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**REPORT 3**  
*(1215/52/IM)*

## **PROPOSED GOVERNANCE CHANGES TO CAPACITY INFRASTRUCTURE SERVICES LTD**

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### **1. Purpose of Report**

The purpose of this report is to consider requests from Porirua City Council and Upper Hutt City Council that they become shareholders in Capacity Infrastructure Services Ltd (Capacity or the Company), with all shareholder customers moving to a common outcomes-based business model.

### **2. Executive Summary**

Capacity is in the process of preparing an offer for Porirua City Council to consider becoming a customer of Capacity. At the same time Capacity is consulting with Porirua and Upper Hutt City Councils about becoming shareholders. This report is recommending that Wellington City Council provide approval for Porirua City Council (PCC) and Upper Hutt City Council (UHCC) to join Capacity as additional shareholders. All shareholder customers will aim to move to an outcomes-based business model, with performance incentives in place. This report recommends that Wellington City Council support this, subject to a shareholders' Memorandum of Understanding which will include such matters as director appointment processes and appropriate due diligence requirements to assure shareholders that, with the additional demands of its wider responsibilities, Capacity can meet the requirements of an outcomes-based business model.

Two of Capacity's initial objectives when it was established were to provide a 'centre of excellence' for the region and to improve long term strategic planning for water services, with a view to eventual full regional water services integration. The proposals outlined in this report would take a large step towards these goals and provide further opportunities for efficiency gains longer term.

In addition, dialogue with Greater Wellington Regional Council (GWRC or Regional Council) on its potential inclusion in a water services Council-Controlled Organisation continues. While there is an appetite to explore this opportunity, officers are not aware of a likely imminent decision on this front. The model outlined in this paper is designed to be 'future proofed' to ensure that it is flexible enough to include the Regional Council should it decide to join at a later date.

Hutt City Council considered an equivalent Capacity governance paper at its meeting on 13 March 2012 and voted unanimously to support the proposals.

### **3. Recommendations**

Officers recommend that the Strategy and Policy Committee recommend to Council to agree to:

1. *Receive the information.*
2. *Approve the inclusion of Upper Hutt City Council and Porirua City Council as shareholders of Capacity.*
3. *Note that this will result in Wellington City Council's voting share of the Company becoming 25%.*
4. *Note that this will result in Wellington City Council's income share of the Company becoming 50%.*
5. *Agree that, as a transitional measure, the Capacity board will be an eight person board with four direct shareholder appointments (one each) and four joint appointments.*
6. *Agree that the Capacity board will eventually be a seven person board made up of joint appointments and note that the transition scenario referred to in recommendation five will be reviewed by the earlier of when Greater Wellington Regional Council joins Capacity or the end of 2013.*
7. *Agree in principle to support Capacity moving to an outcomes-based business model.*
8. *Note that asset ownership as well as responsibility for policy and strategic direction for the three-waters and approval of budgets will continue to reside with the Council.*
9. *Delegate to the Chief Executive responsibility for negotiating and approving a shareholders' Memorandum of Understanding on behalf of Wellington City Council. The Memorandum of Understanding will include such matters as director appointment processes and appropriate due diligence requirements to assure shareholders that, with the additional demands of its wider responsibilities, the Company can meet the requirements of an outcomes-based business model.*
10. *Delegate to the Chief Executive responsibility for approving changes to Capacity's constitution and any other consequential documentation on behalf of Wellington City Council to put these proposals into effect.*

11. *Agree that this proposal will result in an additional capital investment of \$24k in Capacity in 2012/13 to reflect Wellington City Council's 50% income shareholding.*

#### 4. Background

Capacity Infrastructure Services Ltd, a Council Controlled Organisation (CCO), was established in 2003 as a joint initiative between the Wellington and Hutt City Councils. It commenced operations in July 2004. Upper Hutt City Council contracted Capacity to manage its water services in 2008/09.

Capacity's initial objectives centred around financial savings, each Council receiving services that met or exceeded its prior standard, providing a 'centre of excellence' for the region and improving long term strategic planning for water services, with a view to eventual full regional water services integration. While the performance of Capacity in the past has been mixed, in particular in the financial savings area, the proposal outlined in this report would take a large step towards the original goal of regional water services integration and provide further opportunities for efficiency gains longer term.

In May 2010 this Council reconsidered the governance and delivery model options for water services and confirmed that it supported the continued provision of water services through the CCO model "*because this [was] the vehicle that is most likely to deliver the vision and associated potential benefits of an integrated water management system for the region*".

At that time, the Council also requested that officers continue to explore "*mechanisms to achieve a comprehensive regional model for the management of water services*" and noted that "*any changes to the future governance of [Capacity] resulting from other Territorial Local Authority participation [would] be brought back to the Council for approval*".

#### 5. Discussion

As reference, three reports were produced in February 2012 by PwC and Capacity and are referred to in this document.

- a. **The PwC 2012 Report:** The first (prepared by PwC) is a review of the history, development and future outlook for the management of water supply, stormwater, and wastewater (collectively referred to as "three-waters") in the Wellington Region. This report was sponsored by Hutt, Porirua, Upper Hutt and Wellington City Councils, and provides an assessment of the optimal future model for an amalgamated water entity.
- b. **The Capacity Business Case:** The second (prepared by Capacity) outlined why and how a CCO (Capacity as the incumbent) is best placed to help councils achieve the benefits outlined in the first PwC report.<sup>1</sup>

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<sup>1</sup> PwC reviewed the work undertaken by Capacity and has produced a letter acknowledging that Capacity's report is materially consistent with the preferred model outlined in their report.

- c. **The PwC Governance Report:** The third (prepared by PwC) made recommendations on the share structure, board composition and capitalisation of Capacity if both Porirua and Upper Hutt Cities were to become shareholders.

The Capacity board has reviewed and endorsed the Capacity Business Case and supports the proposals outlined in this report.

### **5.1 Proposed Changes to Capacity Governance**

At the request of Porirua City Council and Upper Hutt City Council, Capacity is consulting with each Council about becoming a shareholder. This report recommends that Wellington City Council provide approval for PCC and UHCC to join Capacity as shareholders.

In addition, dialogue with Greater Wellington Regional Council on its potential inclusion in a water services Council-Controlled Organisation continues. While there is an appetite to explore this opportunity, officers are not aware of a likely imminent decision on this front. The model outlined in this paper is designed to be ‘future proofed’ to ensure that it is flexible enough to include the Regional Council should it decide to join at a later date.

Under the proposals discussed in the PwC Governance Report and the Capacity Business Case, Capacity will continue to have a dual share structure (as it currently does). Voting rights will continue to be attached to ‘Class A’ shares, and each Council would be allocated an equal number of voting shares. This reflects the importance of water services to each Council, notwithstanding differences in size.

<b>Existing Structure</b>		<b>Proposed Structure</b>	
<b>Council</b>	<b>Voting Share%</b>	<b>Council</b>	<b>Voting Share%</b>
WCC	50%	WCC	25%
HCC	50%	HCC	25%
UHCC	-	UHCC	25%
PCC	-	PCC	25%
GWRC	-	GWRC	-
<b>Total</b>	<b>100%</b>	<b>Total</b>	<b>100%</b>

Income rights (and therefore financing contributions) will be calculated with reference to ‘Class B’ shares and these will be allocated based on the relative size of the shareholder.

The recommended split proposed by PwC (based on a combination of population, asset value and revenue) is:

<b>Existing Structure</b>		<b>Proposed Structure</b>	
<b>Council</b>	<b>Income Share%</b>	<b>Council</b>	<b>Income Share%</b>
WCC	63%	WCC	50%
HCC	37%	HCC	25%
UHCC	-	UHCC	10%
PCC	-	PCC	15%
GWRC	-	GWRC	-
<b>Total</b>	<b>100%</b>	<b>Total</b>	<b>100%</b>

The view of officers is that this split appears reasonable. While Wellington City Council's share of expenditure is higher than 50% (at 58%), it makes up 50% of the population served and the combined asset value managed by Capacity in the enlarged model. Officers recommend that the voting and income share percentages should be reviewed for reasonableness in the event of structural changes (e.g. another authority joining Capacity or a merger of authorities etc.). The income share percentages should be reviewed on a semi-regular basis regardless (e.g. every five years).

In terms of the Board, PwC recommends that Capacity's Board should eventually comprise no more than seven directors given the size and scope of operations of the Company. PwC recommends that they should all eventually be nominated by shareholders, voted on by shareholders and jointly appointed. As per the Companies Act, directors will be required to act in what the director considers to be the best interest of the company.

However, a transitional approach is recommended while the new shareholding structure is bedded down, whereby each shareholder will directly appoint one director, with the number matched equally by joint appointments. This will result in an eight person board during the transitional period. It is officers' recommendation that this transition scenario should be reviewed by the earlier of when Greater Wellington Regional Council joins Capacity (if it chooses to do so) or the end of 2013.

Under both the optimal and transitional board scenarios, it will remain important for shareholders to consider the skills base and overall composition of the board when making both direct and joint shareholder appointments.

As under the current Constitution, it is expected that the Chair will remain a jointly appointed director.

The PwC Governance Report recommends that the initial paid up shareholder capital should be set at \$800,000. As Capacity has existing paid up capital of \$600,000, Hutt and Wellington City Council's existing capital will need to be adjusted to reflect a new share allocation. The effects of this adjustment (using the proposed income share distribution) are shown below – noting that Hutt

City Council will receive a repayment for capital and Wellington City Council will be making a small additional investment.

If approved, there will be an additional investment of \$24k required by Wellington City Council in 2012/13.

<b>Council</b>	<b>Income Share%</b>	<b>Income Shares \$'000</b>	<b>Existing Invested Capital (\$'000)</b>	<b>Cash to be Invested (\$'000)</b>
WCC	50%	400	376	24
HCC	25%	200	224	(24)
UHCC	10%	80	0	80
PCC	15%	120	0	120
<b>Total</b>	<b>100%</b>	<b>800</b>	<b>600</b>	<b>200</b>

The PwC 2012 Report also recommends that the shareholders should develop a Memorandum of Understanding to agree key governance and strategic principles. This is discussed below.

## **5.2 Proposed Changes to Capacity Service Delivery Model**

Capacity has also requested all shareholder customers to consider moving to an outcomes-based business model, as recommended by PwC in its report. The key attributes of this model would involve Capacity delivering water services for an agreed fee (including an incentive mechanism) in accordance with required Council outcomes. While each Council would retain asset ownership, Capacity would have operational control of the water assets to enable it to provide the services required to meet the agreed outcomes. This compares to the current cost recovery model, where the Councils effectively purchase management services.

Under the outcomes-based model, the following features will not change from the current model:

- Each Council retains ownership of their network assets and Capacity is responsible for delivering the three-water activities.
- Each Council sets policy and the outcomes they require in relation to the delivery of the three waters in their area.
- Each Council approves the relevant Asset Management Plans.
- Each Council approves the relevant annual budget.
- The Councils approve the annual Statement of Intent.

Features under the outcomes-based model include:

- Capacity is engaged on a service delivery contract standardised across the Councils.
- Performance is measured via standardised and agreed KPI metrics. Individual Councils will then agree the level for each measure.
- Capacity will negotiate with each Council an agreed annual charge for direct organisational costs and costs for agreed service delivery.

- Capacity would be rewarded or penalised for performance relative to the required outcomes. This would include a payment mechanism (to be re-invested in the business if achieved) and a contract term extension mechanism, in addition to the existing accountability framework.
- Capacity can fund and authorise renewals capital works expenditure requirements within an annually pre-agreed framework.
- Capacity will advise each Council on asset upgrade expenditure, with any final decision remaining with the Council.
- Contracts will be tendered and awarded in Capacity's name in accordance with the relevant Council's procurement policies and budgets.
- Capacity is likely to have responsibility for managing a range of risks that arguably are currently shared with the Councils, particularly reputational risks involved in service delivery or failure to meet required outcomes.

While Capacity already operates with many of these features in some form, the PwC 2012 report notes that for WCC this option will involve relinquishing certain over-sight responsibilities and moving to more of an arms-length relationship, with a focus on monitoring performance in relation to outputs and outcomes achieved.

The existing Upper Hutt City Council customer relationship with Capacity is the closest example of how this model is likely to work in practice. Officers understand that Upper Hutt City Council has been satisfied with this relationship, albeit this proposal would be on a much larger scale.

The proposals outlined in this report, taken in combination, are designed to allow the better development of a coherent regional strategy on delivering future three-waters services. These proposals would take a large step towards the original goal of regional water services integration and provide further opportunities for efficiency gains longer term.

Accordingly, officers recommend that the Council agree in principle to support Capacity moving to an outcomes-based business model, subject to a shareholders' Memorandum of Understanding as discussed below.

This approach is consistent with the objective discussed in the May 2010 Strategy and Policy Committee report that over time Capacity would be guided towards "*more autonomy to deliver its assigned objectives*". It is also consistent with the PwC 2012 Report that "*the implementation plan will need to include a robust approach to transitioning Capacity to its new role (including building the required capability).*"

Regardless of the business model, Council officers will continue to work with Capacity management and staff to pursue continued improvements in service performance and financial efficiency.

### **5.3 Shareholders Memorandum of Understanding**

As is consistent with good practice in a joint shareholding situation, the PwC 2012 Report recommends that the Councils develop a Memorandum of Understanding (MoU), to agree principles for:

- Collectively managing their ownership interests, including the approval of Statements of Intent;
- Collectively managing the contract for services and licence agreements with the CCO; and
- The strategy and intent for managing water services collectively, including asset development planning.

This MoU will also include such governance matters as director appointment processes and appropriate due diligence requirements to assure shareholders that, with the additional demands of its wider responsibilities, the Company can meet the requirements of an outcomes-based business model.

### **5.4 Position of Other Councils**

Officers' current understanding of the position of the other local authorities is:

- Hutt City Council considered an equivalent Capacity governance paper at its meeting on 13 March 2012 and voted unanimously to support the proposals. It should be noted that the Hutt City Council resolutions focus on the outcome based business model and are not prescriptive in terms of the governance changes.
- Upper Hutt City Council engaged Capacity to manage its water services in 2008/09 and now wishes to become a shareholder, as well as a customer. This issue will be considered at a Policy Committee meeting on 28 March 2012 and by the Council on 4 April.
- Porirua City Council has not participated in Capacity in the past, but is now expressing an interest in joining the CCO as both a customer and a shareholder. Capacity is in the process of preparing an offer for PCC. The PCC Infrastructure team has recently undertaken an organisational review and re-aligned staff roles to facilitate a potential transition to Capacity. Officers understand that this issue will be considered at a PCC meeting on 2 May 2012 and that PCC will undertake a 12 week special consultation exercise in relation to this matter.
- The model outlined in this paper is designed to be 'future proofed' to ensure that it is flexible enough to include GWRC should it decide to join at a later date.



## **5.5 Consultation and Engagement**

As Capacity is an existing CCO of Wellington City Council, there is no requirement for specific community consultation on this proposal under the Local Government Act. Similarly, specific consultation on this proposal is not required under the Council's significance policy. There is generic commentary on this issue as part of the Long Term Plan consultation documentation.

## **5.6 Financial Considerations**

At the proposed levels of investment outlined in the PwC report, this proposal will result in a capital investment of \$24k for Wellington City Council in 2012/13.

As outlined earlier, the key benefits of these proposals are to advance a water 'centre of excellence' for the region, to improve and consolidate long term strategic planning for water services and to continue moving toward eventual full regional water services integration. Over time, there may also be some cost savings and operational efficiencies that result from these proposals.

In general, the potential efficiency benefits fall into three categories:

1. **Planning and operational efficiencies** for example, common specifications across Councils, common reporting frameworks across Councils, potential savings in capital and renewal expenditure from regionally coordinated planning.
2. **Integration of Asset Management Systems across the Councils.** Capacity has estimated that this could possibly save \$300k a year between the Councils in data handling efficiencies. However, there is an estimated \$1.3m establishment cost in creating this integrated system. This initiative will be the subject of a separate business plan to go to shareholders. PwC noted that this Asset Management Systems initiative could probably be achieved whether or not the outcomes-based business model is adopted.
3. **Stranded Council overhead costs.** For example, Capacity estimates that Wellington City Council could potentially save up to \$1.2m a year in Council controlled overheads or 'stranded costs' historically allocated by the Council to water services. However, any savings from this category will depend entirely on the Council being able to shrink its overheads in areas previously allocated to water activities and are likely to be a long term proposition.

## **5.7 Climate Change Impacts and Considerations**

Capacity is a key player in the Council's Climate Change Action Plan. This is referenced in the Plan with the importance of managing infrastructure investment such as designing stormwater systems that can withstand significant

storms, and managing water supply networks to cope with the increasingly frequent dry years that are predicted. Looking to the future, Capacity's work programme will need to consider issues such as sea level rises, higher rainfall intensity and increased temperatures. Capacity's role in this area will be significant regardless of the governance change outlined in this paper and regardless of which business model it operates under.

### **5.8 Long-Term Plan Considerations**

As discussed above, at the proposed levels of investment outlined in the PwC report, this proposal is likely to result in an additional capital investment of \$24k for Wellington City Council in 2012/13.

There is generic commentary on this issue as part of the Long Term Plan consultation documentation.

Going forward, annual budgets for Capacity will be considered as part of the Annual Plan process.

## **6. Conclusion**

Capacity is in the process of preparing an offer for Porirua City Council to consider becoming a customer of Capacity. At the same time Capacity is consulting with Porirua and Upper Hutt City Councils about becoming shareholders. This report is recommending that Wellington City Council provide approval for Porirua City Council and Upper Hutt City Council to join Capacity as additional shareholders. All shareholder customers will aim to move to an outcomes-based business model, with performance incentives in place. This report recommends that Wellington City Council support this, subject to a shareholders' Memorandum of Understanding which will include such matters as director appointment processes and appropriate due diligence requirements to assure shareholders that, with the additional demands of its wider responsibilities, the Company can meet the requirements of an outcomes-based business model.

Two of Capacity's initial objectives when it was established were to provide a 'centre of excellence' for the region and to improve long term strategic planning for water services, with a view to eventual full regional water services integration. The proposals outlined in this report would take a large step towards these goals and provide further opportunities for efficiency gains longer term.

In addition, dialogue with Greater Wellington Regional Council on its potential inclusion in a water services Council-Controlled Organisation continues. While there is an appetite to explore this opportunity, officers are not aware of a likely imminent decision on this front.

Contact Officers: *Peter Garty, Chief Financial Officer and Stavros Michael, Director of Infrastructure*

## 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. There is also a short term financial impact of an additional \$24k investment by Wellington City Council in Capacity.*

### **3) Treaty of Waitangi considerations**

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

### **4) Decision-Making**

*This is a significant decision 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 has included some generic comments in the Long Term Plan.*

#### **b) Consultation with Maori**

*N/A*

### **6) Legal Implications**

*Council's General Counsel and lawyers have been consulted during the development of this report.*

### **7) Consistency with existing policy**

*This report recommends measures that are consistent with WCC policy.*