KPMG

Wellington City Council

Balance Sheet Review

Phase Two

September 2023

KPMG Centre
18 Viaduct Harbour Avenue
PO Box 1584
Auckland 1140

Tel +64 9 367 5800

Private and confidential

Barbara McKerrow and Andrea Reeves
113 The Terrace
Wellington Central
Wellington 6011

[redacted]

Dear Barbara and Andrea

Balance Sheet Review – Phase Two Part A

Thank you for the opportunity to support the Wellington City Council (the “Council” or “WCC”) as it considers options to address its balance sheet constraints.

Our work has been performed in line with the scope of our All of Government Consultancy Services Order (CSO) dated 27 January 2023 and CSO variation dated 7 June 2023, and is based on information provided by the Council or collected from publicly available sources.

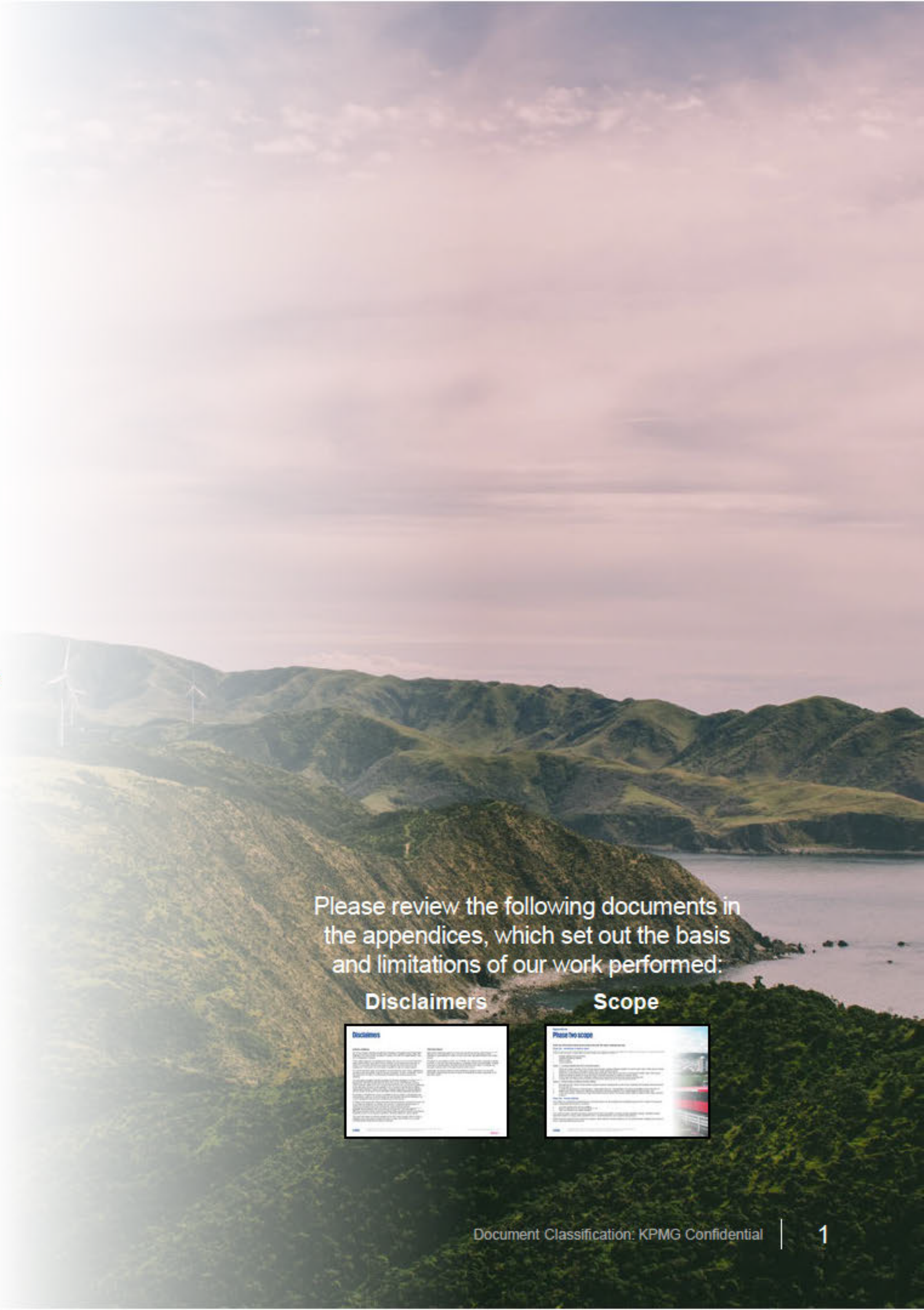
Our work has focused on further exploring options identified in phase one of this balance sheet review.

Please don’t hesitate to contact us if you have any questions.

Kind regards

[redacted]

[redacted]



Please review the following documents in the appendices, which set out the basis and limitations of our work performed:

Disclaimers

Scope

Summary of phase one

The Council has made strategic decisions in recent years to take on additional debt and invest heavily in improving Wellington's services and infrastructure. This has resulted in borrowing nearly doubling since 2017, with multiple high-priority projects currently ongoing or in the planning stages.

WCC is facing a number of balance sheet constraints that may impact its ability to deliver on its work programmes while balancing the need to maintain a strong financial position. These constraints present an imminent financial challenge that must be managed and navigated carefully.

Borrowing constraints

WCC's debt levels have almost doubled over the past five years to over $1 billion. Borrowing is expected to continue increasing, with WCC forecast to breach its self-imposed Net Debt to Total Revenue covenant (including a $270m insurance buffer) from FY23 to FY30. If further debt is raised, WCC may also get close to breaching the LGFA Net Debt to Total Revenue covenant, which would likely have adverse consequences on future borrowing terms and future credit rating.

Rates affordability and tolerance

Rates have increased over recent years, with further increases forecast. Affordability assessments indicate some low-income households may have limited ability to meet further rates increases, especially in the current high inflation environment. Public perception of the pace of rates increases may also limit WCC's scope for further increases, and draw greater scrutiny to WCC's financial management.

Cost increases - particularly interest, insurance and depreciation

Interest rates in New Zealand have increased significantly since the 2021 LTP was finalised. Insurance premiums are set to rise while access to insurance for many of WCC's assets is becoming more challenging. Depreciation is also forecast to increase as investment occurs and asset values increase. These BAU costs absorb much-needed rates revenue.

Insufficient insurance headroom

WCC has been maintaining additional borrowing capacity as an insurance buffer to cover the impact of natural disasters. The current buffer is insufficient given the lack of geographic diversification of assets and it may be spread too thinly, particularly in the event of a large earthquake. There is essentially no capacity to increase insurance headroom and taking additional insurance would result in significant extra cost, if insurance is even available to purchase.

Options identified to alleviate balance sheet pressure

01 **Review non-rates revenue, service levels & capex phasing or prioritisation**

02 **Consider rationalising the WCC investment portfolio**

03 **Utilise IFF further to fund & finance infrastructure**

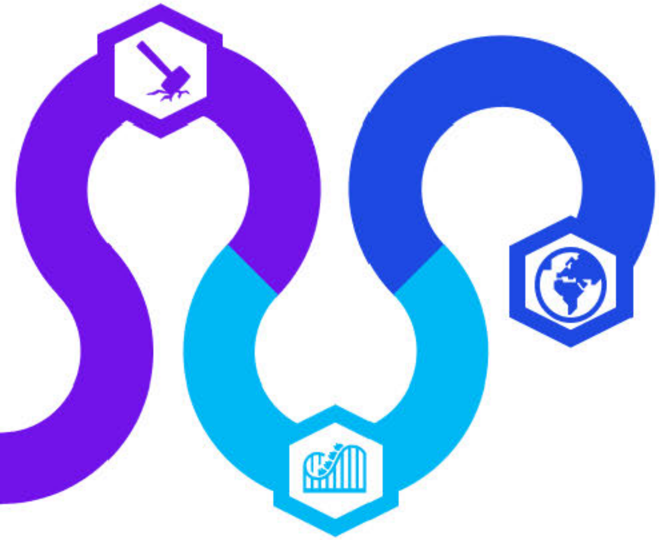
04 **Review insurance & internal covenant settings**

Given the multiple constraints that WCC faces, it is likely that a combination of actions will be required to enable WCC to deliver high priority projects while managing its exposure to risk.

In phase two of this balance sheet review, KPMG has been asked to explore opportunities for rationalisation of WCC's investment portfolio (option 2), while considering how any decision impacts insurance risk management (option 4). Option one is currently being progressed through the LTP process. Option three has not been considered in this work but WCC will likely consider IFF for large capital expenditure projects.

Action is required to ensure balance sheet resilience for WCC

WCC is facing a number of significant constraints that, without action, will impact its ability to deliver on its work programmes while maintaining a stable financial position.



Adverse financial market forces

WCC's debt was forecast to hit $2b by FY28 in the 2021-31 LTP, with this figure expected to rise with the development of the 2024-34 LTP. Interest rates have surged upwards and are forecast to remain high for some time. Asset revaluations have resulted in increased depreciation cost. Some households are approaching limits of affordability, which is likely to be further exacerbated due to the cost of living crisis, leaving limited scope for significant rates increases to cover increased costs.

Increasing balance sheet needs

Some WCC projects and expenditure priorities have not yet been fully factored into long term forecasts. Accordingly, there will be less headroom under the covenants than originally forecast in the 2021-31 LTP.

An increasingly challenging insurance environment which will impact WCC significantly

Wellington's insurance market is tightening. Building and infrastructure revaluations have increased the cost to replace assets, increasing premiums. The release of the new National Seismic Hazard Model (NSHM) has further increased the Probable Maximum Loss (PML) from a major event for many of the Council's assets. Recent weather events across New Zealand have highlighted the reality of climate issues. The insurance market is reducing its exposure to Wellington, causing difficulties in obtaining coverage.

Why does the Council need to act now?

Adverse financial market forces and increasing balance sheet needs will challenge the short to medium term objectives of the Council.

Adverse financial market forces

WCC's debt is currently forecast to hit $2b by FY28 per the 2021-31 LTP. Net debt to total revenue is currently near self-imposed limits and is forecast to continue increasing. Since the 2021-31 LTP was developed, interest rates have surged upwards and are forecast to remain high for some time. This implies that interest expenses will make up a greater share of total expenditure than originally forecast in the 2021-31 LTP.

Net finance costs

In FY22, net finance costs were 7% of rates revenue. In the FY24 annual plan, net finance costs are estimated to consume 13% of rates revenue. This percentage of rates revenue is likely to rise significantly as WCC's effective interest rate rises.

WCC regularly revalues its major assets in line with market values which have historically increased over time and are forecast to continue increasing, which has a flow on depreciation impact. WCC's policy is to fully fund its depreciation expense.

Depreciation

In FY22, depreciation consumed 38% of rates revenue. This is forecast to increase to 51% in FY30 per the LTP.

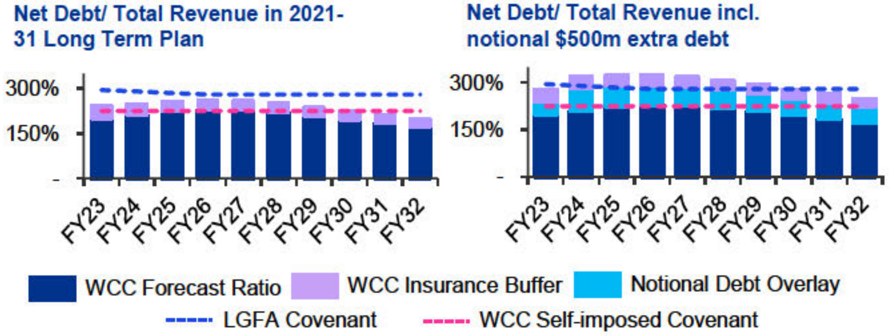
Affordability assessments for some ratepayers, particularly low-income households, are already tight. This indicates there is limited scope for continued large rates increases in the near-to-medium term to meet any increased costs.

Increasing balance sheet needs

In addition to cost inflation, some WCC projects and expenditure priorities have not yet been factored into long term forecasts. Accordingly, there may be less headroom under the covenants than originally forecast in the 2021-31 LTP.

In the 2021-31 LTP, WCC included $270m as an insurance buffer, which is additional borrowing capacity to cover insurance underwriting for major events, in its net debt calculations. When this $270m buffer is included, WCC is forecast to breach its self imposed covenant limit of 225% throughout the majority of the forecast period.

Based on discussions with Council, we understand that actual borrowings are likely to be significantly higher than forecast to cover increased capital expenditure not included in the 2021-31 LTP. The actual requirements are not yet known, but we have used a conservative (lower bound) estimate of $500m.


Net Debt/ Total Revenue in 2021-31 Long Term Plan

Net Debt/ Total Revenue incl. notional $500m extra debt

With $500m of additional debt, WCC would breach its self imposed 225% limit throughout the forecast period and would also breach the LGFA Net Debt to Total Revenue covenant (which excludes the insurance buffer) from FY25 to FY27. In 2022, S&P revised the Council's outlook to Negative due to "after-capital account deficits and debt levels higher than previous expectations, and 'AA+' rated peers". An unremedied LGFA covenant breach and downturn in credit rating would limit WCC's access to premium interest rates, further increasing the cost of borrowing.

Why does the Council need to act now?

WCC's risk profile has changed significantly. This leaves WCC unable to rely on traditional insurance alone as a risk mitigation strategy. The Council needs to think strategically now about how it will mitigate risk in the long-term.

An increasingly challenging insurance environment

Wellington's insurance market is tightening. Building and infrastructure revaluations have increased the cost to replace assets, increasing premiums. The release of the new National Seismic Hazard Model (NSHM) has further increased the Probable Maximum Loss (PML) from a major event for many of the Council's assets. Recent weather events across New Zealand have highlighted the reality of climate issues. The insurance market is reducing its exposure to Wellington, causing difficulties in obtaining coverage. This trend is likely to continue.

In FY22, insurance premiums only consumed 4% of rates revenue; [redacted]

[redacted]

Insurance premiums

Consumed 4% of rates revenue in FY22 and is likely to increase materially over coming years.

WCC is likely to have trouble covering this insurance gap due to the insurance market's hesitance to increase exposure in the Wellington region and the cost of obtaining coverage. This leaves WCC unable to rely on traditional insurance alone as a strategy to mitigate risk going forward.

WCC is currently working with its insurance partner, Aon, to create a roadmap which will outline how WCC should manage risk over the medium to long term. This insurance roadmap will enhance decision-making in terms of risk management beyond the immediate constraints.

How could WCC mitigate insurance risk?

There are a range of measures that WCC may be able to further investigate as ways to mitigate risk, including (but not limited to):

- **Reduce the size of the asset base**, which will reduce the total PML in the event of a 1 in 1000 year event, thus effectively decreasing the shortfall in coverage.
- **Reduce geographic concentration**, which will diversify risk away from the Wellington region meaning not all assets are subject to the same disaster risks.
- **Increase self-insurance** either through a debt capacity buffer or an investment fund that could provide geographic diversity, generate financial returns for WCC and be deployed to mitigate any losses arising from natural disasters.
- **Establish a captive insurance investment vehicle**.
- **Explore alternative insurance solutions** such as parametric insurance and protected cells (which are being considered as part of the Aon review).

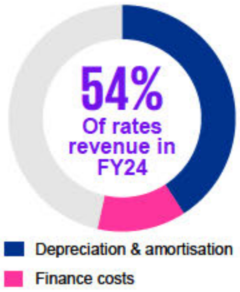
A combination of all of the above will likely be required to appropriately mitigate risk.

Accepted risk is the risk on insured assets that sits above the loss limit on the policy, or results from policy ventilation.
Un-insured risk is the risk on assets which are not currently insured on the policies.

Maintaining the status quo is not feasible

WCC holds a significant portfolio of assets, which is contributing to many of the constraints WCC is facing.

Costs associated with owning and maintaining assets



Per the 2023-24 annual plan, depreciation and amortisation is forecast to consume 41% of rates revenue, and finance costs are forecast to consume 13% of rates revenue.

This means that costs associated with holding assets will consume **54% of revenue collected through rates.**

Insurance required to manage the increased insurance risk

[redacted]

In June 2021, WCC's uncovered risk was 9% of the PML from a 1 in 1000 year event and insurance coverage. [redacted] indicating significantly more coverage will be required going forward, which may not be attainable. This level of exposure would be an unacceptable risk for most governing bodies.

In relation to infrastructure, the Local Government Act requires Council to "provide for the resilience of infrastructure assets by identifying and managing risks relating to natural hazards and by making appropriate financial provision for those risks"[1]. The Council needs to act now to decrease uncovered PML.

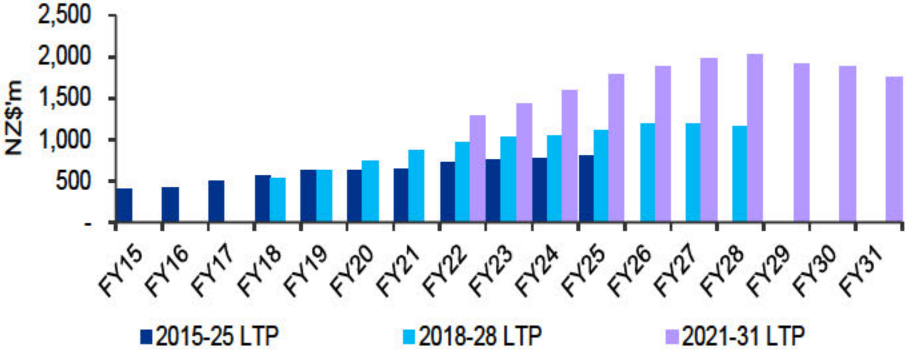
Many of the financial headwinds faced by WCC arise directly or indirectly from its asset holdings. In order to create long term financial stability and flexibility, it would be beneficial to review the asset portfolio to ensure optimal strategic alignment.

What if the Council chooses to stick to the status quo?

The Council is facing both immediate headwinds and longer-term pressures.

Previous Councils have increased borrowings during each LTP planning process in order to fund additional investment. This is demonstrated by the graph below which shows that the 2021-31 has significantly more forecast borrowings than the two previous LTP forecasts.

Forecast Borrowings



The current trajectory of increasing borrowings to fund growth, in the context of these challenges, appears unsustainable and is likely to increase the current pressures being experienced by WCC.

It is important that the Council takes action now to begin to reorientate towards a sustainable long-term position. Failing to act now leaves the Council exposed to significant risk and makes taking action in the future more difficult.

---

[1] Local Government Act 2002 No 84 (as at 13 April 2023), Public Act – New Zealand Legislation

Options to alleviate balance sheet pressure

The Council, through its current LTP planning process, has the opportunity to explore options which may simultaneously increase council resilience, manage risk, and alleviate balance sheet pressure.

In phase one of this balance sheet review, we identified four opportunities to alleviate balance sheet pressure, noting that it is likely a combination of actions will be required to make a real impact on alleviating WCC's constraints.

In phase two of this balance sheet review, KPMG has been asked to explore opportunities for rationalisation of WCC's investment portfolio (option 2), while considering how any decision impacts insurance risk management (option 4). Option one is currently being progressed through the LTP process. Option three has not been considered in this work due to no current live/viable projects.

01

Review non-rates revenue, service levels & capex phasing or prioritisation

WCC, through the Level of Service review, is currently considering the:

- Levels of service offered;
- Phasing of major capital expenditure projects to smooth projected cashflows and provide additional headroom; and
- Whether ownership of core assets still aligns with WCC's purpose and vision.

02

Consider rationalising the WCC investment portfolio

Divesting non-essential assets could enable reinvestment in new assets or priority spending areas, whilst potentially reducing the costs of ownership and boosting financial returns.

In this report, we consider the potential impact of rationalisation of assets in WCC's investment portfolio. To assess assets, we consider how investments impact: strategic alignment and governance, risk management, council resilience, rates, and funding and financing capacity.

03

Utilise IFF further to fund & finance infrastructure

IFF is a useful tool for specific infrastructure projects and will play a part in enabling WCC to execute its capital expenditure program.

04

Review insurance & internal covenant settings

Aon is currently undertaking a thorough review of WCC's insurance settings. This is a multi-year process with no findings expected until later in the year. This report will consider how any decision impacts insurance risk management.

Rationalisation of the WCC investment portfolio

WCC will need to make difficult decisions to ensure the council has long term financial stability.

Investment Portfolio

In phase one we recommended the Council consider the rationalisation of assets in its investment portfolio. WCC has a range of investment properties totalling $300m* and investments in associates and joint ventures totalling $258m*, which may no longer be fully aligned with the Council's vision.

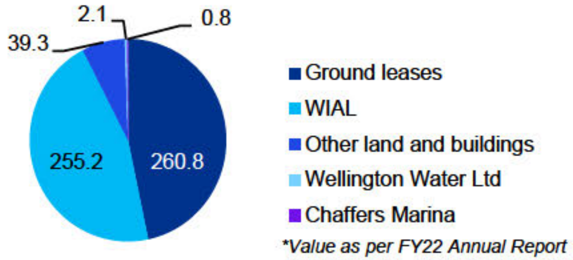
WCC has a range of investments which it has built up over a long period of time. The planning stages of this LTP allow the Council the opportunity to review these investments to determine if they are still strategically sound or if there are better uses of capital.

It is worth noting that this review is limited to:

- Investment properties, which are properties primarily held to earn lease revenue and/or generate capital growth, consists of ground leases and other land and buildings; and
- Investment in associates and joint ventures, which includes Chaffers Marina, WIAL and Wellington Water (excluded from analysis due to ongoing Affordable Water Reform uncertainty).

In addition to the above, WCC has a range of operating assets and controlled entities, which have not been considered in this assessment.

WCC investment assets ($'m)*



**Value as per FY22 Annual Report*

Capital rationalisation to better allocate capital

The rationalisation of capital tied up in assets that no longer meet WCC's investment objectives would allow for the reallocation of capital. When looking at opportunities for capital rationalisation, we have considered how the divestment of the assets noted below would impact strategic alignment and governance, risk management, council resilience, impact on rates, and funding and financing capacity.

The rationalisation options below are assessed on a standalone basis and do not consider the use of any proceeds, noting that loss of income could be replaced by income from alternative investments.

Rationalisation of:	WIAL Shareholding	Portfolio of ground leases	Chaffers Marina	Other land and buildings
Strategic alignment & governance	🟢	🟢	🟢	🟢
Risk management	🟡	🟢	🟢	🟢
Supports council resilience	🟢	🟢	🟢	🟢
Impact on rates	🔴	🔴	🟢	🔴
Funding & Financing Capacity	🟢	🟢	🟡	🟢
Estimated Value[1]	[redacted]	**$261m total** [redacted]	**<$1m**	**$39m**

Detailed assessment of each option is outlined in Appendix two.

[1] Value as per either FY22 financial statements or independent valuation.

[redacted]

WIAL and the portfolio of ground leases provide the strongest opportunities for recycling of capital, based on both scoring against assessment criteria and size of opportunity. Divesting WIAL shares or ground leases would not directly mitigate depreciation or insurance pressures but would allow WCC to utilise proceeds to create balance sheet headroom by paying down debt, or reinvest to target higher returns and geographic diversification.

Sources: WCC Annual Report for FY22, KPMG analysis

Appendix eight contains information that could be considered through WCC s level of service review.

🟢 **Positive / High** 🟡 **Neutral / Medium** 🔴 **Negative / Low** ⚪ **Unknown**

Strategic capital deployment

WCC has the opportunity to think strategically about where capital is best deployed through its upcoming LTP process. WCC should consider how any decision impacts risk management and balance sheet constraints. There are three ways the Council could deploy capital that may arise from the recycling of capital tied up in investment assets or surplus funds arising from affordable water reform.

Repay

WCC could repay some of its current borrowings to reduce its debt burden. This would decrease the annual interest expenditure and increase borrowing capacity.

Pros

- Decreases debt servicing costs.
- Reduces current borrowing constraints, leaving additional debt headroom.

Cons

- Does not in itself enhance investment in the future of Wellington.
- No additional revenue sources derived.
- Does not generate intergenerational wealth.

Strategic alignment and governance	🔴
Risk Management	🟢
Supports council resilience	🟡
Impact on rates	🟢
Funding & financing capacity	🟢

Invest

WCC could invest in a fund (or other income-generating investment) that better aligns with the Council's strategic direction, generates returns, and diversifies risk.

Pros

- Introduces new sources of revenue.
- Risk can be carefully managed through regional diversification of investments, which will be beneficial to Wellington in the event of a natural disaster.
- With proper safeguards in place, has the potential to build resilience for future Councils.

Cons

- Revenue from any investment has the potential to be volatile, and may fluctuate due to macroeconomic conditions (depending on investment asset class).

Strategic alignment and governance	🟢
Risk Management	🟢
Supports council resilience	🟢
Impact on rates	🟢
Funding & financing capacity	⚫

Spend

The Council could choose to increase spending on Council services or direct investment into capital investment projects.

Pros

- WCC may be able to meet more of its immediate spending needs.

Cons

- Not likely to support council resilience, or address any of the Council's current balance sheet constraints.
- Unlikely to change WCC's risk profile materially (albeit, this would depend on the spending decision).
- Does not necessarily enhance future prosperity of Wellington.
- No additional revenue sources derived.
- Does not generate intergenerational wealth.

Strategic alignment and governance	🟡
Risk Management	⚫
Supports council resilience	🔴
Impact on rates	🔴
Funding & financing capacity	🔴

"Spend" is not a viable option based on its negative impact on most of the decision making criteria. "Repay" and "invest" both score relatively highly and the Council could consider a combination of the two to meet WCC's objectives. The appropriate mix of options will likely become clearer once decisions are made in respect to the 2024-34 LTP, insurance roadmap, capex phasing and WCC's contribution to large infrastructure programs expected in the future.

Detailed assessment of each option is outlined in Appendix one.

🟢 Positive / High 🟡 Neutral / Medium 🔴 Negative / Low ⚫ Unknown

What could WCC invest capital in?

There are a wide range of investments which WCC could investigate further for any capital recycling proceeds. Some of these investments could potentially generate better returns than some of the assets currently in WCC's investment portfolio, while also facilitating better risk management through geographic diversification of investments.

Below is a non-exhaustive list of some investments WCC may wish to further investigate.

Investment fund

Future rates increases could be avoided through the returns generated by an investment fund. A fund offers a possibility to achieve greater returns than current investment assets, whilst also diversifying risk away from the Wellington region.

An example is the New Plymouth District Council's PIF.

The investment fund established could be focused on investing on both generating returns and achieving ESG outcomes.

An example is ACC's impact investment funds.

Captive insurance fund

WCC could establish a captive insurance vehicle which would increase WCC's access to insurance while also generating returns through investment.

An example is the City of Gold Coast's captive insurance company.

Other return generating investment

There are a range of other investments that may be appropriate for WCC beyond the examples shown here. When considering any such investment, the effect on the Council's strategic direction, returns, and risk profile should be considered.

The following are selected examples of how other public agencies have chosen to invest.

Te Kaunihera-ā-Rohe o Ngāmotu New Plymouth District Council **Perpetual Investment Fund[1]**	• In 2004, the New Plymouth District Council (NPDC) established the Perpetual Investment Fund (PIF). The fund was created to help offset rates for local ratepayers within the New Plymouth district. • The PIF is managed by New Plymouth PIF Guardians Limited (NPG), a council-controlled organisation (CCO) of NPDC. The CCO has an independent board of directors providing commercial expertise. Mercer New Zealand Limited manages the fund, and monitoring and review is completed by NPG. • On the 28th June 2023, Parliament passed the 'New Plymouth District Council (Perpetual Investment Fund) Bill'. The Act sets out the principles for managing the fund, while dictating safeguards to ensure that independent financial managers make best-practice investment decisions to maintain or increase the value of the fund. • The total return of the portfolio for the past five years has averaged 7.9% per annum.
ACC **Impact Investment Funds[2]**	• ACC has launched two impact investment funds, which provide an example of a Crown Entity investing in ESG outcomes. • The funds have the objectives of improving social or environmental impacts while providing a strong investment return that helps New Zealanders pay less in levies for accident cover. • The first fund is a $100m climate change impact fund, which seeks investment opportunities to increase ACC's impact on emissions reductions. • The second fund is a $50m health, safety and wellbeing impact fund, which seeks investment opportunities that will improve health and wel being, advance health and safety standards in New Zealand, and improve the rehabilitation experience of those receiving support – all while generating returns that help meet the cost of the ACC scheme.
CITY OF GOLDCOAST. **Captive Insurance Vehicle[3]**	• The Council of the City of Gold Coast (Council) operates a wholly owned captive insurance company which was established for the cost-effective financing of selected Council risks. • In 2002, insurance premiums and claims were costing the City millions of dollars each year, and some types of insurance cover could not be purchased. In late 2006, the Council authorised the CEO to establish and operate a captive insurance company domiciled in Guernsey. • The City of Gold Coast has benefited from better risk management, better oversight of its risks, reduced premiums and better cover. • The captive insurance company has also delivered significant financial returns through its investments.

---

[1] Council controlled organisations (npdc.govt.nz)

[2] Our impact investment funds (acc.co.nz)

[3] Captive Insurance Company | City of Gold Coast

Investment fund considerations

Options currently available to WCC

WCC could choose to establish a CCO and inject capital to create an investment fund. This could take the shape of either a general investment fund or an ESG-linked fund, depending on WCC's investment objectives.

Investment fund

WCC could establish an investment fund which invests with the intention of offsetting future rates increases through generated returns while also giving the ability to diversify risk away from the Wellington region. This investment fund has the opportunity to be shaped to achieve a range of outcomes.

Investment funds have the potential to generate larger returns than some of the investment assets that WCC currently holds, noting that returns will still be subject to volatility.

Liquidity and Investment Horizon

Liquidity and investment horizon is largely dependent on the structure of the established fund. The horizon of an investment fund could be anywhere between **medium to long term**.

Advantages

- Potential to target greater investment returns than WCC's current investment portfolio.
- Access to sophisticated investment assets.
- If investments are outside the Wellington region, would build resilience.

Considerations

- Returns may be volatile.
- Stakeholder view on investing public funds in different regions.
- Need to consider the ability of WCC to access funds in the case of an economic or environmental event.
- Process to elect an investment manager.

ESG linked investment fund

The investment fund established could have some or all of the investment focused on achieving both returns and ESG outcomes. Some additional considerations of an ESG linked investment fund include:

- Liquidity is likely to be lower than a non-ESG fund, which may challenge access to funds in the instance of a natural disaster.
- Smaller pool of options available and companies with stronger financial performance may be overlooked.
- Potential for "greenwashing" risk.

Longer term consideration

In the longer term, depending on the outcome of the Aon insurance review, it may be appropriate for WCC to consider establishing a captive insurance fund to assist with risk management. Capital held in an investment fund could eventually deployed into a captive insurance fund.

Captive insurance fund

WCC is currently working on a roadmap with its insurance partner which, in the future, could include the establishment of a captive insurance vehicle. This vehicle which would increase WCC's access to the reinsurance market while also generating returns through investment.

Liquidity and Investment Horizon

Captive investment needs to be **long term** in order to build a successful captive that manages risk and delivers returns. Liquidity is therefore low in captive investments.

Advantages

- Increased access to insurance through reinsurance market.
- Ability to invest proceeds to generate returns.

Considerations

- Captive insurance entities are taxable entities.
- New Zealand's toughening insurance regulation means majority of captive insurers are set up offshore.
- Expert governance required to operate captive insurance vehicle.

Capital recycling opportunities

Capital recycling opportunities

WIAL

The sale, or partial sale, of WCC's investment in WIAL presents an opportunity to generate significant cash proceeds that could be recycled to achieve geographic diversification and potentially greater returns for ratepayers.

WCC currently maintains a 34% shareholding in WIAL, which had a book value of $255m at the end of FY22.

Why should WCC revisit the option of recycling capital invested in WIAL?

Influence

Due to the nature of the minority holding, WCC's influence over decisions making at WIAL is limited.

WIAL's Capital Expenditure Plan

Additional capital contribution may be required for airport Capex, which has been deferred during the COVID-19 pandemic. If WIAL requires additional equity for its capital program, WCC will either need to inject capital or will have a dilution in ownership.

Dividends

WIAL dividends have resumed in FY23; however, for the two years prior, WIAL did not pay dividends. As the WIAL dividend is usually one of WCC's income sources, WCC was required to draw additional debt totalling c.$50m in order to compensate for the missing income, to avoid increasing rates. It is possible that returns from WIAL may continue to be volatile due to WIAL's proposed capital expenditure program. WIAL has delivered a c.20m dividend in FY23, which when compared to FY23 book value would be a 6.7% cash return.

WCC's Investment Returns from WIAL ($'m)

How would the divestment of WIAL shares help to alleviate WCC's constraints?

Cash proceeds arising from a partial or full sale of WIAL could be applied to repay debt in order to reduce interest costs and create balance sheet headroom, or recycled into new investments that could target higher financial returns and achieve geographic diversification.

WIAL's planned Capex may require additional capital contribution from the shareholders. Given the lack of balance sheet capacity, it is possible that the Council would not be willing or able to meet any required capital contribution. If the Council did not meet any required contribution, its minority shareholding could be diluted.

Benefits of retained investment

The shareholding in WIAL provides WCC with an additional source of revenue through dividends. In FY23, the Airport has delivered a ~$20m dividend to WCC. WCC will need to consider the impact on rates that any divestment of shares may have, due to lost income compared to any income received from alternative investments.

Divestment Considerations

If WCC considers there is merit in divesting this asset, a prudent next step would be to appoint an M&A advisor to perform a Strategic Review of WCC's minority holding in WIAL. This will provide WCC with clear guidance on what to expect during a divestment process, having regard to:

1) Objectives - Does WCC have specific requirements of a process?
    - Confidentiality
    - Maximising Value
    - Specific Acquirer requirements given public interest in the Airport
2) Timing - Is it the right time to sell?
    - Balance sheet capacity required
    - Macroeconomic / industry / business readiness factors
    - Shareholder agreement planned?
3) Buyer indication - Who would be interested in purchasing?
    - Logical acquirers (e.g. industry/asset experience, meet WCC objectives, logical financial sponsors, iwi, other etc.)
    - Appetite / capacity (recent M&A activity, financial capacity)

Capital recycling opportunities

WIAL

[redacted]

What capital could be unlocked?

WCC's share in WIAL was recorded at a book value of $255m at the end of FY22 [redacted]

We have developed an indicative value benchmark to provide a guide as to a potential range of value for WCC's 34% shareholding.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Capital recycling opportunities

Ground leases

The portfolio of ground leases offers the Council options for resolving short-term burdens and achieving long-term targets. The Council is currently going through a process of reviewing its portfolio of ground leases, and has selected investments for recycling using a preliminary analysis against five criteria. Capital released through rationalisation could be used to capitalise a fund.

1 Quick wins

[redacted]

2 Calculated moves

P&CP is working on a thorough review of ground leases which is expected to identify additional leases that no longer align with WCC's objectives. These could be rationalised in the medium term to provide capital for another investment opportunity.

3 Long-term alignment

Through P&CP's review, it is anticipated that some leases will continue to align to WCC's objectives. WCC would likely retain these sites and look to other sources of capital for alternative investment opportunities.

[redacted]

Reasons to recycle the capital in selected ground leases

Although stable, ground leases generate relatively low cash returns relative to their capital value or potential development value. Many of the leases are only reviewed every 21 years, which means while leases may generate good returns in the early stages of a 21 year cycle, they will often be underperforming from a cash return towards the end of the cycle.

[redacted]

Benefits of holding ground leases

Although a readily available asset for rationalisation, the ground lease portfolio has historically provided the Council with consistent lease revenues and balance sheet benefits from positive revaluations ($214m in 2020 to $246m in July 2023). The portfolio also provides non-financial benefit through some ability to influence the future of Wellington City through redevelopment (albeit limited). [redacted]

Challenges of divestment

Regulatory burdens serve as a barrier to divestment and subsequent development opportunities due to the time and costs in navigating the Council Policy associated with the sale of Council assets. Possible opportunities to develop or redevelop sites are governed by legislative policies such as the District Plan. Consideration may also be needed in regards to any right of first refusal included in lease terms.

[redacted]

01

Appendices

Appendices

Appendix one – Background

Appendix one – Background

Phase two scope

Phase two of this balance sheet review contains two parts. This report comprises part 2(a) of our CSO variation dated 7 June 2023.

Phase 2(a) – Quantification of Options Impact

KPMG would assess the potential impact of pursuing each of two options to assist in alleviating WCC's balance sheet pressure. In assessing the merits of each course of action, we would apply the same criteria that we adopted in Phase 1:

- Strategic alignment and governance
- Funding and financing capacity
- Impact on rates
- Council resilience
- Risk management (*not included in phase one*)

Option 1 – Consider rationalising the WCC investment portfolio

1. KPMG will compile a summary of WCC assets and investments, including indicative estimates of current market value. These will not be formal valuations but rely solely on information held by WCC or other desktop research;
2. Review the current commercial terms of ground lease agreements, which will be a key factor in assessing the market value of those assets;
3. Analyse potential opportunities for asset divestment and quantify the impact in relation to the above criteria;
4. Provide high level analysis of any challenges relating to asset divestments and how these could be overcome; and
5. Consider the uses of divestment proceeds and summarise the relative merits of each potential divestment.

Option 2 – Review insurance & internal covenant settings

1. Meet with the WCC Finance/Treasury team working on insurance arrangements in order to better understand the potential options arising from the work with Aon;
2. Consider the development of a self-insurance / captive vehicle and pros / considerations of this option (potentially in unison with Option 1);
3. Analyse how insurance options are impacted by other actions that may be taken by WCC to relieve balance sheet pressure; and
4. To the extent possible, summarise at a high level potential insurance options and assess the likely impact on balance sheet capacity and WCC resilience.

Appendix two – Detailed analysis of options

Appendix two – Detailed analysis of options

Assessment criteria

	Description	What demonstrates positive impact	What demonstrates negative impact
Strategic alignment & governance	Options should be assessed with consideration to the impact on WCC's values and long-term strategy.	• Works towards WCC's vision of Pōneke, where people and nature thrive. • Allows future Council's to have flexibility in investment decisions. • Enhances prosperity of current and future Wellingtonians.	• Works in contrast to WCC's vision of Pōneke, where people and nature thrive. • Restricts future Councils from have flex bility in investment decisions. • Decreases prosperity of current and/or future Wellingtonians.
Risk management	WCC is facing an increasing level of uninsurable risk by virtue of its asset base and geographical location. Decisions made should enhance risk management.	• Decreases the quantum of uninsured risk. • Diversifies geographical risk exposure away from the Wellington region.	• Increases the quantum of uninsured risk. • Further concentrates geographical risk exposure in the Wellington region.

Supports council resilience	Options should be considered with respect to WCC resilience, including the ability to withstand unexpected environmental or economic events.	• Builds resilience within the council's balance sheet through:
		  • Investment in different asset types;
		  • Investment outside of the Wellington region; and/or
		  • Establishment of new sources of revenue.
			• Erodes resilience within the council's balance sheet through:
			  • Greater concentration by asset type;
			  • Further investment within the Wellington region; and/or
			  • Does not generate new sources of revenue.

Impact on rates	WCC ratepayers are reaching affordability limits. Options should consider the impact on forecast rate increases.	• Rates decrease as a direct result of this decision. • Rates are maintained within affordable levels. • Ratepayer sentiment is positive. • Supplementary levies or taxes which impact ratepayers are reduced or removed.	• Rates increase as a direct result of this activity. • Rates are not maintained within affordable levels. • Ratepayer sentiment is negative. • Supplementary levies/taxes that impact ratepayers are required.
Funding & Financing Capacity	The extent to which an option would likely provide WCC with additional funding and financing capacity whilst minimising additional administrative burden should be considered.	• Decreases the level of debt held by the council. • Increases the future borrowing capacity of the council. • Has little to no additional administrative burden.	• Increases the level of debt held by the council. • Decreases the future borrowing capacity of the council. • Increases administrative burden.

● Positive / High ● Neutral / Medium ● Negative / Low ● Unknown

Detailed analysis of options for rationalisation

Divestment of:	WIAL Shareholding	Portfolio of ground leases	Chaffers Marina	Other land and buildings
Strategic alignment & governance	● Positive With a minority shareholding, the Council has little influence over Airport decision making. WCC's ownership may be further diluted if WIAL requires additional equity for its capital program. WCC may have similar influence over WIAL without holding shares. **Divestment of WIAL shares is likely to increase strategic alignment.**	● Positive The portfolio affords the Council opportunity to have some influence over urban design and property development in Wellington, however, identified "quick win" divestments do not generally have strategic significance for WCC. **Divesting identified leases in the portfolio is likely to increase strategic alignment.**	● Positive There is little strategic rationale for WCC's ownership of the Marina. WCC's ownership requires maintenance payments and prevents decommissioning in the absence of another owner. **Divestment of Chaffers Marina is likely to increase strategic alignment.**	● Positive Other land and buildings are held for lease revenue and/or capital growth. They are not held for strategic purposes or to provide social services. **The divestment of other land and buildings is likely to increase strategic alignment.**
Risk management	● Neutral WIAL manages its own insurance risk. **There is likely to be no change to the level of uninsured risk due to divestment.** However, there remains the risk that in the event of disaster insurance may not fully respond to address the loss of the value of the shares.	● Positive The portfolio of leases lacks geographic diversification and is exposed to natural hazard risk. **WCC is likely to decrease the level of geographical risk through divestment.**	● Positive WCC insures Marina assets for the full replacement value. **Divestment is likely to decrease WCC's level of uninsured risk.**	● Positive Other land and buildings lack diversification and are greatly exposed to natural hazard risk. **WCC is likely to decrease the level of uninsured risk through divestment.**
Supports council resilience	● Positive WIAL is a Wellington based asset and is subject to the same geographical risks as most of the Council's core assets. **Divestment is likely to increase council resilience.**	● Positive The ground leases are all in the Wellington area. **Divestment is likely to increase council resilience.**	● Positive The Marina is in the Wellington area. **Divestment is likely to increase council resilience.**	● Positive Other land and buildings are all in the Wellington area. **Divestment is likely to increase council resilience.**
Impact on rates*	● Negative WIAL provides WCC with dividends. If the WIAL shareholding was sold, revenue would need to be generated elsewhere. **May cause rates increases, depending on whether replacement revenue is generated.**	● Negative Ground leases generate revenue for the Council. Divestment would bring the need for revenue to be lease replaced by other forms of revenue. **This may cause further rates increases, depending on whether replacement revenue is generated.**	● Positive Divestment of the Marina would eliminate any need for contributions to one-off asset renewal and monthly berth costs. **This may limit further rates increases.**	● Negative Other land and buildings generate revenue for the Council, and any such divestment would create the need for new forms of revenue to replace lease revenue. **This may cause further rates increases, depending on whether replacement revenue is generated.**
Funding & Financing Capacity	● Positive Divestment would result in a decrease in net debt due to a cash inflow. Due to asset size, impact is likely to be high. **Divestment is likely to increase funding and financing capacity.**	● Positive Divestment would likely decrease net debt due to a cash inflow. Impact would be dependent on the specific lease(s) sold. **Divestment is likely to free funding and financing capacity.**	● Neutral Due to the limited size, net debt is unlikely to materially change. **Divestment is unlikely to impact funding and investing capacity due to low asset size.**	● Positive Divestment would likely decrease net debt due to a cash inflow. Impact would be dependent on the specific asset sold. **Divestment is likely to free funding and financing capacity.**
Conclusion	**WCC's minority shareholding in WIAL offers an opportunity for divestment, with market appetite for the shareholding likely to be strong.**	**Ground leases present an option for WCC to divest, with P&CP analysis identifying individual sites with favourable outcomes in current market conditions.**	**Chaffers Marina would be a sensible asset for WCC to divest, however, the Council has had difficulty finding a buyer in the past.**	**Other land and building assets appear to make commercial sense for WCC to divest, however, analysis would needed to identify specific assets that are underperforming.**

*Under the assumption of no alternate investment from proceeds of divestment.

● Positive / High ● Neutral / Medium ● Negative / Low ● Unknown

Appendix two – Detailed analysis of options

Detailed analysis of use of proceeds

	Repay	Invest	Spend
Strategic alignment & governance	● Neutral Repayment of debt remedies short-term constraints but fails to deliver additional revenue sources or assets. In itself, repaying debt is unlikely to enhance WCC's vision, although would generate headroom to finance strategic initiatives. It is also unlikely to generate intergenerational wealth. On balance, **strategic alignment & governance is likely to be negatively impacted.**	● Positive Investment of proceeds have the potential to assist in future-proofing the Council's financial position if proper safeguards are put in place upon establishment. Investing may bolster strategic alignment by having greater funds available in the future for the Council to achieve its long-term strategy and ambitions. **Strategic alignment and governance is likely to increase.**	● Neutral The Council is required to spend money to carry out its range of statutory obligations and achieve strategic goals. Spending of any proceeds of divestment may support short term needs, but is unlikely to impact WCC's long term vision. **This option is likely to have a neutral impact on strategic alignment and governance.**
Risk management	● Positive Repayment of debt would mitigate self-imposed headroom constraints and take pressure off of LGFA covenants. Repayment would alleviate some of the financial risk that the Council is exposed to, in particular exposure to interest rate increases and the scrutiny of external credit rating agencies. **Risk management may improve with repayment of debt.**	● Positive Investment into different assets could enhance Council's risk management through diversification of the asset pool outside of the Wellington region. **Risk management is likely to improve with diversified investment across different geographies and/or asset classes.**	● Unknown The impact on risk management would largely depend on the nature of any spending. **The impact of spending on risk exposure is unknown.**
Supports council resilience	● Neutral Repayment does not diversify investment into different assets or geographies, nor does it bring in any new sources of revenue. Although repayment provides short-term relief, it does not support lasting resilience to the Council's financial position. **Repayment is not likely to change council resilience.**	● Positive Investment into different assets or geographies supports resilience in the Council's balance sheet, and protects sources of revenue in lieu of an unexpected environmental or economic event. **Investment is likely to improve council resilience.**	● Negative Spending proceeds dampens the Council's ability to respond to unexpected environmental or economic events. Although spending is a necessary function of the Council, it fails to support resilience at a time when it is needed and proceeds could be better utilised. **Spending is likely to decrease council resilience.**
Impact on rates	● Positive WCC would incur lower interest expenditure, which may lead to lower rates increases in the short term. Long term impacts are uncertain, and any benefit has the potential to be offset by lost revenue if income producing assets are sold. **Repayment may decrease the need for further rates increases.**	● Positive Investment of proceeds into assets that generate greater returns than the Council's current investment portfolio is likely to reduce the need for future significant rates increases. It is, however, worth noting that investment returns may fluctuate. **Investment may decrease the need for further rates increases.**	● Negative Ratepayers are likely to have a negative view on further Council spending when its financial capacity is greatly constrained. Choosing to spend proceeds from divestment is likely to have a negative impact on forecasted rates in a time where ratepayers are already feeling squeezed. **Spending may cause further rates increases.**
Funding & Financing Capacity	● Positive WCC would decrease its level of borrowings, which would increase its financing capacity for future needs. **Funding and financing capacity would increase.**	● Unknown Although investing would not decrease its current level of borrowings, investment revenue may create headroom in the net debt to total revenue covenant for WCC in the future. The impact on funding and financing capacity will be case dependent. **The impact on funding and financing capacity is unknown.**	● Negative Expenditure of proceeds would likely worsen the Council's funding and financing capacity. **Funding and financing capacity would decrease.**
Conclusion	**Repayment of debt is a valid option that could assist in alleviating the Council's short-term constraints.**	**Investment of proceeds is a valid option for the Council to achieve its long-term vision.**	**Spending proceeds on Council services is likely to worsen Council resilience and exacerbate financial constraints.**

● Positive / High ● Neutral / Medium ● Negative / Low ● Unknown

Appendix three - WIAL Analysis

Appendix three - WIAL Analysis

WIAL

WIAL Investment

WCC currently holds a minority shareholding in Wellington International Airport (WIAL). WCC's share in the airport is 34%, which was valued at $255 million at the end of FY22.

[redacted]

Divestment from WIAL has been considered before

WCC previously indicated appetite to review its investment in WIAL to determine if there was the opportunity to realise more value through divestment and using the proceeds to either offset borrowings or reinvest in assets with a better financial return[1].

In October 2021, the previous Council voted to keep its minority share in WIAL during its review of the Council's investment portfolio[2,3].

Arguments in favour of selling the Airport shares were WCC's lack of diversity, and its climate ambitions. Arguments for holding the minority investment included the opportunity to actively engage with assets contributing to climate change; however, the Council's minority shareholding means it already has little control over operational decisions.

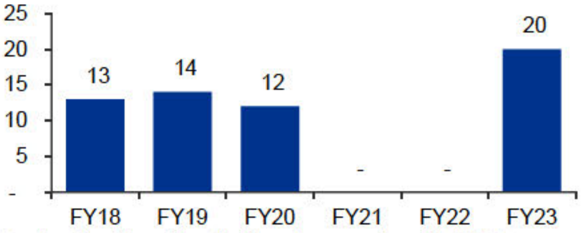
Similar arguments were raised in response to Auckland Council's proposed divestment from Auckland Airport: to avoid further rates increases or expenditure cuts.[4]

Why should WCC revisit the option of divestment from WIAL?

Since the 2021 vote, no alternative option to free up balance sheet capacity has been pursued, and there are limited options available. The balance sheet position has subsequently eroded, and maintaining a minority shareholding may be at the expense of the Council's desired capital projects and the ability to react to a shock event.

Over the ten years to 2019, WIAL paid a total of $120.5m in dividends to WCC. WIAL did not pay dividends in FY21 or FY22 due to COVID-19; however, has delivered a ~$20m dividend to WCC in FY23.

Dividend income from WIAL (NZ$'m)



During the time the dividend was not paid, WCC was required to draw additional Debt totalling c.$50m in order to compensate for the missing income, to avoid increasing rates.

Additional capital contributions may be required for future airport Capex. Failure to contribute may result in WCC's shareholding being further diluted in favour of Infratil.

An assessment of return on equity (ROE) shows that WIAL has historically provided a lower return on equity than other airports in New Zealand, noting that this is on the full airport and not WCC's share.

Return on equity

	FY18	FY19	FY20	FY21	FY22
Wellington International Aiport	4.2%	3.9%	4.5%	(5.3%)	0.4%
Auckland International Airport	11.4%	8.7%	2.9%	5.9%	2.4%
Christchurch Airport	8.7%	5.5%	4.4%	3.2%	4.3%

WCC also must consider its emissions exposure through its investment in WIAL, and determine how this interacts with its net zero ambitions.

---

[1] 2021-31 Long Term Plan (LTP) Volume two | Wellington City Council

[2] Wellington International Airport Limited Shareholder Proposal | Wellington City Council

[3] Wellington City Council votes to keep ownership of international airport | Stuff

[4] Auckland Council: To sell or not to sell – the airport shares | NZ Herald

Source: Wellington City Council Annual Report FY22; Auckland, Wellington and Christchurch airports Annual Report.

Appendix four - Ground Lease Analysis

Ground lease summary

The portfolio of ground leases continue to provide the Council with stable lease revenue and balance sheet benefits from positive revaluations. However, the nature of the long-term lease arrangements pose barriers to the Council maximising lease revenue. The recycling of capital tied up in ground leases may help to alleviate tightening balance sheet constraints.

Overview

- The Council's investment property portfolio is predominantly made up of perpetually renewable ground leases, typically with 21-year renewable terms.
- Ground lease holdings consist of 63 properties. The majority are situated within the Wellington CBD, with interests also in the wider Wellington area.
- As per WCC's July 2023 Ground Lease Disposal 2023 Review, the portfolio has a total market value of $246m and provides the Council with annual revenue of $9.8m.
- The nature of ground lease terms means that rent reviews traditionally only occur upon renewal of the lease, thus restricting the ability to negotiate with lessees and align rent rates with market levels. Infrequent rent reviews usually lead to significant variance in seller and buyer prices in negotiations.
- The majority of WCC's investment assets are directly influenced by the performance of the Wellington CBD. The ground lease portfolio is exposed to financial and natural hazard risks.

Strategic recycling of capital in WCC's ground leases

- Recycling of capital in identified ground lease assets allows for realisation of one-off value and avoids unnecessary future risk exposure. Due to the nature of the portfolio and the income that leases provide, benefits of a sale against retainment of sites must be considered.
- The ground lease portfolio offers the Council an opportunity to influence the shape and future of Wellington through development. However, given existing financial constraints, the Council should consider whether it is best placed to develop sites and whether funding is better deployed elsewhere.

Home is where the heart is

- Ground lease assets are attractive prospects for incumbent lessees and large investment funds.

[redacted]

- When the Council is assessing the value of the asset, consideration should be given not only to the financial aspect of the offer but also to the intended outcome sought by purchaser – as this is likely to be the lasting effect on the people of Wellington.

Market outlook

- Changing market dynamics, specifically rising interest rates and inflation, have tempered activity in property markets. Once interest rate declines are imminent, the expectation would be to see more buyers and sellers finding a logical middle ground.

[redacted]

[1] https://www.cbre.co.nz/insights/articles/wellington-market-outlook-2023

Assessment of the WCC ground lease portfolio (1/2)

Stable returns and infrequent reviews characterise the Council's ground lease portfolio. A qualitative analysis of the portfolio could be undertaken to identify whether specific sites, or the portfolio as whole, align with the Council's long term ambitions as per the LTP.

What is the current portfolio position?

WCC's ground lease portfolio, primarily located in the Wellington CBD, has historically provided the Council with consistent lease revenues and balance sheet benefits from positive revaluations ($214m in 2020 to $246m in July 2023). Ground leases are relatively low-risk assets that have minimal carrying costs. The land parcels held as investments are leased to external parties, rather than being utilised by WCC.

The majority of the portfolio are on perpetually renewable terms that are subject to 21-year lease cycles and, therefore, rent reviews traditionally only occur upon renewal of the lease. The current return of the portfolio hovers at around 4% per annum. Annual income per the WCC Property & Capital Projects' (P&CP) July 2023 review is $9.82m. Although stable, the returns are modest and remain difficult to influence due to the structure of lease terms, meaning there is no adjustment for inflation on a timely basis.

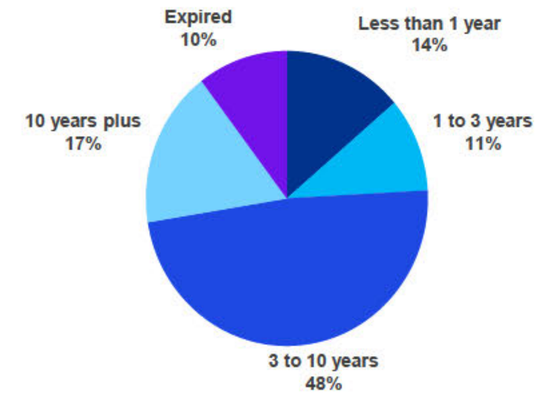
Rent reviews

The majority (84%) of the portfolio are on 21-year rent reviews, with the remainder ranging from 3-year to 63-year terms. Long-term leases have the potential to disadvantage both lessor and lessee, particularly in the case of land used for residential purposes. The lessor loses out on income from infrequent rent reviews, and a lessee must face a large jump in rent upon review.

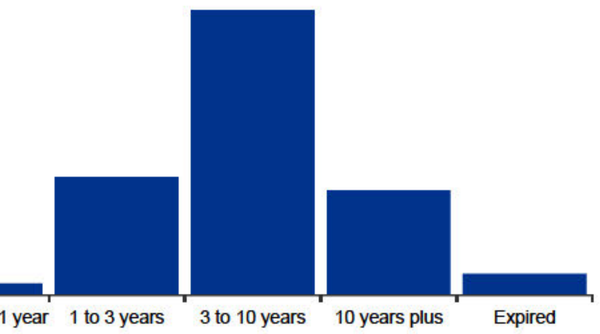
Market forces stemming from the Covid-19 pandemic have made predicting the property market and the ensuing valuations a difficult task. For this reason, land values and their commensurate lease prices are likely to fluctuate, making fair market rentals difficult to quantify.

21% of the portfolio by value is due for a rent review in the next three years increasing to 79% in the next ten years. The value received for the lease upon rent review will be materially influenced by its position in the renewal cycle. New leases are likely to be repriced to market values, resulting in higher property values. Market uncertainty has the ability to significantly impact long-term forecast income returns and property value.

Ground leases by year to renewal



Ground lease portfolio value by year to renewal



Sources: *FY20 Annual Report*, P&CP May 2023 Ground Lease Review, P&CP Ground Lease Disposal Review July 2023

Assessment of the WCC ground lease portfolio (2/2)

Commercial treatment

Council revenues from investment properties are primarily from ground leases. Investment properties exclude those properties held for strategic purposes or to provide a social service. This includes properties which generate cash inflows as the lease revenue is incidental to the purpose for holding the property. The Council's social housing assets are an example of the types of properties excluded. For this reason they are held within operational assets in property, plant and equipment.

Certain ground leases on the waterfront and within the central city have, for accounting purposes, been treated as sold assets due to the very long-term nature of the lease and peppercorn rentals. At a future point in time, prior to the asset being returned to the Council ownership, the Council will begin to incrementally re-recognise the value of the asset. The amortisation of the estimated future value will reflect the prevalent economic situation and will be more relevant in terms of both the estimated value and materiality.

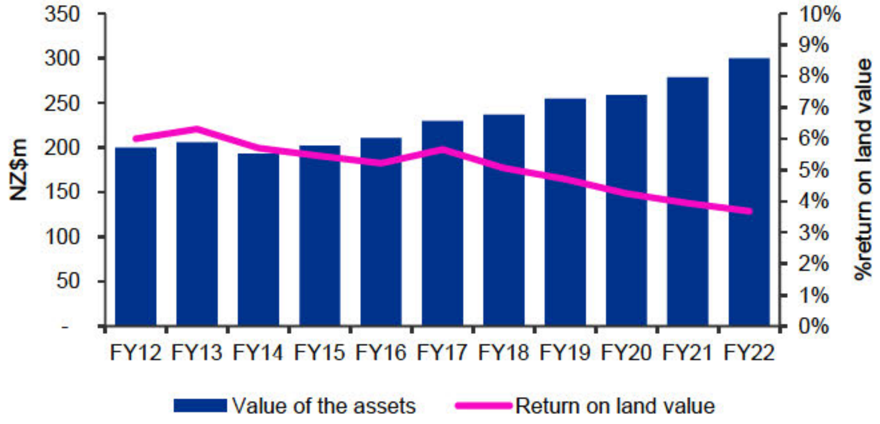
The basis of valuation varies depending on the nature of the lease. For sites that are subject to a terminating lease the approach is to assess the value of the lease revenue over the remaining term of the lease and add the residual value of the land at lease expiry. For sites subject to perpetually renewable leases, values have been assessed utilising a discounted cash flow and arriving at a net present value of all future anticipated gross lease payments. Borrowing costs incurred during the construction of investment property are not capitalised.

Commercial divestment

The 2021 Financial and Infrastructure Strategy stated Council's target was to achieve an average return over time greater than its long term cost of funds for non-strategic assets. The Council's longer term cost of funds is likely to have grown in line with increases in borrowing costs. Returns from the investment property portfolio are declining relative to the longer term cost of funds and capital employed.

Justification for capital recycling sits within WCC's Investment and Liability Management Policy. Under this policy, the Council, *"where appropriate, … may choose to dispose of investments/financial assets that no longer meet [its] investment objectives."** Ownership of properties subject to long-term ground leases generally provides a declining return on land value when rent reviews occur relatively infrequently. Long-term lease structures, such as WCC's 21-year renewable period, restrict the ability to align rent rates market levels when land values increase.

Investment property return on land value



Redevelopment

[redacted]

An analysis of specific sites suited to divestment has been undertaken by P&CP and this is presented on page 15.

Sources: P&CP May 2023 Ground Lease Review, *FY22 Annual Report*

**Investment and Liabilities Management Policies (wellington.govt.nz)*

Issues with ground leases

Long-term lease structures and infrequent rent reviews limit the control that the Council is able to exercise over its portfolio of ground leases. Although this structure prevents against significant downside loss in asset value, the undiversified nature of the Council's investment assets leaves the Council exposed to a number of risks.

What risk does the ground lease portfolio expose the Council to?

Financial risk

The nature of WCC's ground leases being largely based on 21-year perpetually renewable terms opens up multiple financial risks. The infrequency of rent reviews means short-term appreciations in land value aren't encapsulated, and cash flows are inhibited until the next review.

There is plenty of uncertainty that exists around the future of the property market. Higher interest rates are likely to have a negative impact on land values, and the RBNZ expects the OCR to remain stable at its current elevated level well into 2024.

Further risk exists in the forecasted demand for office space in the CBD on account of employee preference to work from home, compounded by the growing insurance premiums exhibited in Wellington.

There is also the opportunity cost that exists on account of the recycling of capital into assets that offer a greater financial return.

Legislative and regulatory risk

Revenue growth remains stagnant due to the length of lease terms and is only influenced by inflation. The Council are constrained in their ability to influence or change the terms of future leases on account of the Wellington City Leasing Act 1904.

Despite WCC indicating its appetite to review investments in the portfolio, any opportunities to develop or redevelop sites are governed by legislative policies such as the District Plan. There may also be the right of first refusal in some instances.

Natural hazard and environmental risk

WCC's high concentration of ground leases exposes them to significant and worsening natural hazard risk. Events such as an earthquake or flooding due to rising sea levels carry the potential for significant damage to these assets. Full recoverability of assets may not be possible due to a lack of insurance cover. Ground leases contribute a small amount to the Council's asset value insured. However, the greatest loss to the Council would come from the loss of income from lessees if the buildings on ground leases are damaged in an event.

Wellington as a City is facing increasing insurance premiums on account of its seismic risk, which are expected to drive down annual returns. The release of the NSHM has further worsened the PML of Council assets. WCC is facing issues over their current insurance cover (including self-insurance) being insufficient to cover the damages incurred by a large environmental event.

What are the drawbacks of the current leasing framework?

Some of WCC's ground lease assets generate sub-par returns relative to their capital value or potential development value. The return of the portfolio of 4% per annum is stable, but the Council misses out on potential income on account of the majority of market rent reviews only occurring upon the renewal of the lease.

Long-term lease structures, such as WCC's 21-year perpetually renewable terms, restrict the ability to align rent rates with market levels when land values increase in the short term. This is complicated when considering that market rates are not guaranteed to increase moving forward. As the bulk of WCC's leases do not have a ratchet provision, there is no protection against potential rent reductions in future review cycles.

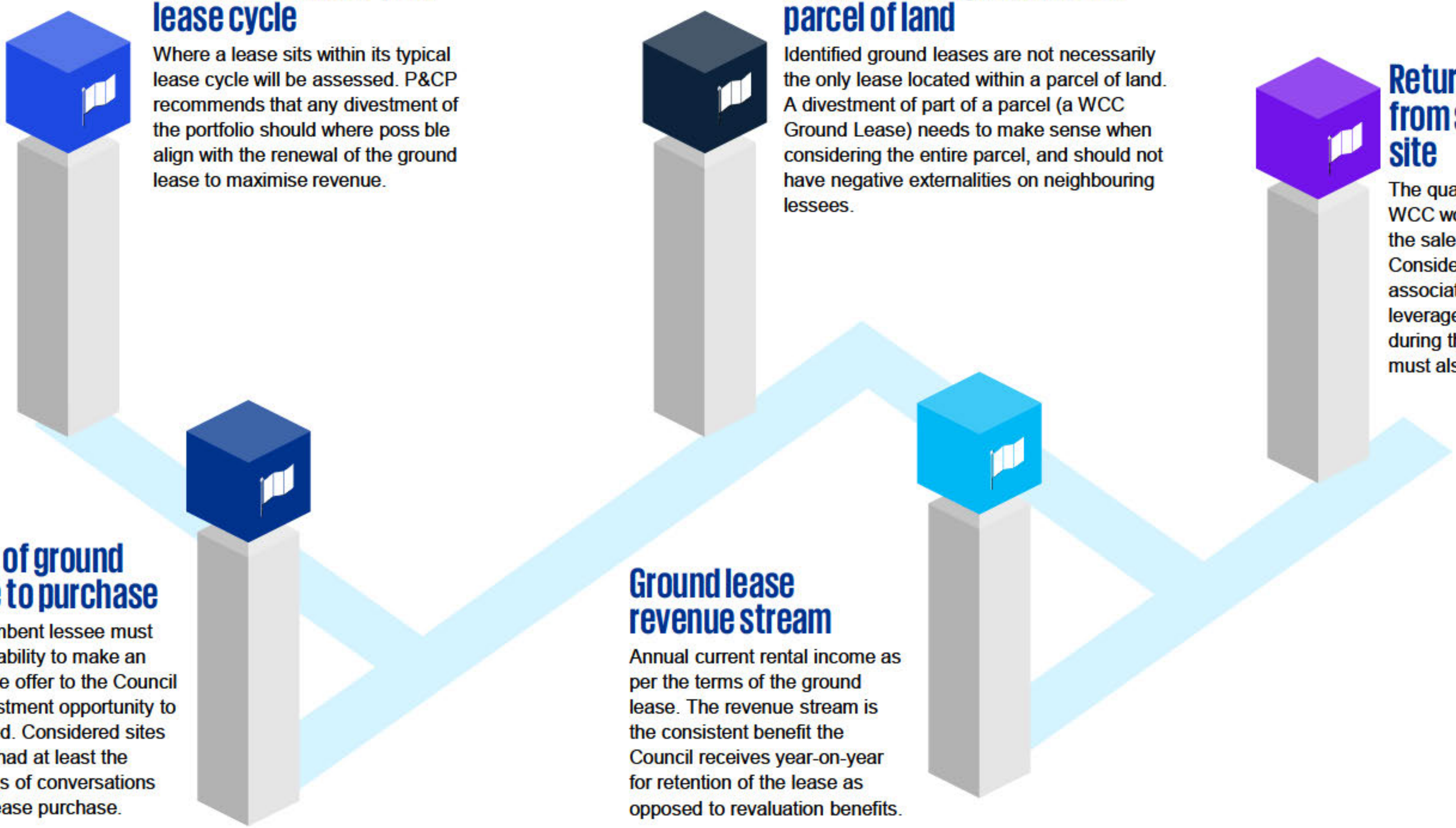
[redacted]

Some current lessees have the first right of refusal on their lease. Ground leases provide tenants with a more affordable way for them to own their premises in comparison to freehold. However, infrequent rent reviews usually result in ballooning lease payments, meaning tensions between lessor and lessee can occur.

Source: *WCC Draft Ground Lease Portfolio Review (2021)*

Short-term divestment analysis

Options identified by P&CP for a first tranche of short-term divestment were selected on a preliminary analysis against five criteria.



Position within 21-year lease cycle

Where a lease sits within its typical lease cycle will be assessed. P&CP recommends that any divestment of the portfolio should where possible align with the renewal of the ground lease to maximise revenue.

Impact on the ground lease parcel of land

Identified ground leases are not necessarily the only lease located within a parcel of land. A divestment of part of a parcel (a WCC Ground Lease) needs to make sense when considering the entire parcel, and should not have negative externalities on neighbouring lessees.

Return of capital from sale of the site

The quantum of capital that WCC would receive upon the sale of a lease. Consideration for the costs associated for potential leverage and negotiation during the sales process must also be considered.

Ability of ground lessee to purchase

The incumbent lessee must have the ability to make an acceptable offer to the Council for a divestment opportunity to be realised. Considered sites will have had at least the beginnings of conversations about a lease purchase.

Ground lease revenue stream

Annual current rental income as per the terms of the ground lease. The revenue stream is the consistent benefit the Council receives year-on-year for retention of the lease as opposed to revaluation benefits.

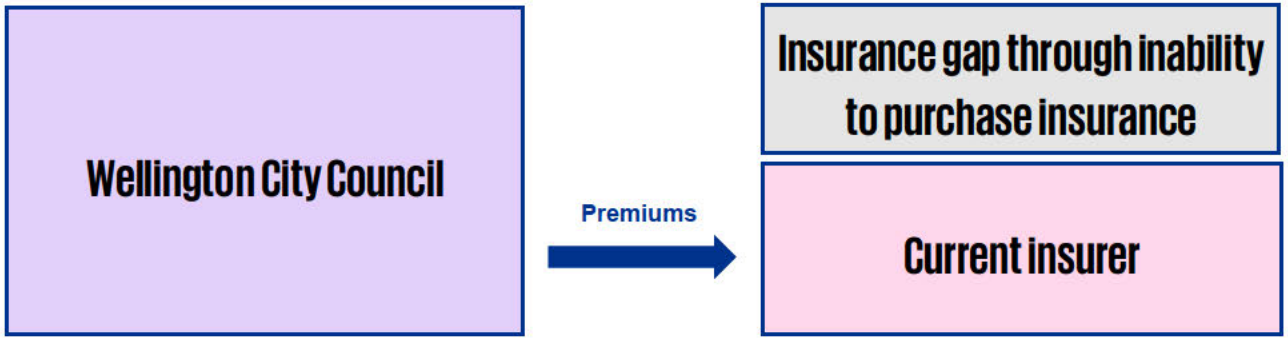
[redacted]

[redacted]

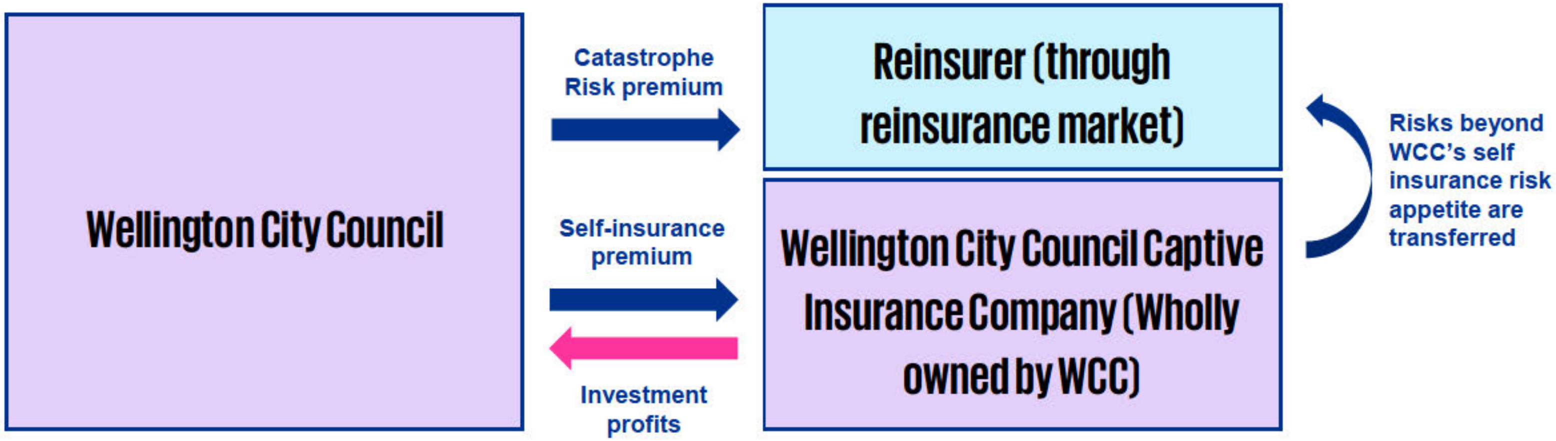
Appendix five – Insurance

How could captive insurance work for WCC?

Current insurance Model:



A basic captive insurance model:



Captives insurance guide: everything you need to know | Lockton

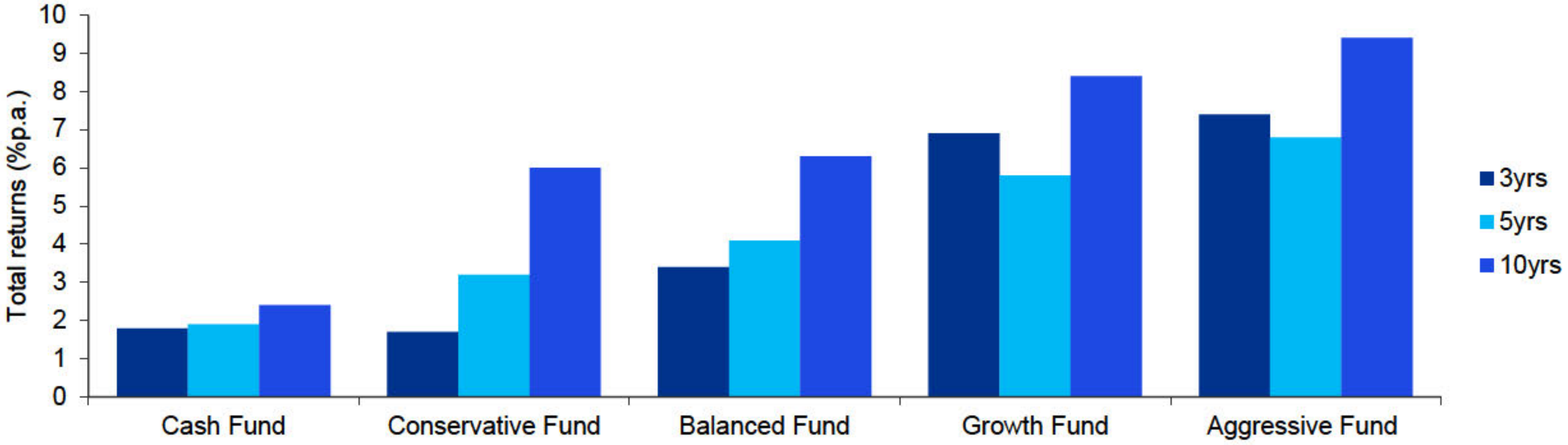
Appendix six – Investment funds

Appendix six – Investment funds

KiwiSaver Returns

We have looked at various KiwiSaver fund returns and considered them as a proxy for potential returns for a Council investment fund. Suitability will be dependent on the size of the investment available and desired investment objectives.

Average annual returns of various Kiwisaver schemes



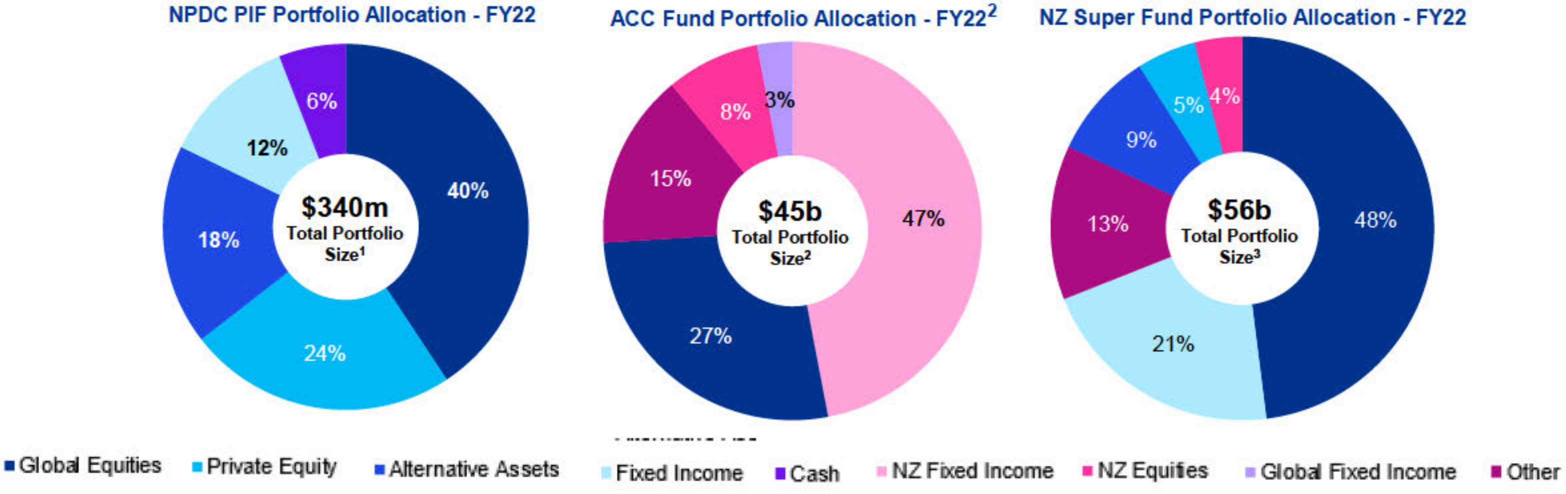
KiwiSaver Fund	Provider	Risk Tolerance	Size ($bn)	Asset Allocation	Average Annual Returns (over last 3yrs/5yrs/10yrs)
Cash Fund	ANZ New Zealand Investments Limited	Low	1.052	100% Income assets (cash and cash equivalents)	1.8% / 1.9% / 2.4%
Conservative Fund	Milford Investments Limited	Low	1.350	82% Income assets: 18% Growth assets	1.7% / 3.2% / 6.0%
Balanced Fund	ANZ New Zealand Investments Limited	Moderate	3.379	50% Income assets: 50% Growth assets	3.4% / 4.1% / 6.3%
Growth Fund	ANZ New Zealand Investments Limited	High	4.705	20% Income assets: 80% Growth assets	6.9% / 5.8% / 8.4%
Aggressive Fund	Generate Investment Management Limited	High	2.159	5% Income assets: 95% Growth assets	7.4% / 6.8% / 9.4%

Sources: KiwiSaver Survey – June 2023 (cdn.morningstar.com.au)
KiwiSaver (anz.co.nz)
KiwiSaver and Performance (milfordasset.com)
KiwiSaver (generatewealth.co.nz)

Public Agency Investment Approaches

Further breakdown of the investment portfolios outlined on page 10.

	New Plymouth District Council PIF	ACC Impact Fund	NZ Super Fund
Investment objectives and return target	- Primary objective is provide sustainable Council revenue, which is to help offset rates. - To maintain a long term sustainable level of real capital of the PIF, for current and future generations. - Return target of 3.3% p.a. + CPI + management costs (measured on a rolling five year basis).	- To provide liquidity that can meet injury claims. The investment income ensures that ACC can continue to provide future coverage without needing to increase levies. - Preference for long-term investments that deliver relatively certain income streams for long periods of time. This is to meet its cash flow needs. - To actively manage the portfolio with the objective of gaining better risk-adjusted returns than investing passively. - Return target of 0.3% above ACC's market based benchmark portfolio.	- To maximise returns without undue risk to the portfolio as a whole, and focus on managing the NZ Super Fund in line with global best practice. - To employ strategies based on their long time horizon and low liquidity requirements. - Expectation to outperform NZ Super Fund's Reference Portfolio by 1% p.a. (which since inception, has a return of 8.02% p.a.).
Constraints	- To maintain strategic asset allocations. - Funds to be distributed quarterly, with pay-outs based on a release payment policy which seeks to balance the fund's benefits between current and future generations.	- Must meet the number of claims each year. - Investment guidelines use credit, exposure and markets risks to mitigate liquidity and other trading risks as well as the amount of leverage across investments.	- N/A
Benchmark(s)	- Benchmark target of 3.3% p.a. + CPI + management costs (measured on a rolling five year basis).	- To achieve a return after costs of 0.3% above ACC's market based benchmark portfolio.	- To exceed NZ 90-day Treasury Bills + 2.8% p.a. (before tax) over any 20 year moving average period. - Its bespoke reference portfolio.
Estimated risk tolerance	High	Low	High



---

[1] Council controlled organisations (npdc.govt.nz)

[2] Our impact investment funds (acc.co.nz), acc8430-acc-annual-report-2022.pdf note that the impact fund is unable to be assessed on a standalone basis, and this represents ACC's full investment portfolio allocation.

[3] Annual reports (nzsuperfund.nz)

Appendix seven – WIAL Indicative Value Range

[redacted]

[redacted]

[redacted]

[redacted]

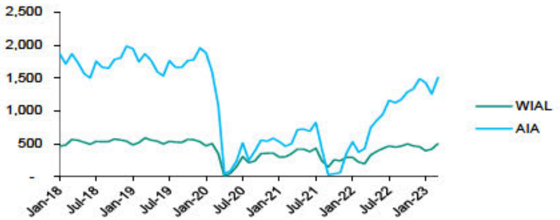
[redacted]

WIAL Operational summary

WIAL operations

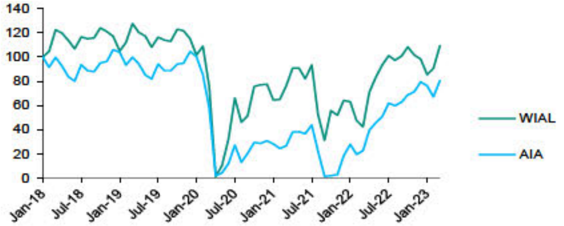
- WIAL has rebounded strongly post-COVID-19. Compared to Auckland airport ("AIA"), its most comparable company, WIAL has seen passenger numbers recover at faster rate relative to the base period of January 2018.
- Passenger numbers for domestic passengers have returned to 90%[1] of pre-pandemic levels while passenger numbers for international passengers have returned to 61%[1] of pre-pandemic levels as at 31 March 2023.
- All pre-pandemic airlines have returned to Wellington, except for Singapore Airlines and Virgin Australia who have not signalled when or if a return may take place.
- WIAL's faster recovery compared to AIA has been driven by a larger domestic passenger base and proportion of aeronautical revenue.

Passenger numbers (000's)



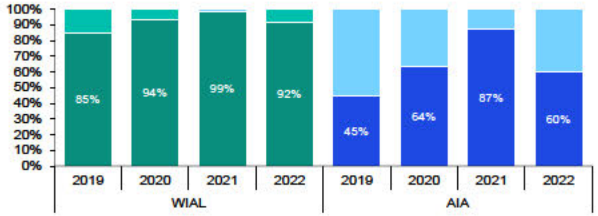
Source: Air traffic monthly reports for AIA and WIAL

Passenger numbers relative to base month (100)



Source: Air traffic monthly reports for AIA and WIAL

Domestic passengers/Total passengers (%)



Source: Air traffic monthly reports for AIA and WIAL

[redacted]

1: WIAL FY23 Annual Report

WIAL Financial overview – Financial performance

Financial performance

- The table opposite summarise WIAL historical financial performance for the last five years.
- The majority of WIAL's revenue is generated from aircraft movement and terminal charges, making up over 50% of total revenue for each of the last five financial years. The exception being FY21 (49%) where WIAL suffered a 53% reduction in revenue as a result of the COVID-19 pandemic.
- WIAL's other revenue streams include retail concession fees, hotels and other trading activities (34% of FY23 total revenue) and property rent and lease income (11% of FY23 total revenue).
- Employee remuneration and benefits ($15.3m) is WIAL largest expense comprising ~ 30% of total expenses. Amongst operating expenses, the most significant are rates and insurance ($11m), cleaning and energy ($3.2) and repairs and maintenance ($2.4).
- Post-pandemic, EBITDAF has grown in line with the recovery in passenger numbers, up 58% to $89.6m in FY23.
- Based on forecasts sourced from Standard & Poors, earnings are expected to reach FY20 levels in the next year (FY24) with S&P's debt rating for WIAL forecasting EBITDA of $95-$105m.

WIAL statement of financial performance

NZ$m 31 march year end	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24 Forecast**
Revenue						
Aircraft movement and terminal charges	81.5 [1]	80.8	34.0	54 3	77.3	
Retail and trading activities	43.5 [1]	52.1	22.1	27.4	46.8	
Property rent and lease income	12.9 [1]	13.5	12.7	13 8	15.7	
Total revenue	137.9 [1]	146.4	68.8	95 6	139.8	148.1 [2]
EBITDAF	101.4 [1]	103.2	36.0	56 8	89.6	100.0 [2]
Key Metrics						
Revenue growth %	7%	6%	(53)%	39%	46%	6%
EBITDAF growth %	6%	2%	(65)%	58%	58%	12%
EBIT%	8%	(4)%	(91)%	281%	129%	
EBITDAF %	74%	70%	52%	59%	64%	

Source [1]: Historical figures are from WIAL annual reports

Source [2]:Midpoint forecast EBITDA range ($95m - $105m) from S&P Global Ratings Research WIAL dated 16 October 2022

Note: EBITDAF refers to earnings before interest, tax, depreciation, amortisation, change in fair value of financial instruments, impairments, gain/(loss) on sale of assets and subvention payment on sale of assets and subvention payment

Financial overview – Historical financial position

Historical financial position

- The table opposite summarises WIAL historical statement of financial position over the last five years.
- Property, plant and equipment ("PP&E") has increased in each of the last five years. Pre-pandemic this was largely due to high capital expenditure of $72m and $81m in FY19 and FY20. However post-pandemic, as large amounts of capex has been deferred and capital expenditure has decreased substantially ($13m in FY22 and $42m in FY23), the increases in PP&E mostly reflect positive movements in asset revaluation.

WIAL historical statement of financial position

NZ$m 31 march year end	FY19	FY20	FY21	FY22	FY23
Current assets					
Cash and cash equivalents	20.3	15 6	30.8	27.3	112.7
Short-term deposits	-	-	50.0	15.0	-
Short-term investments	-	-	-	-	14.1
Receivables	17.9	14.1	10.0	6.8	13.9
Prepayments and sundry receivables	5.8	5.4	5.6	6.9	7.5
Current tax asset	-	-	0.5	-	-
Total current assets	43.9	35 0	96.8	56.0	148.2
Non current assets					
Property, plant and equipment	1,127.0	1,206.4	1,292.9	1,359.1	1,502.8
Investment properties	86.6	92.1	97.0	108.1	132.2
Sundry receivables	-	-	-	5.9	8.7
Derivative financial instruments (non-current asset)	2.9	38.4	9.0	1.6	8.9
Total non current assets	1,216.6	1,336 9	1,398.9	1,474.7	1,652.6
Total assets	1,260.5	1,372 0	1,495.7	1,530.7	1,800.7
Current liabilities					
Trade and other payables	2.0	1 6	1.4	2.6	3.0
Current tax payable	17.5	15.1	-	0.4	8.0
Accruals and other liabilities	16.4	13 6	10.2	11.4	15.3
Accrued employee benefits	4.0	3 8	1.1	3.3	3.8
Derivative financial instruments (current liability)	-	-	0.3	-	-
Loans and borrowings (current liability)	75.0	55.0	105.0	-	75.0
Current liabilities	115.0	89.2	118.0	17.6	105.1
Non current liabilities					
Deferred taxation	125.9	97.9	101.9	128.1	137.7
Lease liabilities (non-current)	-	10.7	10.5	10.3	33.9
Derivative financial instruments (non-current liability)	10.9	17.4	12.2	2.4	-
Other Liabilities	-	-	-	-	21.0
Loans and borrowings (non-current liability)	405.1	515 9	580.7	621.7	625.4
Total Non current liabilities	541.9	641 8	705.3	762.5	818.0
Attributable to shareholders	603.7	640 9	672.5	750.6	877.6
Total equity	603.7	640.9	672.5	750.6	877.6
Total equity and liabilities	1,260.5	1,372.0	1,495.7	1,530.7	1,800.7
Net debt	470.8	572 6	617.4	581.8	573.6
Leases	-	10.7	10.5	10.3	33.9

Source: WIAL Annual Reports

Appendix seven – WIAL Indicative Value Range — Valuation exhibits

Sources of information

Information provided

[redacted]

- WIAL annual and half-yearly reports 2019-2023
- Infratil annual and half-yearly reports 2019-2023

[redacted]

- Wellington monthly air traffic reports 2019-2023
- Auckland monthly air traffic reports 2019-2023
- Standard & Poors Global Ratings Research Wellington International Airport Limited, dated 16 October 2022

Appendix eight – Other

Out of scope: Sale and leaseback of property assets

Asset revaluations, worsening seismic evaluations and increases in insurance premiums mean WCC could be in a position where some assets may become uninsurable and/or unable to be rebuilt following an event. One further option to alleviate this, which has not been considered in this work, is the sale and leaseback of key assets (e.g. venues) that would reduce the cost and balance sheet burden of asset ownership.

Sale and leaseback transactions are arrangements in which the holder that sells an asset can lease back that same asset from the purchaser. Sale and leasebacks offer an alternative method of funding for organisations, like the Council, that are unable to take on more debt.

The Council is dictated by policy to be the natural owner and guardian of critical infrastructure such as roads and the three waters. Local Government legislation gives Councils the power to establish facilities which "provide for the recreation, amusement and instruction of the public."[1]

Sale and leasebacks will not bring an end to services being provided to the communities they serve. Similar transactions have happened in the NZ commercial sector; with companies such as Visy and Toll NZ going on to reinvest capital into their businesses.[2] The Council could explore this option further.

Key Considerations

01

Cultural significance

Weighting given to the role a site plays in the lives of Wellingtonians and the esteem of being categorised as a historical place in NZ.

02

Up front benefit against higher annual costs

Evaluation of the one-time revenue from sale against the cost of leasing. Lease payments may be greater than current maintenance costs, but these costs are continuing to rise.

03

Transfer of risk

Leasing provides budget certainty through predictable lease payments whilst transferring the Council's risks of owning the buildings – notably unexpected costs or natural hazard repair.

04

Position in the market cycle

Market conditions dictate lease costs in a lease agreement. As a leaseback is likely to have a very long or perpetual lease terms, minimising expected annual costs would be a priority.

---

[1] Library Policy (wellington govt nz)

[2] https://www.stuff.co.nz/business/300429715/the-38-billion-property-opportunity-in-new-zealand

Disclaimers

Inherent Limitations

This report has been prepared and is delivered by KPMG, a New Zealand partnership (KPMG, we, us, our) subject to the agreed written terms of KPMG's Consultancy Services Order with Wellington City Council (Client, you) dated 27 January 2023 and CSO variation dated 7 June 2023 (Engagement Contract).

Unless stated otherwise in the Engagement Contract, this report is not to be shared with third parties without KPMG's prior written consent. However, we are aware that you may wish to disclose to Councillors elements of any report we provide to you under the terms of this engagement. In this event, we will not require Councillors to sign any separate waivers.

The services provided under our Engagement Contract (Services) have not been undertaken in accordance with any auditing, review or assurance standards. The term "Audit/Review" used in this report does not relate to an Audit/Review as defined under professional assurance standards.

The information presented in this report is based on that made available to us in the course of our work/publicly available information/information provided by Wellington City Council Management. We have indicated within this report the sources of the information provided. Unless otherwise stated in this report, we have relied upon the truth, accuracy and completeness of any information provided or made available to us in connection with the Services without independently verifying it. Nothing in this report constitutes legal advice or legal due diligence and you should not act upon any such information without seeking independent legal advice.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, Wellington City Council management and personnel consulted as part of the process.

In relation to any prospective financial information/forecasts/projections included in the report, we do not make any statement as to whether any forecasts or projections will be achieved, or whether the assumptions and data underlying any such prospective financial information/forecasts/projections are accurate, complete or reasonable. We do not warrant or guarantee the achievement of any such forecasts or projections. There will usually be differences between forecast or projected and actual results, because events and circumstances frequently do not occur as expected or predicted, and those differences may be material.

This report was based on information available at the time it was prepared. KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

Third Party Reliance

This report is solely for the purpose set out in the Consultancy Services Order dated 27 January 2023 and for Client's information, and is not to be used for any other purpose or copied, distributed or quoted whether in whole or in part to any other party without KPMG's prior written consent.

Other than our responsibility to Client, none of KPMG, any entities directly or indirectly controlled by KPMG, or any of their respective members or employees assume any responsibility, or liability of any kind, to any third party in connection with the provision of this report. Accordingly, any third party choosing to rely on this report does so at their own risk.

Additionally, we reserve the right but not the obligation to update our report or to revise the information contained therein because of events and transactions occurring subsequent to the date of this report.

KPMG

The contacts at KPMG in connection with this report are

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

kpmg.com/socialmedia

Document Classification: KPMG Confidential