacity would calculate and report the savings to WCC, and acknowledged that the cost reduction targets specified in the SLA would not be achieved. Capacity and WCC have agreed to work together to establish a revised annual savings target to apply from 1 July 2009. The revised target will be loaded into the LTCCP but is unlikely to be close to the original savings target of \$0.960m per annum.

5.3 Upcoming Review of Service Level Agreement

The first five year term of the SLA will expire on 30 June 2009 and the parties have agreed to commence a review of the SLA in the New Year with a view to

concluding negotiations on the next five year term prior to expiry of the current term. Among the items to be decided is responsibility for strategic (asset) planning, which was discussed by the Subcommittee at its meeting in October 2008.

5.4 Upper Hutt City Council Water Services

Capacity has secured the contract for the provision of water services to UHCC effective 1 July 2008. This contract is reported to be a fixed fee contract and as such may pose some cost risk for WCC (and HCC) if costs exceed the fixed fee. Conversely, if the fee exceeds the costs of service provision then the surplus will be repatriated to WCC and HCC.

UHCC has also requested WCC and HCC, as Capacity's existing shareholders, present for consideration a proposal for UHCC to take an equity position in the company. Whilst consistent with Capacity's regionalisation strategy, substantive discussion in respect of this matter would be premature given the weight of the upcoming SLA review. Officers will report back to the Subcommittee in March 2009 on the implications of UHCC taking an equity position in Capacity.

6. Conclusion

Achieving significant targeted cost reductions was one of the key objectives of establishing Capacity and is one of more obvious performance indicators for the company. The SLA specifies a cumulative savings target of \$2.505m is to be achieved by 30 June 2009 but, instead of directing the parties as to how the savings would be measured, it obligates the parties to negotiate and agree a model which Capacity would use to calculate and report the savings.

Through collaboration several iterations of the model have been developed over the first four years of the SLA without resolution until November 2008. WCC and Capacity had each embraced different scenarios but it was clear that neither scenario would show that the targeted cost reductions to 30 June 2009 would be achieved. To resolve the impasse, move to a position of being able to report against that performance indicator, and apply staff time and resources more effectively, agreement was reached to adopt the scenario proposed by Capacity.

The Capacity scenario indicates that savings of \$0.702m have been achieved to 30 June 2008, which is \$0.843m short of the \$1.545m target by that date. Capacity has also indicated that the five year savings target of \$2.505m will not be achieved however both parties have agreed to work together to establish a revised annual savings target to apply from 1 July 2009, which will be loaded into Council's LTCCP. The new target is unlikely to be close to the initial annual savings target of \$0.960m per annum specified at the time Capacity was established.

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Supporting Information
<p>1) Strategic Fit / Strategic Outcome <i>This activity supports the following community outcomes</i></p> <ul style="list-style-type: none"> ▪ <i>Wellington will promote the sustainable management of the environment, and support increased opportunity for kaitiakitanga or environmental guardianship</i> ▪ <i>Wellington's long-term environmental health will be protected by well-planned and well-maintained infrastructure.</i>
<p>2) LTCCP/Annual Plan reference and long term financial impact <i>The five year cumulative cost reduction target of \$2.505 million will not be met by 30 June 2009 and will be stated as not achieved in the 2008/09 Annual Report. WCC and Capacity will work together to establish a revised ongoing annual savings target to apply from 1 July 2009, which savings will be loaded into the upcoming LTCCP. It is unlikely the revised target will be close to the initial target of \$0.960m established at commencement of the current Service Level Agreement.</i></p>
<p>3) Treaty of Waitangi considerations <i>There are no Treaty considerations associated with the subject of this report.</i></p>
<p>4) Decision-Making <i>This is not a significant decision.</i></p>
<p>5) Consultation</p> <p>a) General Consultation <i>All affected parties have been identified and consulted.</i></p> <p>b) Consultation with Maori <i>Consultation with Maori is not appropriate in this circumstance.</i></p>
<p>6) Legal Implications <i>There are no legal implications associated with this paper.</i></p>
<p>7) Consistency with existing policy <i>This report is consistent with existing WCC policy.</i></p>