CENTRAL OTAGO
DISTRICT COUNCIL

ATTACHMENTS

Council Meeting
Under Separate Cover

Friday, 4 April 2025

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28 March 2025

Paul Hope
Waitaki District Council

By email: phope@waitaki.govt.nz cc andrew.strahan@geoco.co.nz

Dear Paul

High-level review of Morrison Low report for the 'group of 4' southern District Councils

You asked us to review reports prepared by Morrison Low to inform decisions by the 'group of 4' District Councils for the Clutha, Gore, Central Otago and Waitaki districts.

You asked us to comment on, but not to re-run financial projections and to provide observations based on our expert knowledge of utility asset management and regulation.

We are preparing a fuller report, however, recognise Mayors and Councillors require a summary of our views as soon as possible and before our report is completed. Our views are, in summary:

1. The Morrison Low analysis is thorough, and it very likely reaches the right conclusion – that amalgamation is in the short and long-term interests of group of 4 water users.

2. We consider assumed benefits of amalgamation are cautious and will most likely be materially higher than the assumed 1.5%.

   This is principally due to very material efficiency gains available from improved strategic and operational asset management maturity. These gains require minimum scale and are unlikely to be realised by any of the individual group of 4 entities.

3. The financial projections are reasonable, given inputs available at this point, but will require revision as entity composition and structure settle; and, as:

   i. information quality improves. For example, consistent inputs, base year and forecasting practices across each network area

   ii. *strategic and operational* asset management maturity grows, enabling optimisation of maintenance and renewal investment. Our experience is that investment in asset management maturity pays for itself very quickly and will be expected by your regulator.

4. It is important the group of 4, in addition to preparing its water services delivery plan for submission to the DIA, develops its understanding of and prepares for economic regulation by the Commerce Commission – expected to be in place from late 2025.

In our view, it is highly likely that each of the group of 4 and the water users in their regions will be better off combining their resources in the proposed joint CCO than on their own. This is principally

because of the economies of scale available in strategic and operational asset management, which we consider enable significant cost savings and operational flexibility.

We are available to discuss any of the summary views above. We will provide our fuller report in due course.

Yours sincerely

Jeremy Cain

Director, Concept Consulting Group Ltd

Central Otago District Council
Local Water Done Well Financial Modelling
March 2025

Introduction

This report outlines the initial results of our financial modelling of Central Otago District Council's (CODC) three waters functions under alternative service delivery models and capital investment programmes.

Delivery Models

The delivery models and modelling assumptions applied to each are summarised in the table below.

Service delivery	Description	Modelling assumptions
In-house Council division	The existing service delivery model, encompassing the current structure of three waters teams within CODC's wider infrastructure group.	Source data provided by CODC forms the foundation of the modelled outcomes, with specific adjustments applied for the following: • Progressive depreciation funding to 100% fully funded by FY2028. Adjustments are applied to targeted rates. • Debt movements and financing costs aligned to targeted rates movements. • Depreciation calculated based on global rates and alternate capital investment profiles. • Where required, increase revenue to maintain total council debt-to-revenue below 250%.
Council-controlled organisation (CCO) – CODC only	Establishment of a newly formed CCO to deliver water services from 1 July 2027.	Modelling inputs are aligned to the in-house model above, with separate adjustments to allow for: • Establishment costs and ongoing additional overheads[1]. • Efficiencies as a result of the service delivery model. • Where required, increase revenue to maintain a funds from operations (FFO) to debt ratio above 12%[2].

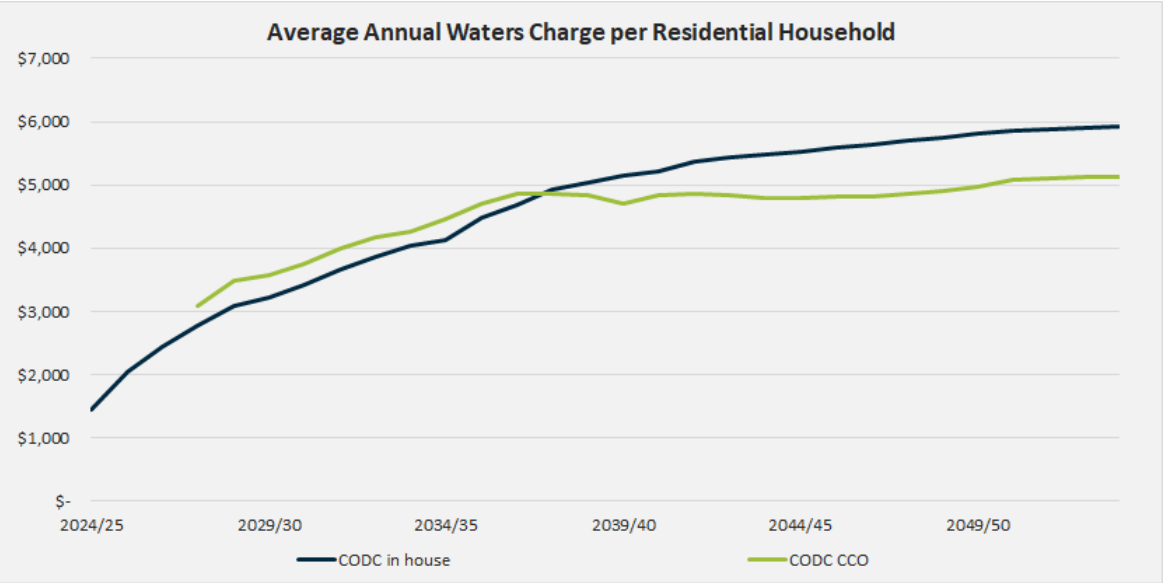
[1] Further details provided in Appendix A
[2] In the case of CODC, funds from operations effectively represent its net operating cash flows.

Results

Average household charges

The chart below compares average residential household waters charges for CODC as an in-house division and as a single council CCO. For comparative purposes, all costs are nominal (i.e. they include inflation).

Figure 1 Average annual waters charge per residential household



CODC In-house division vs single council CCO

The household costs under a CODC CCO diverge from the in-house business unit from inception. This is primarily due to the requirement for the CCO to increase revenue (and therefore household charges) to stay within borrowing limits. The in-house business unit faces similar debt constraints, but not until the outer 20 years projected. The effect of debt constraints is explained further in the debt section below.

Additionally, the CCO requires capital investment during setup and incurs higher ongoing operational costs than the in-house business unit, both of which are funded through increased charges. Projected efficiencies associated with the CCO model are modest at the size and scale of a CODC CCO and are not fully realised until over a decade into its operation.

Over time, the higher upfront charges of the CCO model keep down debt and, along with the efficiencies, contribute to the lower annual household costs under the CCO model in the long term (FY2039 onward). However, the cumulative value of household charges to this point are notably lower under the in-house business unit.

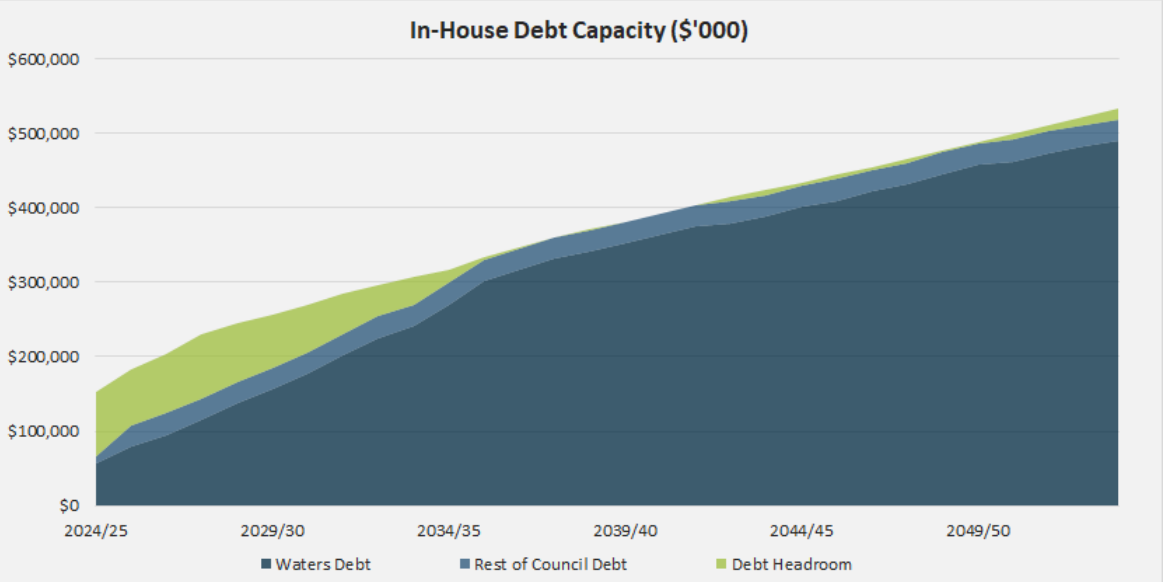
Three waters debt

A key difference between the CODC CCO and the CODC in-house division models is debt. More specifically, the different borrowing limits that apply and the practical impact those differences have on household charges are explained below for each model and shown in the corresponding charts.

Debt under the in-house model

Under the in-house model, debt continues to be measured at a total council level. At the point of CCO transition at the end of FY2027 CODC's debt is estimated to be 65% three waters and 35% non-three waters. Therefore, Council is effectively using the wider Council revenue to support high levels of debt in three waters (as do many other councils). That position continues throughout the thirty-year period with the proportion of three waters debt growing over time (see Figure 2 below).

Figure 2 In-house debt capacity

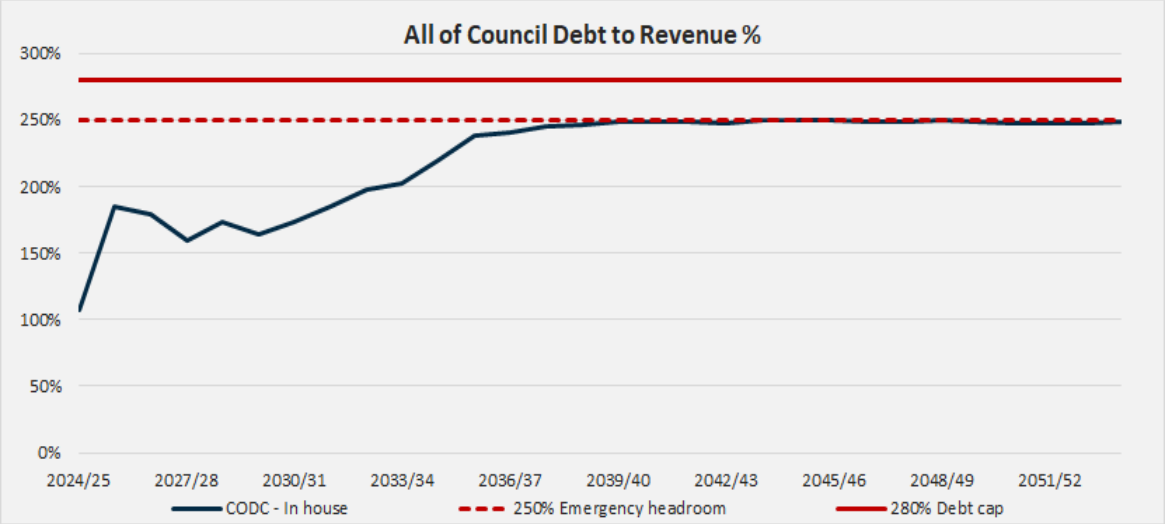


From FY2025, CODC operates with a gradually declining level of debt headroom, and by FY2035 all of Council debt capacity is fully utilised. To remain within the targeted debt-to-revenue ratio of 250%, our modelling assumes an increase in rates revenue during this period, resulting in higher household charges.

The proportion of debt allocated to three waters is substantial and significantly limits Council's ability to adjust its non-waters investment programme if needed. Given that regulatory requirements largely dictate investment in water infrastructure, Council's flexibility to strategically shape its broader capital programme is effectively constrained.

Because the three waters debt is over-leveraged, meaning its debt-to-revenue ratio is higher than CODC's overall ratio, transferring three waters to a wholly owned CCO would free up capacity on CODC's balance sheet, providing greater financial flexibility for other priorities.

Figure 3 All of Council debt to revenue %



Debt under the CCO model

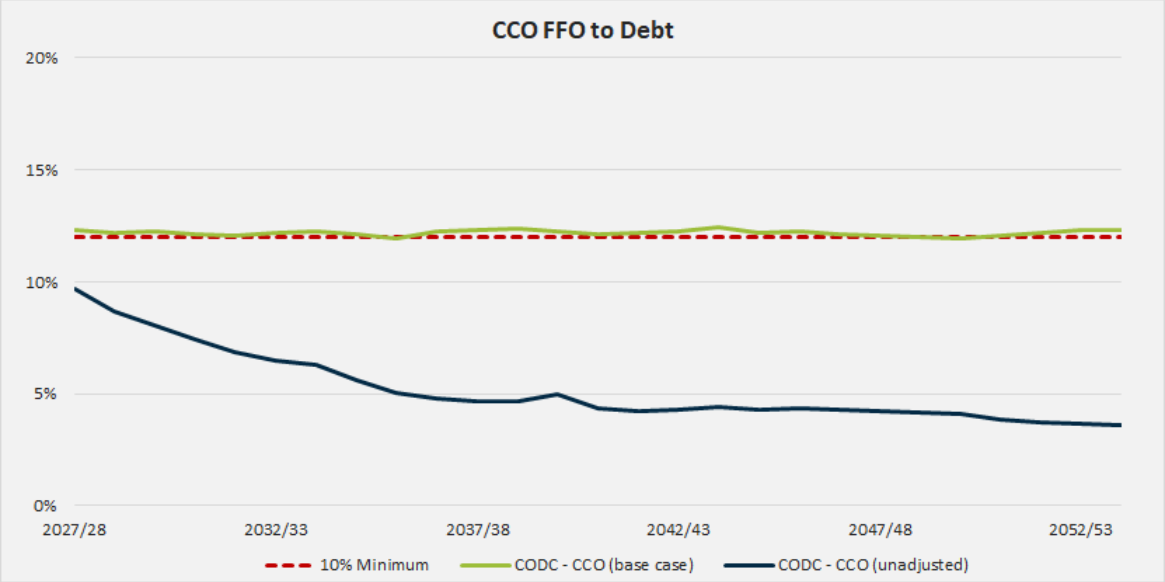
Under a CODC CCO. there is a different approach to debt and how it is measured. Total Council debt and revenue are no longer relevant. Only debt transferred to the CCO and only revenue generated by the CCO is considered.

A different ratio is also used, funds from operations (FFO) to debt, where the benchmark is maintaining a ratio above 12%. For CODC, FFO effectively represents operating profit minus depreciation, which is a non-cash expense. The 12% FFO-to-debt threshold often produces outcomes near 500% debt-to-revenue. However, FFO focuses on free cash flows relative to the closing debt balance rather than comparing operating revenue to debt.

Where these FFO limits were breached in our modelling, an adjustment is applied to the CCO's revenue to ensure no breach occurs in the base case results presented in this reporting.

The chart below illustrates this effect, comparing the CCO base case (staying within FFO to debt limits) to an unadjusted version where no specific increases in household charges are modelled (no FFO debt limits). The unadjusted base case is shown to fall well below debt limits without specific adjustments to household charges.

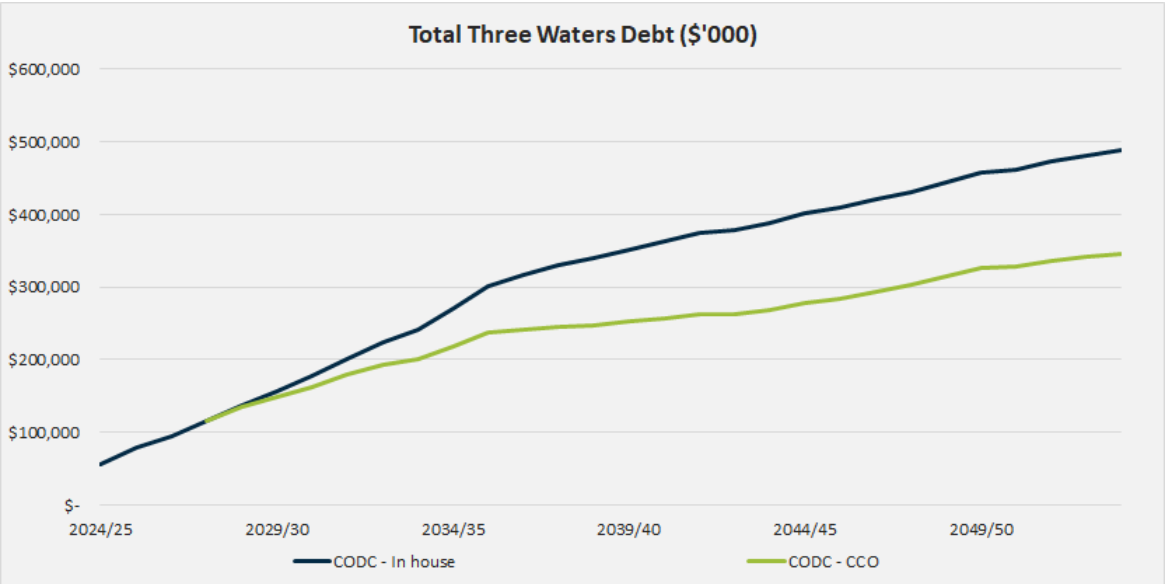
Figure 4 CCO FFO to debt



Impact on three waters debt

As shown below, the immediate debt constraints and subsequent higher household charges under the CODC CCO model ultimately result in less three waters debt over the 30-year period. This contributes to lower annual household costs of the CCO over the longer term (FY2041 onward) as fewer financing costs are incurred.

Figure 5 Total three waters debt



Appendix A – CCO establishment costs and additional overheads

The transitional establishment costs and additional overheads unique to the CCO were determined by comparing Morrison Low's initial assessment with bottom-up work completed by Rationale. Given the increased level of detail in Rationale's work, we have applied those costs where appropriate in a wholly owned CCO model. For clarity, total CCO costs are similar (typically +/—10%) under either approach. However, the distribution of costs differs.

Table 1 CCO establishment costs

CCO establishment costs	Amount
Change management	$1,873,000
Office fit out	$1,305,000
IT infrastructure & systems	$945,000
Total	**$4,123,000**

Table 2 CCO additional overheads

CCO additional overheads	Amount
Directors	$220,000
Stakeholder governance framework	$191,000
Executive Team costs	$195,000
Additional resources	$1,334,000
IT infrastructure & systems	$852,000
Council rates	$2,000
Office overheads	$343,000
Total	**$3,137,000**