Attachment 4

KAIPARA
DISTRICT

Report

mangawhai ecocare KDC
Maintaining Our Environment

RECOMMENDATION: PROGRESSION OF PROJECT

Prepared for

Mangawhai EcoCare

By

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1 BACKGROUND

The Local Government Bill was passed through all stages to become the Local Government Act 2002 (LGA 2002) on 20 December 2002. It was reported back to the House from the Local Government and Environment Select Committee in mid December 2002 with some "quite substantial changes arising from the submissions made[1]". The new Legislation had been released in draft form since July 2001 however "redrafting of the Original Bill (which occurred under urgency prior to Christmas) a number of provisions "loopholes" in the Original Bill were removed. The equivalent provisions were inserted. The equivalent provisions in the LGA are a good deal more specific and prescriptive than their counterparts in the Original Bill[2]."

These changes were not subject to wide consultation but were part of the political process involved in ensuring a smooth passage of the Legislation.

The changes have also been the subject of press releases from the Green Party which focus on aspects of asset ownership within the water sector, which have consequential impacts in terms of public perceptions. (Copy Attached).

In addition the LGA 2002 has two commencement dates with some provisions commencing immediately with the remainder to apply from 1 July 2003. The previous drafts specifically did not address retrospective issues and therefore any scheme established prior to the law becoming effective would have been allowed to continue.

The previously announced Sanitary Works Subsidy Scheme (SWSS) for small community schemes was also formally approved in conjunction with the new LGA and potentially offers significant advantages for KDC and the Mangawhai Project. The Government has made $15M available to fund the scheme.

The subsidy arrangements and revised LGA therefore require some changes to be made to the final negotiations presently underway with the Preferred Proponent for the Mangawhai Project, Simon Engineering, (SEA) as detailed in this recommendation. Importantly, the Council decision on 12 August 2002 where it was determined to investigate alternative funding options for the project specifically facilitates consideration of potential application of SWSS funds and alternative financing options given that Council are now likely to own the assets.

2 LOCAL GOVERNMENT ACT BILL IMPACTS

The major impacts of these changes are outlined below together with a recommended approach for the Mangawhai EcoCare Project.

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[1] Brookfields Note dated 20 December 2002.

[2] Bell Gully letter dated 19 January 2003

2.1 Restriction on private ownership of assets.

The enacted legislation now requires that Councils largely retain ownership of the assets notwithstanding legal opinions on what exists at the time of commencement compared to green field sites.

Politically, what is clear is the intent to restrict private ownership of water and wastewater assets. The current negotiations with SEA commenced with the BOOT principles being preferred by KDC whereas SEA through their bid indicated a clear preference for the option to transfer total ownership of the assets and infrastructure to Council as soon as possible. Negotiations have to this point been successful in ensuring SEA accepts that they must retain ownership of the assets and infrastructure. Given the above, it is possible to accede to SEA preference and modify the current Project Deed to allow Council to retain ownership of the assets and infrastructure with SEA financing the works through the nominated period, with toll payments only commencing on Commercial Acceptance.

The focus will then shift to the risk weighted finance charge proposed by SEA (via ABN Amro). Negotiations with SEA and ABN Amro indicate a strong desire to continue with the project from both parties and therefore it is proposed the negotiation team focus initially on securing the most advantageous financing charge from ABN Amro as the first priority. If successful this will then allow the remainder of the negotiations to proceed on a consistent basis.

This will involve a complete review of the Project Documentation to ensure no gaps consequently appear however the project team is confident that this can be achieved with little impact on the risk position of Council as the documentation is focussed on the design, construction, operations, maintenance and performance of the system. It therefore largely suits both approaches with the review being required to ensure removal or change of relevant clauses does not result in any inconsistency.

Effectively SEA must operate the system and provide services for at least 2 consecutive months in accordance with performance specifications prior to receiving payments. They then remain open to toll reductions if performance subsequently fails to meet specifications. The major change is that now Council does not possess the psychological threat to" takeover the assets" however they retain the threat to not pay for the service.

This change in ownership will probably increase the price charged by SEA as they will not be able to benefit from the taxation advantages associated with depreciation and other charges associated with long term infrastructure assets. It is anticipated that this can be overcome by utilising the Sanitary Works Subsidy Scheme (SWSS) to offset this disadvantage. Council will need to determine its position relative to the SWSS subsidy recognising the policy and financial implications of this decision. (See Section 3 below.)

It is acknowledged that current Council policy is against introducing district wide charging.

It is recommended that negotiations proceed initially to:

- **Secure best risk weighted financing arrangement possible from ABN Amro; and then**
- **Compare it with Council's interest rates (risk adjusted) to determine most appropriate approach; and then**
- **Complete negotiations with SEA based on outcome of the above.**

2.2 15 year maximum for operating contracts

The LGA 2002 is clearly focussed on imposing a 15 year maximum term on major contracts.

The existing documentation is focussed on 25 years to assist in the affordability issue whilst providing a sufficient period for population growth to occur. This assumed a zero written down asset value at the expiration of the 25 years.

It now appears more appropriate to focus on a 15 year period with a zero written down value if sufficient subsidies are achieved or alternatively leave a residual value (yet to be determined) at the expiration of the 15 year period. This would also mitigate against any inter generational issue arguments however it simply defers Council addressing the Treasury Management Policies issue until that time assuming Council does not have sufficient funds to pay the residual value. Importantly the legislation does not address the length of any financing contract and therefore it is possible to establish a 15 year operating contract together with a range of financing options including longer term arrangements.

It is recommended that negotiations now proceed based on a 15 year maximum operating period and a range of financing options that may include a 25-30 year financing period, and a residual value if appropriate.

There are a range of other provisions that specify changes in the Council decision making process including more prescriptive consultation process as well requiring Councils to develop policies relative to private sector involvement in the provision of services.

It is not considered that these directly impact on the negotiations but will need to be addressed by Council in its future processes.

It is recommended that further consultation is undertaken relative to the proposed funding arrangement including elaborating on the respective role of SEA and Council in the management of services, performance standards, pricing and strategic directions including the application for SWSS grants.

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3 SANITARY WORKS SUBSIDY SCHEME

The SWSS guidelines provide for a maximum subsidy of 50% of the construction costs including design, management and construction activities. The scheme expressly provides for arrangements between Councils and the private sector to be included in the SWSS.

To be eligible for the scheme the Council must:

- Provide an equivalent subsidy to the extent of subsidy sought from the Central Government. The Councils subsidy may include all feasibility reports and investigations, costs of consents, project management, council and consultant costs;
- Guarantee the scheme will operate and be maintained for at least 20 years;
- Guarantee adequate replacement and repair of the assets; and
- Guarantee that the subsidy will be passed onto ratepayers.

The extent of the subsidy applied for is based on a sliding scale from 50% down to 10% based on the "participating population" which is based on projected permanent residents within the next 5 years. The maximum population size is capped at 10,000 (10% subsidy), with 100 being the smallest population size (50% subsidy). Certain contributors to population including schools and commercial/ industrial users are excluded from the calculation of population numbers and must not receive any subsidy benefits. (ie they can participate in the scheme but must pay full cost for their portion)

The four conditions imposed above range in impact on the Mangawhai Project.

The first condition imposes a limitation on the extent of subsidy claimed by requiring the Council to also provide an equivalent subsidy to Mangawhai using Council's district wide cash reserves. Effectively this becomes part district wide charging. Note that this can include the costs of feasibility studies, investigations, consultants and council costs as well all Consent costs as a minimum. Therefore it is likely that a portion of the Mangawhai Infrastructure Assets Study report can be included, all associated NRC costs as well as the project management costs of Beca can be counted as part of the equivalent contribution.

The second and third conditions are expressly provided for in the current Project Deed and therefore Council is in the best possible position to demonstrate how they can guarantee these functions. Specifically, SEA must provide an independent Asset Condition Report every five years to demonstrate assets remain in sound condition and are in appropriate condition to match their expected asset life. On the basis that it is now expected that the Project Deed will be focussed on the initial design and construction period together with a 15 year operating period, then Council will need to separately guarantee the operations of the scheme for the period between years 15 and 20.

This condition should also ensure that all Councils focus on the longer term service delivery aspects including providing for the full costs over at least the next 20 years which should mitigate against keeping rates artificially low by ignoring future costs.

The fourth condition refers to transparency in the rating model to ensure that eligible ratepayers receive the benefits and this can clearly be achieved.

A specific criteria has been developed to evaluate the proposals based on:

CRITERIA	MEASURE	WEIGHTING	INDICATIVE MANGAWHAI	SCORE
Reduction in Public Health risk and Improved Environment Outcomes	Score based on a point systems and MoH assessment.	**6.8**	**6.18**	**42.02**
Socio-economic conditions of the community	2001 census Deprivation Index based on **Mangawhai area**.	**2.5**	**7**	**17.5**
Rating ability and available debt financing ability of Council	Average Index across KDC based on 2001 census Deprivation Index	**0.5**	**5**	**2.5**
Whether the community has previously received funding and if so how effectively it has been applied	Assessment and Council statement	**0.2**	**10**	**2.0**
TOTAL				**64.02**

The above score is based on a preliminary assessment by Beca Planning and will need to be confirmed although a score of between 60 –75 is within reasonable expectations.

However Council will need to determine its policy in regard to the matching district wide subsidy, as it may establish a precedent for other communities within Kaipara. Importantly only $15M has been made available for the first round and therefore the priority ranking will be critical in actually being allocated funding. Again, it is noted that Council currently operates on "a user pays basis" and therefore may have some political difficulties in adopting a modified district wide scheme to gain the advantages of any Central Government subsidy. Council will also need to consider developing a negotiating strategy with the Central Government to modify the SWSS guidelines or alternatively obtain special consideration of the Mangawhai Project based on work completed to date.

In summary, the SWSS provides Council with an opportunity to gain Central Government subsidy in the range of $1.5M to $7.5M provided the:

- Preconditions can be met;
- Priority ranking is sufficiently high; and
- Sufficient funds remain in the $15M pool.

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RECOMMENDATION

It is recommended that;

- **Council consider its position relative to question of district wide subsidies to eligible participating communities, as it is likely that most communities within Kaipara who current do not have reticulated sewerage schemes will qualify notwithstanding that their priority rankings may be substantially different.**
- **A parallel approach is adopted relative to the SWSS guidelines; with a submission under the current SWSS guidelines being submitted as a matter of urgency to register Mangawhai under the scheme whilst a negotiation strategy be developed to lobby government to modify the guidelines.**

4 IMPACTS ON RISK PROFILE

All of the above issues have impacted on the Mangawhai Project however it is considered the project can progress as outlined above with only minor changes to the previously agreed risk profile.

The key risk issue is the risk during the construction and proving stage of the plant and the sewer network. Once this has been satisfactorily completed the risk of design and construction cost over runs has been eliminated, plant performance has been demonstrated and the sewer network as constructed has been found sound. With the current negotiations all these risks remain with SEA.

SEA in its offer submitted a financing proposal that was more focussed on providing low cost finance to meet Council's "affordability" objective rather than the stated requirement for the private sector to own the assets. SEA was able to offer the lowest possible price based on this approach whilst substantially meeting the risk profile.

With the legislation now requiring Council to own the assets this may in fact simplify the negotiations with SEA (and ABN Amro) however will require changes to the documentation. Council will retain the right to reduce payments to SEA for poor performance and may be supported by appropriate Bank Guarantees, Performance Bonds in addition to the Parent Company Guarantees to reinforce performance obligations.

In the event of a Material Default occurring and not being rectified within the Cure Period Council previously could takeover the assets, replace SEA with an alternative operator and sue SEA under the Parent Company Guarantee for any costs in rectifying the problems. Under the current proposal Council can still replace SEA and may have direct access bank

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guarantees or performance bonds before relying on enforcement of the Parent Company Guarantee.

The change to the ownership of the asset primarily:

- reflects on taxation benefits associated with the claimable depreciation allowances by the private sector which significantly lowers the toll required by the private sector. With the Council now owning the assets these benefits will not be achieved however this potentially can be offset by the extent of the subsidy from the Central Government, subject to Council's decision on this issue discussed above; and
- impacts on the extent Council is involved in longer term sustainability of the disposal options

The remaining risk profile remains largely as before and will be subject to further negotiations with SEA including finalisation of the Guaranteed Maximum price arrangement.

Once these negotiations are complete Beca (and legal advisors) will provide a covering letter outlining how the risks have been addressed within the Project Deed to provide Council with surety that the risk position has been managed through the negotiation phase.

5 PROCESS RISK

The Council decision of Council on 12 August 2002 that requested the Project Team investigate alternative financing arrangements has been impacted by the SWSS and the changes to the LGA. It is now appropriate to proceed utilising an approach where Simons finance the project with Council owning the assets after the construction period and proving period.

The Evaluation Assessment Team also considered the impact of this change on the evaluation process and has considered that, on balance the evaluation criteria and weightings remain applicable for the amended approach now required.

6 RECOMMENDATION

It is therefore recommended that:

- The Steering Committee reports the above matters to Council, and,
- Recommends to Council that negotiations continue with the Preferred Proponent in accordance with the framework outlined above.

Report Prepared By: Mike Ritchie *Signed* ....

Report Prepared By: Peter Elliott *Signed* ....

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