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Report to the Utility Services Committee
from David Benham, Divisional Manager, Utility Services
and Greg Schollum, Chief Financial Officer

Water Levy – 1999/2000

1. Purpose

To assist in setting the water levy for 1999/2000, this report:

- backgrounds the various associated issues
- reviews the Citys' and Mayors' submissions, and
- provides various levy options, and details the impacts of those options.

2. Background

The Council, when approving the proposed Bulk Water Levy on 18 March 1999 resolved:

(2) That the bulk water levy for 1999/00 remains at the same level as the 1998/99 financial year.

(3) That the Proposed Long-term Financial Strategy for Wholesale Water Supply, incorporating the 1999/00 Proposed Annual Plan be approved for inclusion within Facing the Future 1997-2007: 1999 update.

(4) That Council immediately discuss, with the four City Council customers, the issues associated with setting the levy.

Subsequently presentations outlining the various issues were made to all four city councils. Since then, submissions have been received from each city council and a joint submission received from the four mayors of those cities. Councillors have now had the opportunity to hear oral submissions from representatives of the city councils and to review background notes prepared for the Policy and Finance Subcommittee by the undersigned.

3. Comment

Generally the issues fall into two categories:

- water surpluses and efficiency gains and
- debt repayment.

3.1 Water Surpluses and Efficiency Gains

As outlined earlier in our responses to the various submissions, in our view, any implementation of operational changes must be brought in, in a careful and prudent manner. This is particularly important in a vital utility like water delivery where the drive to save the last dollar could have disastrous implications. Our approach has been deliberate and carefully planned. Further, some of the changes implemented take some time to deliver the financial benefits, some programmes require expenditure up front to deliver savings later and some of the savings may not be permanent, or are one-off.

Some of the operational changes we refer to have been implemented in the following areas but will inevitably involve some degree of risk, hence the need for considerable care:

- Staff restructuring and changes to work practices (e.g. reduction in 44 hour week to 40 hour week)
- Further automation of treatment plants
- Optimisation of treatment plant performance
- Electricity usage optimisation
- Chemical usage optimisation
- Improved profitability of Laboratory and Engineering Consultancy Group

The savings from such changes are not always immediately known and can take some years to filter through but clearly the savings and efficiencies are now emerging from a range of efficiency initiatives undertaken in recent years. We expect further cost savings to emerge over time.

However there are also areas where we face increased costs. For example, we have had to place greater emphasis on catchment management in order to protect the raw water supply.

Some may argue this approach is too conservative. We believe it is appropriate given our type of business and the relatively high levels of debt currently carried by the wholesale water activity.

The budgeted and actual improvement in the financial performance of the water operation is as follows:

	1996/97 Budget $000	**1997/98 Budget $000**	**1998/99 Budget $000**	**1999/00 Budget $000**
Revenue				
Levy	25,218	25,218	25,218	25,218
Other Income	973	1,045	1,358	1,101
	26,191	26,263	26,576	26,319
Expenses				
Direct and indirect expenditure	12,958	13,410	12,634	12,162
Financial Costs	8,492	7,101	6,847	5,832
Depreciation	3,959	4,121	4,407	4,553
	25,409	24,632	23,888	22,547
Operating Surplus	**782**	**1,631**	**2,688**	**3,772**

	Actual	**Actual**	**Forecast**
Operating Surplus	**1,825**	**3,739**	**4,300**

As can be seen, the budgeted surplus has been steadily moved upwards as the savings have accrued. While the actual surplus for each year has exceeded the budgeted surplus by some margin the following year's budgeted surplus has reflected some of those gains – about $1 m improvement each year. All surpluses above budget have then been applied to debt repayment. That policy has moved the net debt in 1997 of $72.6 m to a projected position at June next year of $63.5 m with projections of being debt free in about 12 years time. This is a $3 m per annum saving in operational and financial costs – a 12 percent reduction in budgeted costs in the last 2 – 3 years. The compounding effect of using surpluses to repay water debt is clearly evident in the projections, which means the benefit of the surpluses generated is being put to good effect on behalf of our customers.

Over the years the water operation has been strictly ring fenced as required by law in terms of financial reporting. You can be assured that those in the Water Group keep a very close eye on that fence. Overheads and internal charges are apportioned to all areas of the Council, including water, on bases which as far as practicable, approximate usage. The level of these charges is seen as appropriate for an organisation of the nature and size of the Council. Nevertheless we are constantly looking at ways of reducing our corporate costs (e.g. the recent move to contract out photocopying services).

The Water Group already contracts out a large percentage of work in the water area, contrary to what is being implied by the submitters. However, management is mindful of the need to maintain sufficient inhouse knowledge to enable careful and proper management of contracts let. We do not believe efficiency can be significantly increased through increased contracting out.

In essence it is the extent of savings achieved that are generating the debate as what to do with the increased surplus – reduce revenue (i.e. the cost to the four cities) or reduce debt.

3.2 **Debt Repayment**

It appears that the submissions from the cities and the mayors all support a "prudent programme" of debt repayment. The mayors' submission (paragraph 10) states that:

> *The four cities all support a reduction in bulk water levies which would arise from a programme to fully repay water related debt by 2017 but note this reduction stands alone from any efficiency savings.*

This would seem to suggest that the mayors believe that the water operation should be debt free by 2017. The key question is, with the compounding effect of debt repayment (on interest costs) when is the appropriate time to reduce the levy, and reduce debt repayment accordingly? (i.e. should Council continue with its projected debt programme reduction and reassess it in future years, or is now the appropriate time to reduce revenue and therefore debt repayment?)

It is certainly interesting to note the four cities debt to total assets percentage ranges from just over 2% to nearly 19% compared with a current percentage in the Council's water business of 34.2%. It would therefore appear that the cities are arguing for quite a different standard in the water business than they are prepared to carry in their own Councils. One is tempted to ask why. What's so different about bulk water than say their water operation, waste water, roads, drainage etc?

As has been previously outlined, we have two pieces of work that need to be completed prior to setting a future debt repayment programme.

Firstly, we will be completing a review and revaluation of assets over the next few months that will, amongst other things, provide further information on remaining lives of assets and consequent depreciation provisions required. This will also enable us to confirm our capital expenditure programme.

Secondly, based on this information, we will review our debt levels taking into account projected future new water source requirements and intergenerational equity issues. This exercise will be carried out by independent consultants.

The Local Government Amendment Act No. 3 requires all Councils to set revenue at a level to cover all expenditure, including depreciation. Given that we are a few months away from receiving the above mentioned asset information, the currently projected operating surplus is providing a 'buffer' against the depreciation expense being understated (which on the basis of benchmarking work carried out with Watercare Systems Ltd could be possible).

The level of debt and speed of repayment is clearly a judgement call and must be made by the Council in the light of the above information. There is clearly no right or wrong answer. The key question is, is now the appropriate time to be adjusting revenue given the current debt levels in the wholesale water activity?

4. Where Should the Levy be Set for 1999/2000?

As outlined above we do not yet have all the information and therefore it can only be a pure judgement call as to whether any reduction in the levy should be made now, or indeed whether to wait for the receipt of all information and look to reduce the levy in the future. Clearly any reduction in the levy will reduce the debt repayment programme.

Therefore, from an officers' point of view, the prudent approach would be to retain the levy at the current level until all the necessary information is available. We are however conscious of the intergenerational issues and in recognition of the significant savings achieved, we believe if the Council wished a reduction in the levy, a reduction of no more than 4% could be sustained. This position would be very much caveated on the outcome of the reviews alluded to above.

To summarise the impact of any changes to the levy:

Levy	Reduction		Debt Free by
$000	$000	%	
25,218	-	-	2012
24,714	504	2	2014
24,209	1,009	4	2017
23,326	1,892	7 ½	Well beyond 2020
22,696	2,522	10	Debt level does not reduce

A further option available is that as a result of a review of all information relating to asset values and debt reviews, together with expected surplus levels for the year end June 2000, it is possible for the Council to reduce the levy from January 2000 if it so wished.

5. Recommendations

(1) That the report be received and the contents noted.

(2) That the Committee recommend to the Policy and Finance Committee that the bulk water levy for 1999/2000 be set at:

(a) The same level as 1998/99, or

(b) Reduced by 2% from the 1998/99 level, or

(c) Reduced by 4% from the 1998/99 level.

(3) The Committee notes that the future levy position be reviewed subsequent to the asset revaluation and debt reviews.

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