Council Investment Strategies and Implications - July 2024

TX1 Insight

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Executive Summary

Issues

Councils across New Zealand are looking to optimise balance sheets as they lock in 10-year long term plans accompanied by 30-year infrastructure strategies.

Councils' requirements for regular cashflows combined with limited borrowing headroom come at a time when many of their legacy income-generating assets require significant capital investment over the next 10 to 20 years, limiting their ability to pay dividends.

Active portfolio management and potential divestments have formed a key narrative in Council community consultation processes the length of the country with councils looking to manage a range of emerging risks and opportunities including balance sheet capacity, risk concentration, self insurance and cashflow requirements.

Models

There are a range of council investment models in place across New Zealand with New Plymouth District Council's (NPDC) Perpetual Investment Fund considered one of the more mature examples in the sector following 20 years of evolution.

Elements of the NPDC perpetual investment fund:

- CCO – fully independent board - PIF Guardians
- Fully Outsourced Agent - Mercer
- Diversified portfolio based on statement of investment policy and objectives
- Structure underpins NPDC's AA+ credit rating
- Sustainable dividend policy requires a super majority (>75% vote) of council to change
- Act of Parliament protects the capital base and geofences benefits in perpetuity
- Fund provides a level of self insurance

Community implications of Council divestments

New Plymouth District Council sold its stake in Powerco in 2004 which led to a full takeover of the company by Australian business Prime Infrastructure.

The impact of ownership change on Powerco's performance from a customer and community perspective has been positive with international investors bringing their expertise and capital to continuously drive improvements in an organisation that has a long history of being well run.

Key positive outcomes following the sale:

- Increase in staff numbers
- $100m capital injection 2010
- >$30 invested in New Plymouth offices and control-rooms
- CPP investment of $1.27b 2018-2023
- Industry leading environmental and social governance
- International expertise
- Community sponsorship and engagement
- Improved customer experience
- Stable network performance
- Increased network investment

Proposals

Five Councils including Dunedin City Council have been working through potential changes to their investment strategies over the past 18 months.

A range of proposals have been considered from active portfolio management, asset leases, diversification, divestments and the establishment of perpetual investment funds.

The table below summarises these investment strategy reviews and their current status with details of the various projects outlined in the body of this report.

Project	Proposal	Current Status
Auckland Council / Auckland Airport	2023 Airport share sale to pay down debt	Partial sale approved $836m ✓
Auckland Council / Auckland Airport	2024 Airport shares to perpetual investment fund	Share sale and fund approved ✓
Auckland Council / Ports of Auckland	2024 Port lease to perpetual investment fund	Lease declined dividends increased ✗
Bay of Plenty Regional Council Toi Moana / Port of Tauranga	2024 Port share sale to diversify investments	Partial sell down to 28% ✓
Christchurch City Council	2024 Active Portfolio Management within CCHL	Proposal declined prior to consultation ✗
Absolutely Positively Wellington City Council / Wellington Airport	2024 Airport share sale to perpetual investment fund	Proposal progressing to test the market ✓

Conclusions

Decision-makers across the country have been assessing the risks and potential benefits of a range of active portfolio management and divestment options.

Decisions largely revolve around spread of risk, availability of free cashflow to equity, debt levels at both subsidiary and group level, insurance implications, the definition of strategic investments and the financial implications of retaining the status quo.

Several of the proposals include provision for perpetual investment funds to be designed in a way that provides a level of self-insurance, reducing external insurance premiums, providing coverage for significant natural events and more predictable, regular cash flows aligned to local government revenue and finance policies and planning requirements.

There are a range of structural, policy and legislative options employed across New Zealand which enable Councils to safeguard their investment portfolios, regardless of composition, and ensure the benefits of those investments continue to flow back to their local communities in perpetuity

20 Years from Powerco to PIF

Introduction

There are a range of council investment models in place across New Zealand with New Plymouth District Council's (NPDC) Perpetual Investment Fund considered one of the more mature examples in the sector following 20 years of evolution.

Establishment

NPDC's Perpetual Investment Fund (PIF) was established on 9 November 2004 from proceeds of selling the Council's 38.2% shareholding in listed lines and gas pipeline business Powerco Limited. The opening balance of the PIF was $259 million.

The PIF is a significant financial asset for the New Plymouth District, enabling financial benefits to accrue to the Council and its communities.

The PIF has operated with the intention of being a sustainable fund, whereby an annual release from the PIF is provided to Council to subsidise general rates. That release payment should, over the medium term, be lower than the earnings of the PIF (inflation adjusted) so that the PIF maintains or grows its capital base.

However, the PIF has not always been managed sustainably.

Releases were not reduced to account for lowered market returns during the 2008 global financial crisis (GFC) and the fund lacked diversity, with a high concentration of value locked into a number of Tasmanian dairy farms which required significant capital investment. The PIF lost around $113 million in value over 5 years. Subsequently, the Council considerably reduced releases and increased rates to enable the PIF to recover its pre-GFC value.

From 2016, the Council implemented a series of changes to how the PIF was managed in order to prevent these issues from recurring.

Current structure

Currently the New Plymouth PIF Guardians Limited, a Council-controlled organisation, is comprised of a fully independent board of experienced financial governance specialists. The Guardians oversee the PIF as a sustainable perpetual investment fund in accordance with a Governance Deed.

Governance Deed

This PIF Governance Deed constitutes a deed dated 1 March 2017 between NPDC and the New Plymouth PIF Guardians.

The deed outlines the process for appointing PIF Guardians.

The deed also outlines objectives for the management of the PIF as follows:

The parties understand that the Council's objectives (PIF Objectives) in relation to the management of the PIF are:

- *to at least maintain the real capital of the PIF as a sustainable perpetual investment fund in the long term (the Founding Principle) whilst generating a sufficient return to maintain a sustainable release to the Council; and*

to ensure that the following principles underpin the operation of the PIF:

- *all investments are made on purely commercial terms; and*
- *the PIF will be managed on the basis of a prudent, commercial, diversified portfolio investment style and asset allocation, which manages risk to further the Founding Principle.*

Operation of the PIF: The parties agree that their obligations under this PIF Governance Deed shall be construed in light of their mutual intention that the PIF Objectives be achieved.

The Governance Deed locks in a supermajority of council and support of the PIF Guardians as a requirement to make any amendments as follows:

Amendment: No amendment to (or termination of) this Deed will be effective unless executed by the Council and NPG. The Council may not execute any such amendment (or termination) otherwise than with the authority of a vote of not less than 75% of elected members of the Council.

Investment policy and objectives

The Governance Deed also requires the PIF Guardians to regularly review the Statement of Investment Policy and Objectives (SIPO) as follows:

Review of SIPO: To review the SIPO (including the Strategic Asset Allocation) on a regular basis to ensure that it remains consistent with this PIF Governance Deed (including the PIF Objectives) and, without prejudice to the foregoing, to conduct a detailed review of the SIPO (SIPO Review) on an approximate 3 yearly basis. The SIPO Review will be conducted with the intention that the results will be available for consideration in the preparation of the Council's long term plan.

The SIPO Review shall include:

(a) a comprehensive review of the performance of the PIF;

(b) the preparation and conduct of a workshop for the Council covering, among other things: PIF history; organisational architecture principles; structural arrangements; advisor and agent performance measurement; and monitoring arrangements; and

(c) recommendations to Council for ratification of existing or revised arrangements with third parties.

Any amendments to the SIPO will be notified to the Council as soon as reasonably practicable.

The SIPO provides guidance for the Fully Outsourced Agent (FOA) which is tasked with implementing strategies.

The SIPO (included in the appendices of this report) provides a structured framework for quantifying risk, capturing investment benefits and ultimately communicating investment strategy to the FOA and Investment Managers responsible for implementation.

The diagram below summarises the Guardians’ process for making investment decisions:

Investment objectives and risk tolerance	▪ Guardians determine the long-term investment objectives having considered the Founding Principle and set the risk parameters within which the investment objectives are to be achieved.
Selection of FOA	▪ Guardians select a FOA in line with the provider due diligence requirements set out in Section 4.10.
Strategic asset allocation	▪ Guardians determine long term (strategic) asset allocation with a 10+ year view ▪ FOA implement the investment approach that corresponds to the Guardians' investment beliefs
Dynamic asset allocation	▪ FOA dynamically tilts asset allocation into/away from asset sectors based on a medium-term (3-5 year) view
Investment strategies	▪ FOA determines the underlying investment strategies to be implemented within each asset class
Investment Managers	▪ FOA appoints investment managers to implement the investment strategies
Securities selection	▪ Investment managers buy and sell securities

Strategic Asset Allocation

The Guardians have, in consultation with the FOA, developed the following strategic asset allocation (SAA) and allowable ranges.

The total exposure of the Fund to growth and income assets is set out in the table to the right. The ranges for these override the ranges set for each individual asset class – i.e. the individual asset class allocations may not be such as to cumulatively have the effect of making the total exposure of the Fund to growth or income assets fall outside the growth or income range.

Asset class	Strategic asset allocation %	Allowable range %
Global equities – developed markets	40	25 - 55
Global equities – emerging markets	5	0 - 10
Private equity	17.5	10 - 25
Alternative assets	17.5	10 - 25
Total growth assets	***80***	***60 - 95***
Fixed income	15	5 – 25
Cash	5	0 – 20
Total income assets	***20***	***5 – 40***
Total	*100*	

Fully Outsourced Agent

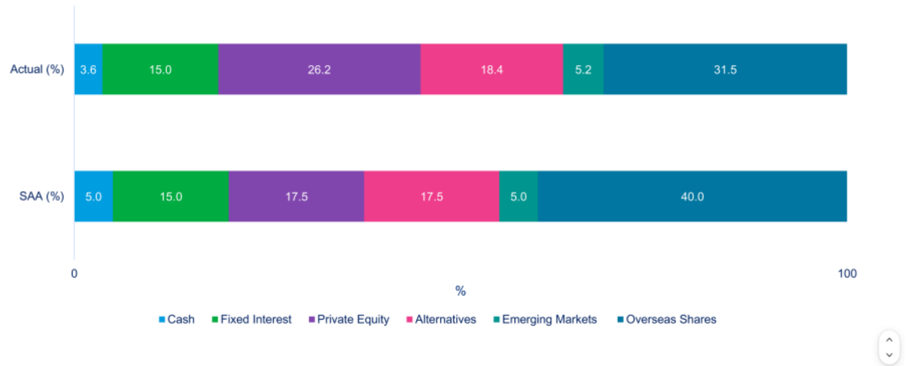
As per the above process diagram the PIF Guardians are responsible for the appointment of a fully outsourced agent (FOA) which is responsible for implementing the SIPO.

The FOA is responsible for appointing investment managers who are tasked with implementing investment strategies by buying and selling securities.

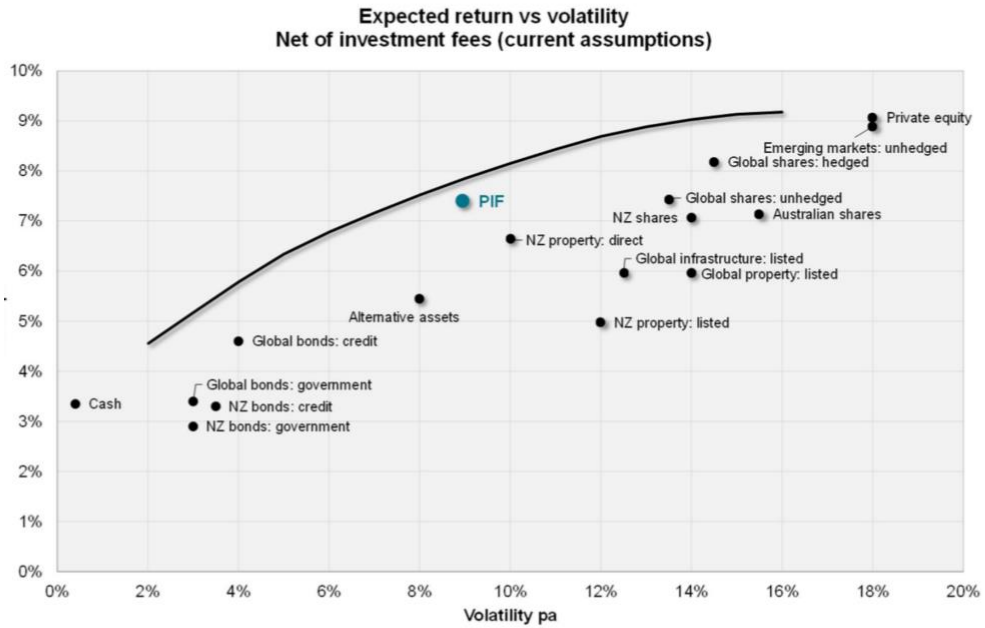
In 2017 when the current structure was put in place the PIF Guardians appointed Mercer as FOA. Mercer's performance and fee structure is reviewed regularly, and the Guardians have the option to change agents in line with the processes outlined in the Governance Deed.

The PIF Guardians provide quarterly reports to Council covering a range of metrics articulated in the SIPO including the following:

Asset Allocation



- The Private Equity allocation is currently above the benchmark SAA level which has reduced the Overseas Shares allocation by -8.46% and Cash by -2.12%.
- The target hedging ratio for Overseas Shares is 50% (effective 31 August 2019).



Currency hedging

The Fund's policy is to target a foreign currency exposure of 25% of the total portfolio. The allowable range for foreign currency exposure is 0 – 50% of the portfolio.

The FOA is to implement this exposure in the most efficient manner depending on the available products.

Dividend release rule

The release to the NPDC from the PIF is based on a model that follows industry best practice and a formula that enables the PIF to fulfil its perpetual objective both in terms of the maintenance and enhancement of the target capital value over time and the delivery of sustainable levels of release payments to the NPDC.

The annual release payment is based on the following formula in the long term:

$$D_t = \underbrace{80\% \times D_{t-1} \times (1 + C\mathrm{PI}_{t-1})}_{\text{Weight on previous year's payment}} + \underbrace{20\% \times 3.3\% \times \mathrm{PIF}_{t-1} \times (1 + C\mathrm{PI}_{t-1})}_{\text{Weight towards long-term 3.3\% pa target}}$$

where

- D_t = release payment in year t
- D_{t-1} = prior year's release payment
- $C\mathrm{PI}_{t-1}$ = prior year's inflation rate
- PIF_{t-1} = prior year's opening audited PIF value

This rule means that the annual release will average approximately 3.3% of Fund value over time. The 80% weight on previous year's release provides a smoothing mechanism to ensure that the release payment is relatively stable.

The release payment made by way of four equal payments which are made in the last week of each calendar quarter or with mutual consent between NPDC and the Guardians.

PIF underpins NPDC's AA+ Credit Rating

The structure of the PIF has been developed in a way that underpins NPDC's AA+ credit rating from S&P Global, assisting Council to minimise its costs of borrowing and also allowing for the optimisation of Council's insurance arrangements.

The following excerpts reflect S&P's commentary on NPDC in its most recent assessment:

New Plymouth's PIF bolsters its operating revenues. The PIF had a balance of NZ$362 million as of January 2024, which would be enough in itself to fund about two years of the council's operating expenses. PIF targets a total return on its portfolio over the medium term of 3.3% a year plus inflation. This allows it to pay an annual "release" to the council to subsidise the latter's budgets. The cash release will be NZ$11.8 million in fiscal 2024.

New Plymouth's PIF underpins its exceptional liquidity coverage. The council's total free cash position - after applying our standard haircuts to non-cash assets, and after budget needs - should be sufficient to cover about 196% of debt service during the next 12 months.

Supporting our strong financial management assessment is New Plymouth's prudent management of the PIF. Assets are diversified across listed equities, fixed income, alternative assets, private equity and cash. The council has outsourced management to Mercer (N.Z.) Ltd. and an independent "board of guardians" monitors the PIF. The New Plymouth District Council (Perpetual Investment Fund) Act 2023 was passed in the New Zealand Parliament in July 2023. The Act aims to ring-fence the benefits from the PIF to current New Plymouth residents. The bill also outlines general principles for sustainable management of the fund.

The full S&P report on NPDC is available here:

https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3162082

NPDC Perpetual Investment Fund Act 2023

The Council resolved, during long-term plan deliberations on 19 May 2021, for Council officers to report on introducing a local bill to contain the benefits of the PIF to the current district boundaries and provide legislative protections to its capital base to ensure benefits flow to the New Plymouth District communities in perpetuity.

Council officers explored various options for achieving these goals and reported back to the Council on 20 January 2022.

Council officers recommended that:

- draft legislation should be developed for community consultation, on the basis that geographically containing the PIF and ensuring it is used in a perpetual manner through legislation is both feasible and in the public interest:
- the Council should retain some ability to use the capital base of the PIF, for example in emergency situations, in order to avoid a negative impact on the Council's credit rating and insurance.

New Plymouth District Council Perpetual Investment Fund Act 2023 was approved by Parliament in June of 2023. A copy of the Act is attached in the appendices of this report.

Investment performance as at June 2024

NPDC PIF

Fund size
$376.0m

Returns (after fees and taxes)

Since inception p.a. (Nov 2004)	5 years p.a.	3 years p.a.	1 year	3 months
7.2%	8.8%	7.7%	12.9%	5.3%

Distributions to Council (release payments)

Since inception (Nov 2004)	5 years	3 years	1 year
$260.2m	$49.6m	$31.7m	$11.5m

NB. Implementation of Guardian and Full Outsource Agent (Mercer) model took effect 1 March 2017.
Results and distributions incorporate TIML results for period prior to March 2017.

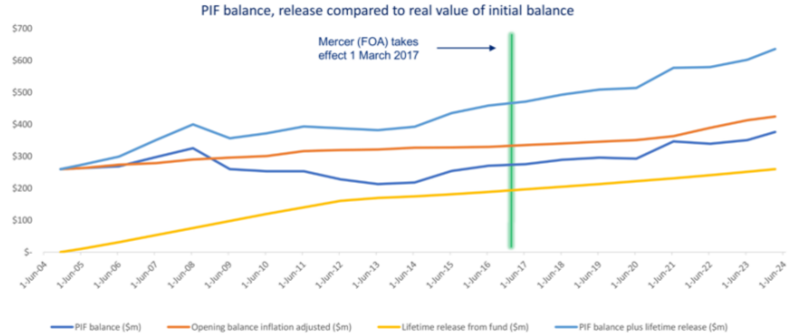
Fund Performance

- The NPDC PIF returned 5.3% for the quarter (after fees). The Fund is above its CPI + 3.3% objective over all time periods shown except 3 years (+3.8% vs objective over the quarter and +5.5% vs objective over 1 year). The Fund is lagging against the secondary benchmark across all timeframes as high inflation continues to eat away at total relative returns.
- Worth noting is the strong performance of equities, fixed income and cash relative to benchmark (+0.8% over 3 months, +1.2% over 1 year). Within the Overseas Shares sleeve, Schroder's have generated excess returns of +2.0% over 1 year.

	3 months (%)	1 year (%)	3 years (% p.a.)	5 years (% p.a.)
Fund return (net of fees)	5.3	12.9	7.7	8.8
Value-add (total portfolio including legacy PE)				
• Relative to CPI + 3.3%	*+3.8*	*+5.5*	*-1.5*	*+1.2*
• Relative to benchmark*	*-0.8*	*-3.3*	*-1.0*	*-0.3*
Equities, Fixed Interest and Cash	9.3	20.8	8.3	9.8
Relative to benchmark	*+0.8*	*+1.2*	*+1.0*	*+1.0*
Private Equity and Alternatives**	2.0	6.3	9.7	9.1
Relative to benchmark	*+0.2*	*-3.4*	*-1.3*	*-0.2*

*The Fund's secondary benchmark is a composite of the underlying sector benchmarks. This includes CPI + 4% for Alternatives (Listed Real Assets) and CPI + 6% for Private Equity.
**Alternatives includes Listed Property & Infrastructure.

PIF Balance



Note: The "PIF Balance plus Lifetime Release ($m)" trend only adds lifetime releases from the Fund to actual balances at each year end, and therefore omits hypothetical compounding returns which would have been achieved had the release amounts remained invested along with the existing balance.

Source: NPDC.

PIF performance since inception

The table above shows the PIF balance and distributions over the past 20 years.

As outlined previously in this report, during the period between 2008 and 2013 the balance of the fund decreased by more than $100m as a result of the global financial crisis.

Despite the deterioration in performance, the PIF continued to pay annual dividends of around $20m to Council until 2012, effectively paying capital out to the shareholder to meet cashflow requirements.

Through this period the fund divested various shareholdings to fund release payments. As a result the PIF ended up with the majority of its investment value concentrated in a group of Tasmanian dairy farms in need of ongoing investment.

In 2012 the annual release was cut to around $9m as a new Council administration sought to stabilise the fund and review Council's investment strategy.

In late 2016 the PIF sold its Tasmanian dairy farming operations for $307m and implemented the PIF Guardians model outlined in this report.

A comprehensive comparison of investment performance between the PIF and Council's historic 38.2% shareholding of Powerco over the past 20 years would require consideration of the following elements:

- Timing and quantum of distributions during the period
- Timing and quantum of equity injections during the period
- Market value of investments at the closing date of the comparison

Powerco is no longer a listed company meaning it is not required to disclose debt levels, equity injections and/or distributions to shareholders.

At the last public disclosure in 2018, Powerco's Annual Report outlined borrowings of $1.35b, with debt levels increasing annually by around $50m as the business ramped up capital expenditure. The company paid a $58m total dividend, with a 38.2% share equating to $22.3m.

The market value of Powerco shares can only be determined immediately following a share sale.

To develop a market estimate for Powerco requires consideration of following:

- the value of the regulated asset base (RAB),
- determination of an appropriate RAB multiple reflecting the premium the market will be willing to pay for the business
- adjustment to account for internal borrowings

Given the information required to undertake this analysis is not publicly available, it is not possible to develop a robust comparison of investment performance between Powerco and the PIF.

Other Council investments

Council has also grown its investment portfolio outside of the PIF, purchasing the Government's 50% share in New Plymouth Airport and establishing a CCO to operate the airport and oversee construction of a new terminal which was completed in 2020.

The Airport Company, known as Papa Rererangi I Puketapu (PRIP), borrows funds from NPDC on commercial terms and is in the process of making the final investment decision on a solar farm on land NPDC owns around the airport site.

The balance sheet capacity and credit strength the PIF provides NPDC has enabled Council to undertake the investment in the Airport and consider other potential commercial opportunities.

In the 2024-34 LTP Council resolved to explore opportunities relating to creating a new commercial development division within council (DevCo) with a view to identifying further opportunities to grow public wealth and capture value in areas including but not limited to land development, housing, minor works, traffic management and commercial signage.

Community outcomes following the sale of Powerco

In 2004 New Plymouth District Council sold its share in listed electricity and gas distribution company Powerco to Australia's Prime Infrastructure.

Prime Infrastructure purchased the council shares and subsequently acquired 100% of the company leading to its delisting from NZX.

Several shares sales have occurred since then with the company now owned by QIC (the Queensland State Government pension fund) and Dexus (formerly AMP Capital).

This section provides a summary of what has changed for customers and communities over the past 20 years.

Economic impact

At the time of the sale the company's head office was in New Plymouth with regional offices in Tauranga, Palmerston North and Wellington with around 165 staff working across its Corporate, Electricity and Gas asset management teams.

Powerco's head office remains in New Plymouth with regional offices in Tauranga, Palmerston North and Wellington and now employs around 300 staff in its Corporate, Electricity and Gas asset management teams. Powerco is a significant employer in New Plymouth with around 200 full time staff.

Following delisting new Australian directors brought their expertise with experience across multiple industries and countries with improved focus on risk management, environmental management and health and safety practices.

The company has made investments >$30m in its New Plymouth offices over the past 20 years with a range of new offices, a new back-up control room and most recently a state-of-the-art Network Operations Centre opened in 2019. Links to two of the projects below:

https://www.powerco.co.nz/what-we-do/our-projects/network-operations-centre

https://www.boon.co.nz/projects/powerco-project-open/

In 2010 shareholders QIC and Prime Infrastructure invested an additional $100 million into the company to prepare the business for a step change in its asset management maturity and a corresponding increase in capital investments in the company's networks. https://www.stuff.co.nz/business/3463812/Powerco-to-repay-100m-of-bonds

Environmental and social governance

Powerco continues to mature its approach to environmental and social governance. Starting out with Enviromark Certification in 2010 the Company has subsequently joined the Sustainable Business Council and is also a member of GRESB.

GRESB (Global Real Estate Sustainability Benchmark) is a mission-driven and investor-led organisation that provides actionable and transparent environmental, social, and governance (ESG) data to financial markets.

The company has also developed a comprehensive Emissions Reduction Programme. Links attached: https://www.powerco.co.nz/-/media/project/powerco/powerco-documents/what-we-do/2021-sustainability-reference-report.pdf https://www.gresb.com/nl-en/

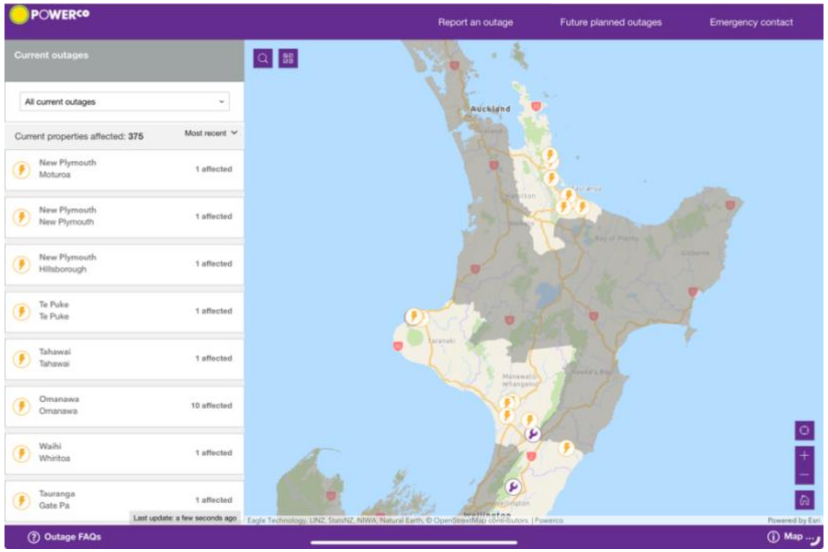
The company is involved in a range of community projects and sponsorships and each year takes applications for a Community Fund for projects which meet the following criteria:

- Contribute directly to the community
- Contribute long term solutions to issues
- Demonstrate the ability to make effective use of the funds requested
- Have clear measurable outcomes

Customer experience

Since 2004 Powerco has made a step change in its customer focus with a range of investments including a customer call centre and online outage portal developed to provide customers information in realtime related to planned and unplanned network outages and estimated restoration times.

Powerco outage web-portal

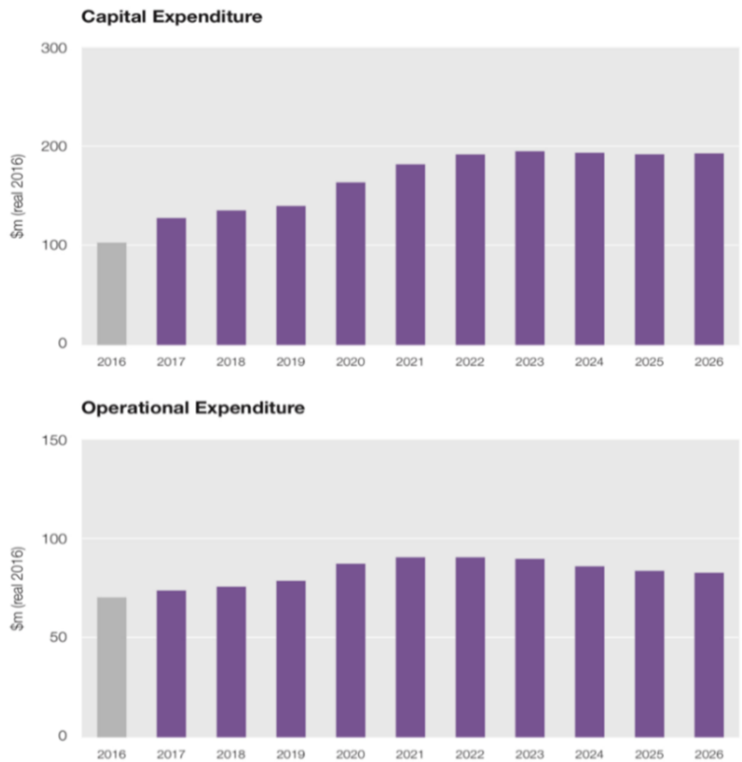


Two of the key measurable outcomes for customers are number of power cuts and duration of power cuts. Powerco has maintained its network performance over the past 20 years, ie the average time customers are without power, adjusted for severe weather events, has been stable.

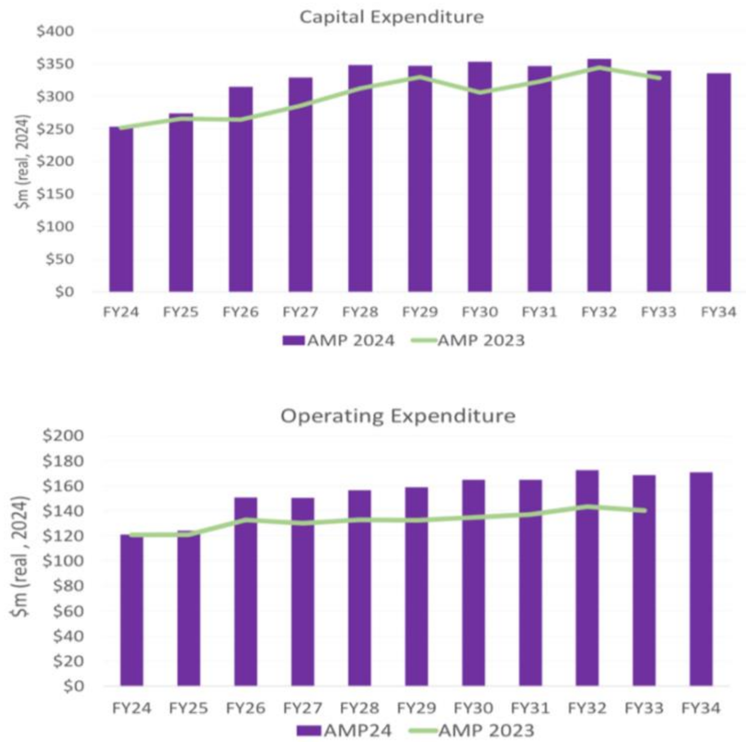
The company has consistently lifted both capex and opex over the past 20 years and the following graphs illustrate both historic investment levels and forecast expenditure.

The company successfully applied for and then delivered an electricity network customised price path proposal which invested $1.27 billion in its networks between 2018 and 2023.

Powerco 2016 Asset Management Plan Capex and Opex forecasts



Powerco 2024 Asset Management Plan Capex and Opex forecasts



Conclusion

Powerco was recognised as a well-run successful business in 2004 when it was sold. Subsequent owners have continued to invest in and grow the business, building its connections within community and performance in terms of environmental, social and corporate governance. Shareholders have provided significant capital, empowering the company to hire more people, invest in technology, improve customer service and participate in community projects.

Local Government Operating Environment

You are not alone

Councils across NZ are assessing balance sheet composition as they approach borrowing limits and face emerging risks in preparation for a prolonged period of significant capital investments outlined in 10-year long term plans accompanied by 30-year infrastructure strategies.

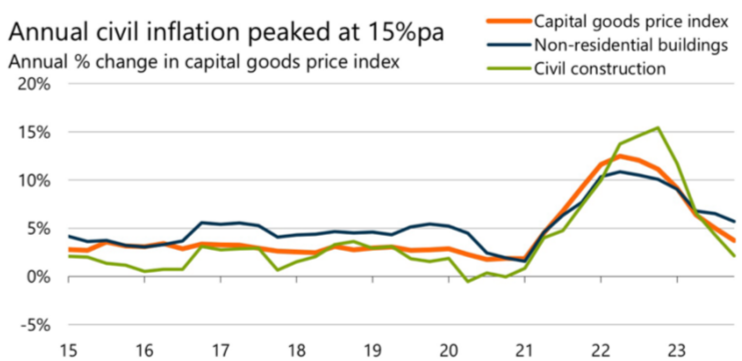
Cost escalations evident in LTPs

Draft LTP's across the country have the highest proposed average rate increases the sector has ever seen and contain financial forecasts requiring significant increases in borrowings to fund significantly expanded capital works programmes.

The financial forecasts underpinning LTPs reflect cost escalations over 2021-2023, with the overall capital goods price index peaking at 13%pa and civil construction costs at 15%pa.

Cumulative inflation since 2020 (when Long Term Plans were last assessed) is more than 25% across the capital costs that local

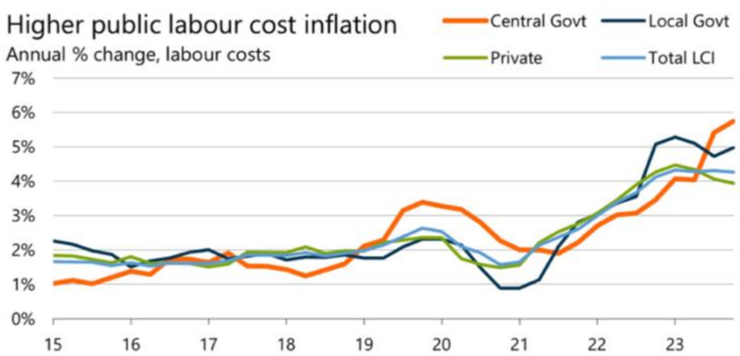
Annual civil inflation 2015-23. Infometrics



government invests in. Civil construction costs are up 27% over the last three years (compared to 19% for consumer price inflation).

Over the last three years local government labour costs have also increased just over 13%, compared to below 12% for other sectors.

Annual labour costs 2015-23. Infometrics



Changes to water reform

The former Government's Three Waters Reform model was expected to address some of the challenges many councils have relating to funding future capital requirements by transferring them off balance sheets as well as providing additional borrowing headroom for councils by transferring their water-related debt to the proposed statutory entities.

However, following the change in Government, it is unclear what impact water reform will have on council credit metrics outside of Auckland over the next two to three years. Auckland Council is the outlier with specific legislation within the Local Water Done Well reform designed to create balance sheet separation from Watercare expected to be passed this year.

The above factors have led to a high level of scrutiny on all aspects of Councils' operations including the management of investments.

Investment strategies under review

Investment strategy reviews across the country are considering long term implications of retaining legacy assets, investment concentration, investment cycles, growth vs dividend investments, regional risks and related planning implications.

Investment concentration and regional risk

As Council risk management processes mature, awareness of the implications of investment concentration around legacy assets are starting to be better understood.

Councils across New Zealand have interests in a range of legacy assets including ports, airports, lines companies, gas networks, contracting businesses and forests.

Councils' investments in these assets range from full ownership to shareholdings. In several cases one or two investments represent most or all of a Council's income generating investments. Council owned ports, airports and networks are exposed to the same localised risks as their shareholders, causing Councils to consider how their investments offset or contribute to regional risks.

As an example, Wellington's exposure to seismic and sea level rise risk is compounded by its primary income generating investment being its shareholding in Wellington International Airport which is itself exposed to those same risks.

When considering the impact of significant natural events, this creates the potential for income generating assets to be impaired at a time when their Council shareholders will have to be funding recovery efforts, over and above traditionally budgeted activities.

Several of the proposals include provision for perpetual investment funds to be designed in a way that provides a level of self-insurance, reducing external insurance premiums and providing coverage for significant natural events. The self-insurance consists of retaining the ability to call on part of the capital of a fund following a significant natural event that leads to a material impairment of a Council asset base.

Councils are also having to look through the life of their infrastructure strategies and understand medium to long term capital requirements of their asset bases as well as the asset bases of their investments, dividend availability and long-term investment performance.

Growth vs Dividend investments

New Zealand is entering a period of prolonged capital investment and many of the legacy assets comprising Council investment portfolios (e.g. ports, airports and lines companies) have developed asset management plans requiring a ramping up of their capital investment programmes.

Planned capital investments will continue to deliver growth in the value of these assets, however in some cases the levels of capital required limit the abilities of the businesses to pay dividends over the period of LTPs.

Governance teams are being asked to determine whether growth or dividend investments are the best fit with their LTPs.

Related financial implications

Council financial processes favour investments capable of generating stable and predictable cash flows. Unpredictable dividend streams have to be mitigated either with rate increases or borrowing to make-up for shortfalls in revenue requirements.

As Councils prepare to significantly ramp up capital investments many are at or approaching borrowing limits with a number of those rated by S&P currently on negative outlook.

Borrowing constraints are one of the primary drivers of a shift of Council preferences from growth investments to those capable of delivering regular predictable dividends.

The factors outlined above have come together in a way that has seen Auckland Council, Bay of Plenty Regional Council, Wellington City Council, Christchurch City Council and Dunedin City Council all consider making changes to their investment strategies over the past 18 months.

Proposals have included partial divestment, full divestment, asset lease, active portfolio management and the establishment of diversified perpetual investment funds as outlined later in this paper.

Auckland Council – Auckland Airport 2023

Auckland Council considered selling its 18.09% shareholding in Auckland International Airport Limited (AIAL) during its annual plan 2023/24. The proposed sale aimed to improve the council's financial position by reducing debt to deliver savings on interest costs, which were projected to be greater than the dividends received from the shares.

Key Proposal Details

Amendment to Shareholding Policy: The council proposed amending the Auckland Airport Shareholding Policy in the 10-year Budget 2021-2031 to allow for the sale of the entire shareholding.

Use of Proceeds: Proceeds from the sale would be used to reduce the council's debt.

Financial Benefits: The sale was expected to alleviate budget pressures by lowering annual interest costs, leading to a better cash position than retaining the shares and receiving dividends.

Lack of Strategic Control: The council's minority shareholding did not provide significant control or influence over AIAL. Strategic outcomes could be achieved through other means, such as regulation or commercial incentives.

Preferred Option: The preferred option was a full sell-down rather than a partial one, as it would yield higher interest savings compared to future dividend income.

Rationale for the Proposal

Interest Savings vs. Dividends: The council was paying significant interest on debt while not receiving dividends due to the impact of COVID-19 on AIAL's operations. The sale was projected to save $719 million in interest over eight years compared to an estimated $532 million in dividends.

Strategic Value Assessment: The council had no significant strategic outcomes tied to its AIAL shareholding. Key considerations such as regional infrastructure, monopoly control, external impacts, and New Zealand ownership were managed through other regulatory and commercial mechanisms.

Financial Projections and Assumptions

Market Price and Interest Rates: The financial assessment was based on current market prices ($7.46 per share) and projected interest rates. The council assumed the sale and debt reduction would occur on July 1, 2023.

Sensitivity Analysis: Projections considered potential variations in share prices, interest rates, and dividend growth. The estimated savings ranged from $647 million to $791 million for interest savings and $497 million to $570 million for potential dividends.

($millions)	**FY24**	**FY25**	**FY26**	**FY27**	**FY28**	**FY29**	**FY30**	**FY31**	**Total**
Interest cost savings	87	87	88	89	90	91	93	94	**719**
Potential dividend foregone	39	49	63	73	75	76	78	79	**532**
Net funding benefit	**48**	**38**	**25**	**16**	**16**	**15**	**15**	**15**	**187**

Implications of the Proposal

Strategic: The council's influence on AIAL through land-use planning and regulatory roles would continue without shareholding. Current shareholding was insufficient to control AIAL's strategic direction.

Balance Sheet: Selling shares would reduce the council's financial assets and debt, providing additional borrowing capacity.

Operating Statement: Lower debt levels would reduce annual interest costs, improving the council’s operating funding position. The council would no longer receive dividends or need to account for annual fair value adjustments of shares.

Options Analysis

Full Sell-Down (Preferred Option)

Advantages: Projected $48 million funding benefit in 2023/2024, $187 million over eight years, and reduced borrowing needs.

Disadvantages: Loss of potential future dividends and share value appreciation; no longer holding a ‘blocking stake’ against takeovers.

Status Quo

Advantages: Continued receipt of dividends; maintenance of a ‘blocking stake’.

Disadvantages: Did not address financial challenges, potential erosion of shareholding percentage, holding a financial asset with returns below cost of debt.

Immediate Partial Sell-Down

Advantages: Provided $22 million funding benefit in 2023/2024, $90 million over eight years, retained a ‘blocking stake’.

Disadvantages: Less impact on financial challenges, need for significant reinvestment to avoid dilution of shares, reduced potential for benefiting from future dividend increases or share value appreciation.

Outcome: Council decided to implement a partial sell down from 18.09% to around 11% raising $836 million to reduce debt. Completed 2023.

Auckland Council – Auckland Airport to Auckland Future Fund 2024

Following the 2023 divestment, the Auckland council owned just over 11% of AIAL. Council also owned 100% of Ports of Auckland (POAL).

Note: Detailed analysis of the POAL options considered are covered later in this report but are referenced in this section as the Council consultation material combined both assets in the investment strategy changes proposed as part of LTP 24 deliberations.

Investment Performance and Strategic Importance

These investments have experienced fluctuations in returns, influenced by commercial factors and the COVID-19 pandemic. Despite these fluctuations, the investments remain integral to the council's financial strategy. Key objectives include protecting asset value, providing financial resilience, enhancing cash returns, diversifying investment risks, improving investment flexibility, and achieving strategic outcomes for the airport and port.

Objectives of the Proposal

Protecting Asset Value: The proposal aims to maintain the real value of the council's intergenerational assets over the long term.

Providing Financial Resilience: The proposal supports the council's ability to respond to shocks, such as climate change impacts, natural

events, and financial disruptions, ensuring liquidity and funding for emergency expenditures.

Enhancing Cash Returns: The proposal seeks to improve cash returns from investments, surpassing the council's long-term cost of capital.

Delivering Diversification: The council intends to spread investments across a range of assets to reduce risk.

Improving Flexibility: The proposal allows the council to rebalance investments to reflect changing community needs and investment objectives.

Achieving Strategic Outcomes: The proposal ensures continued delivery on strategic objectives for the airport and port.

Key Decisions for the Council

Establishing a Regional Wealth Fund:

The council is considering the establishment of an Auckland Future Fund to manage financial investments.

Transferring AIAL Shareholding:

The council was evaluating whether to transfer its AIAL shareholding into the fund.

Leasing Port Operations:

The council was contemplating changing the way the port is run by leasing operations while retaining ownership of the land and wharves, and potentially investing the proceeds in the fund.

Proposed Option

Option 1: Auckland Future Fund with AIAL Shares and Port Lease Proceeds

This option involves establishing the Auckland Future Fund, transferring the council's AIAL shares into the fund, and granting a 35-year operating lease for port operations. The upfront payment from the lease would be invested in the fund, while the council retains ownership of the port land and wharves.

Other Options Considered

Option 2: Enhanced Status Quo

No establishment of the Auckland Future Fund. The council retains AIAL shares and continues to operate POAL, working to enhance financial performance and returns.

Option 3: Auckland Future Fund with AIAL Shares Only

Establishing the fund and transferring AIAL shares, but POAL continues operating the port without transferring port returns to the fund.

Option 4: Auckland Future Fund with AIAL Shares and POAL Dividends

Establishing the fund with AIAL shares and investing POAL dividends into the fund, while POAL continues to operate the port.

Overview of Options Assessment

The proposed Auckland Future Fund aims to spread investments across multiple assets, reducing risk and potentially improving long-term returns. It would enhance the council's financial resilience, provide a level of self-insurance, and support council operations with annual cash distributions.

Self-Insurance Component

A portion of the fund, estimated at a minimum of $1 billion, would be set aside for self-insurance, reducing insurance premiums and providing coverage for significant natural events.

Financial Assessment and Implications

The financial assessment of the fund is based on several uncertain factors, including investment returns and the level of investment.

AC's summary of options and implications

	Option 1 Auckland Future Fund with AIAL and port lease	Option 2 Enhanced Status Quo	Option 3 Auckland Future Fund with AIAL	Option 4 Auckland Future fund with AIAL shares and POAL dividends
Protecting assets	✓+ Base case dividends set at level to maintain real asset growth.	✓ Limited levers to ensure value is protected.	✓+ Base case dividends set at level to maintain real asset growth.	✓✓ Reinvestment of dividends provides for growth exceeding inflation
Self-insurance / resilience	✓✓ Greater ability to absorb shocks, albeit changes to fund value or dividends may be needed.	✗ Low portfolio liquidity and ability to use asset value to self-insure	✓ Limited ability to self-insure against larger shocks without impacting fund value and future dividends	✓ Limited ability to self-insure against larger shocks without impacting fund value and future dividends
Enhanced cash returns	✓✓✓ Potential for greatest returns	✓ AIAL / POAL dividends received	✓✓ Potential for greater returns from diversified portfolio, albeit limited cash following self-insurance event	✗ Lower cash returns than status quo due to reinvestment of POAL dividends
Diversification	✓✓✓ Full asset value / proceeds reinvested in diversified investment portfolio	✗ Concentrated investment exposure/ risk.	✓✓ Reinvestment of AIAL proceeds in a diversified investment portfolio	✓✓ Reinvestment of AIAL proceeds in a diversified investment portfolio
Flexibility	✓✓✓ Larger scale provides greater flexibility to balance financial objectives.	✓ Limited ability to rebalance assets to reflect changing community needs.	✓✓ Fund expected to enable timely response to changing community needs and market conditions.	✓✓ Fund expected to enable timely response to changing community needs and market conditions.
Strategic outcomes	✓✓✓ Strategic outcomes for airport maintained through other means Strategic outcomes for port improved	✓✓ Strategic outcomes continue to be delivered	✓✓ Strategic outcomes for airport maintained through other means Outcomes for port maintained	✓✓ Strategic outcomes for airport maintained through other means Outcomes for port maintained
Projected financial contribution (9 years: 2025/2026 – 2033/2034)	**$1.8 billion**	**$1.2 billion**	**$1.7 billion**	**$1.0 billion**
Projected rates increase for 2025/2026	**3.5%**	**6.5%**	**4.2%**	**7.5%**

The expected average return is projected at 7.5% annually, with 2% reinvested into the fund. This net return (5.5%) would be distributed to the council for operations.

Projected Financial Benefits

The fund is expected to provide greater financial benefits compared to maintaining current AIAL and POAL operations, reducing the need for higher rate increases. It also offers a level of self-insurance, potentially lowering external insurance premiums by approximately $12 million per year.

Airport Shareholding Proposal

Transfer to Auckland Future Fund: The council proposes transferring its remaining AIAL shares into the Auckland Future Fund, managed by an investment manager authorised to sell the shares and reinvest the proceeds.

Strategic Assessment

Given the council's limited control over AIAL with an 11% stake, the shareholding has no significant strategic value for the council's goals. The influence on the airport can continue through land-use planning and regulatory roles without holding shares.

Financial Implications

Transferring AIAL shares to the fund was projected to provide higher cash distributions compared to retaining the shares, enhancing funding for council operations and reducing the need for rate increases.

Current Status

Council decided shares valued at 1.3b will be transferred into an investment fund and sold as part of LTP2024.

Auckland Council - Ports of Auckland to Auckland Future Fund 2024

Auckland Council owns 100% of Port of POAL, which manages Auckland's commercial freight and cruise ship harbour facilities on the Waitematā Harbour. POAL operates on 77 hectares of reclaimed land used for containers, cars, and other cargo.

The council considered two main options for the future operations of the port with a third status quo plus hybrid as outlined below:

Continued Operation by POAL – status quo

POAL would continue to own and operate the port, implementing a turnaround plan to improve returns to the council.

The Status Quo option was forecast to deliver projected profits of $856 million over nine years.

Lease of Port Operations - preferred option

The Council or POAL would lease the port land and operations to an external party for about 35 years. The council would receive an upfront payment, while the lessee would operate the port, make capital investments, and earn profits. The port's operations and land would revert to the council at the lease's end.

The Lease Option was forecast to deliver an estimated $941 million contribution over nine years, factoring in interest costs on POAL debt.

Reinvestment Approach - Status Quo plus

The third option considered was for POAL to continue to deliver port operations but for the annual dividends from the port to be invested into an Auckland Future Fund, rather than used by the council to fund existing services.

The Reinvestment Approach with annual dividends from POAL being reinvested was forecast to deliver a lower projected contribution of $185 million over nine years.

Figure 5: Projected POAL profit from port operations

$ million	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34	Total
POAL projected profit		**78**	**84**	**89**	**93**	**98**	**101**	**103**	**104**	**106**	**856**

Figure 6: Projected financial contribution from investment of port lease proceeds in a fund

$ million	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34	Total
Projected gross fund return		158	161	164	167	170	174	177	181	185	**1,536**
Less reinvestment into fund		(42)	(43)	(44)	(45)	(45)	(46)	(47)	(48)	(49)	**(410)**
Net fund proceeds		**116**	**118**	**120**	**123**	**125**	**128**	**130**	**133**	**135**	**1,127**
Less: Interest costs on retained port debt		(19)	(19)	(20)	(20)	(21)	(21)	(22)	(22)	(22)	**(185)**
Projected financial contribution		**96**	**99**	**101**	**103**	**104**	**106**	**108**	**111**	**113**	**941**

Figure 7: Projected financial contribution from investment of port dividends in a fund

$ million	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33	FY34	Total
Projected gross fund return		0	6	12	19	27	34	43	51	60	**253**
Less reinvestment into fund		0	(2)	(3)	(5)	(7)	(9)	(11)	(14)	(16)	**(67)**
Projected financial contribution		**0**	**4**	**9**	**14**	**20**	**25**	**31**	**38**	**44**	**185**

Strategic Assessment and Implications

The Port of Auckland is a strategic asset for the region and the country, integral to the North Island supply chain.

As the sole owner, the council has governance control but cannot be involved in daily operations due to legal constraints under the Port Companies Act 1988. The Act mandates that POAL operates as a 'successful business' akin to privately-owned companies.

The council outlined six strategic objectives for POAL:

1. Retain Ownership of Port Land: Ensuring continued council ownership of the port land and seabed.
2. Secure POAL's Development: Supporting POAL as a community asset and economic growth enabler, ensuring access to capital for investment needs, and optimising the North Island logistics chain.
3. Deliver Efficient and Sustainable Services: Providing competitive port services, adhering to community expectations, and maintaining high safety and environmental standards.
4. Optimise Waterfront Land Use: Releasing waterfront land for community purposes, preserving options for future port relocation, and mitigating transfer risks.
5. Enhance Community Control: Safeguarding community interests, enhancing council governance, and ensuring compliance with legal obligations.
6. Optimise Financial Returns: Maximising dividends and returns on ratepayer capital without increasing the funding burden on ratepayers and reducing POAL's debt impact on the council.

Financial Assessment and Implications

A financial assessment, based on expert external advice and peer-reviewed projections, estimated an upfront lease payment of $2 billion to $3 billion for the port operations, with a central estimate of $2.1 billion.

Comparing the two main options over a 35-year lease term, the lease option was assessed as having the potential to deliver approximately $300 million in higher returns than the enhanced status quo.

Leasing the port operations and investing the proceeds in the AFF was projected to deliver the highest financial contribution, supporting council operations and reducing the need for rate increases and debt.

Other Considered Options

Debt Repayment: Using lease proceeds to repay debt would reduce financial contributions to the council but not protect long-term asset value.

Shorter/Longer Lease Terms: A significantly shorter lease may not attract operators, while a longer lease would restrict long-term decisions.

The analysis indicated that leasing the port operations was likely to yield the best financial outcomes and support council's strategic objectives.

Current Status

Council decided not to proceed with the lease of port land and assets.

PoAL, the union and Mayor developed a proposal to increase dividends and presented it to the LTP deliberations.

PoAL agreed to contribute $1.1 billion in profits to Auckland Council over the next 10 years, exceeding the projected net returns from investing the proceeds of a port lease by $172 million.

Christchurch City Council – CCHL Active Portfolio Management 2023

Introduction

In December 2021, the Christchurch City Council (CCC) issued a Letter of Expectations (LOE) to Christchurch City Holdings Limited (CCHL), prompting a review of its core purpose and alignment with the city's strategic priorities and future challenges.

Due to personnel changes at CCHL, the Council managed the review and commissioned Northington Partners Limited (Northington) to evaluate CCHL's operations.

By December 2022 Council resolved to develop a clear Value Strategy for CCHL and to create business cases for a hybrid portfolio management approach. CCHL also engaged KPMG for a portfolio review, leading to workshops with elected members to understand CCHL's position and develop relevant business cases.

CCHL explored options for more active management of its portfolio and sought guidance from the CCC on the next steps.

A report was prepared for CCC's Finance and Expenditure Committee in December 2023, influenced by a recommendation letter from CCHL, aiming to provide a basis for Council's decision-making regarding future portfolio management.

CCHL's board made a recommendation to CCC to consult on an Active Portfolio Management operating model through the draft 2024-2034 Long Term Plan process, noting such a decision would override the December 2022 Council decision.

Options Considered

Status quo: Not advanced due to external advisors' assessment.

Enhanced Status quo: Continued operations with improved capital management and operational oversight.

Active portfolio management: Recommended by CCHL, involving a new investment governance framework and greater investment flexibility.

Divestment of all assets: Not supported by Council or CCHL.

For 'Option 3 - Active Portfolio Management,' a public consultation process was required under the Local Government Act 2002 (LGA), necessitating an amendment to the Long-Term Plan.

The amendment process involves detailed proposal preparation, stakeholder engagement, and compliance with decision-making requirements, including auditing.

CCHL provided the following rationale for its request.

In making this recommendation we also note that over the course of the 10-year period covered by the LTP, the more flexible mandate could deliver nearly $450m of additional dividends to Council over CCHL's existing forecasts, and over $220m above what is possible under an enhanced status quo discussed below.

Council Value Strategy

CCHL noted that during 2023 it worked closely with Council to develop the Value Strategy which informed Council's long-term requirements from its investment portfolio.

The Value Strategy workshops identified the following investment objectives (in priority order):

- For the benefit of current and future generations
- Supporting growth of Christchurch and Canterbury through resilient infrastructure
- Sustainable real growth in dividends
- Balanced risk appetite.

In addition to this Council identified a funding gap of approximately $80m to 100m per year over the LTP period (assuming rate increases were limited to the Local Government Cost Index (LGCI) plus 2%). CCHL was asked to consider how best to contribute to reducing this funding gap, over and above the existing dividend forecasts provided to Council.

CCHL's recommended option responded to both the Investment Objectives and the request to help close the funding gap over the course of the LTP.

Active Portfolio Manager

CCHL identified the key features of the Active Portfolio Manager as follows:

CCHL is acknowledged as the key Strategic Asset owned by Council, with capital remaining fully invested in meeting Council's long-term investment objectives, unless otherwise requested by Council.

Current Governance arrangements between Council and CCHL are modified to add an Investment Governance framework, through the adoption of an Investment Policy Framework (IPF). The IPF will have four main features:

i. Council approves CCHL's Investment Objectives;

ii. Council approves CCHL's permitted investment activities (Asset Allocation);

iii. CCHL is granted greater flexibility to invest within the approved asset allocation; and

iv. CCHL delivers greater certainty to Council in respect of future income through the adoption of a distribution policy.

The IPF will include "guardrails" which seek to preserve the public interest in accessing sustainable, inclusive and affordable economic infrastructure assets.

Existing Council governance processes relating to strategic and operational expectations, such as the Statement of Intent, would remain in place.

In exercising investment flexibility, CCHL would be required to establish a liquidity portfolio as part of a more prudent, long-term approach to managing Council's invested capital.

To deliver the dividend commitments identified in transitioning to a distribution policy the liquidity portfolio would need at least $350m invested in suitable assets.

CCHL's view of the Enhanced Status Quo

This option would see CCHL continue to operate within the existing mandate and existing assets, while seeking to lift returns over time through stronger oversight of capital management and operational improvements.

While CCHL believed a lift in performance was possible, as reflected in the revised dividend forecasts, it did not believe the mandate delivered on Council's Value Strategy.

CCHL's concerns were reflected at the public annual stakeholder meeting, noting the status quo did not resolve the material tension in addressing:

- Council's desire for stronger dividends, including the ability to ask for special dividends;
- CCHL's requirement to repay debt attached to the post-quake special dividend;
- Subsidiaries' capital requirements to invest in growth and resilience that supports Christchurch and Canterbury; and
- The flexibility required to successfully adapt to the mega-trends of climate change, digital transformation and changing consumer preferences.

It was CCHL's view that, under the enhanced status quo, it would see a dilution of long-term ownership in existing assets given the constraints on access to new capital.

CCHL expressed a firm belief that the Active Portfolio Manager option provided Council with more effective levers to shape the circumstances under which new capital could be accessed and plan for that in a way that ensured the growth of the region was not restricted.

Key Decisions for Council

Council was asked to decide whether to continue developing the business case for Active Portfolio Management and whether it should be part of the Long Term Plan 24 or through a special consultative procedure post-adoption.

The Council was asked to direct the preparation of assessment and advice in response to CCHL's recommendations.

Management's advice was, given the public interest and the scope of work, a substantial change to CCHL's operating model was impractical for the immediate draft Long Term Plan. Therefore, a special consultative procedure post-adoption of the final Long Term Plan was recommended for considering the business case for Active Portfolio Management.

The Finance and Performance Committee was advised to acknowledge CCHL's work and thank the Board and staff for their efforts in conducting the Portfolio Review and engaging with elected members.

Current Status

Council decided not to consult on Active Portfolio Management in its draft long term plan.

Wellington City Council – Wellington Airport to Perpetual Investment Fund 2024

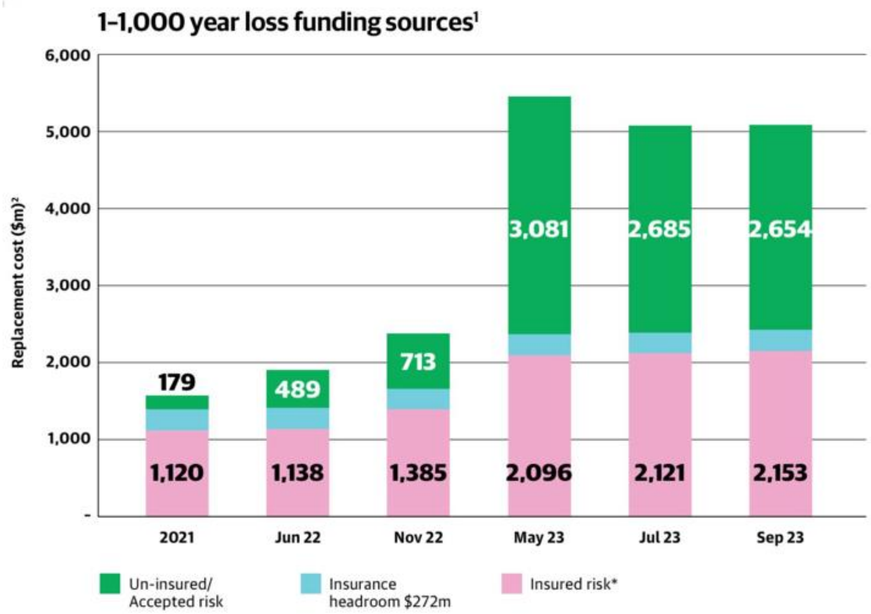
Wellington Council is grappling with two major financial challenges: increasing difficulty and cost of insuring its assets, leading to significant underinsurance, and a lack of diversification in its investment portfolio, which leaves it exposed to uniform types of risk.

The insurance issue is exacerbated by Wellington's seismic profile and climate change impacts, making coverage either unavailable or extremely costly. Additionally, the Council's investments are heavily concentrated in Wellington-based property assets and a 34% shareholding in Wellington International Airport Ltd (WIAL), leading to vulnerability from local disruptions like natural disasters.

Challenge 1: Cost and Availability of Insurance

Wellington's seismic risk has made it increasingly difficult for the Council to secure adequate insurance coverage. The 2022 National Seismic Hazard Model indicates a higher potential payout for insurers after a major earthquake, thus driving up premiums. Combined with the rising value and replacement costs of buildings and infrastructure, the Council faces a significant insurance gap.

Over recent years, the Council has become unsustainably underinsured, with an estimated shortfall of $2.6 billion. The $272 million debt headroom held by the Council to cover uninsured risk is now insufficient to manage the expected losses from a major event.



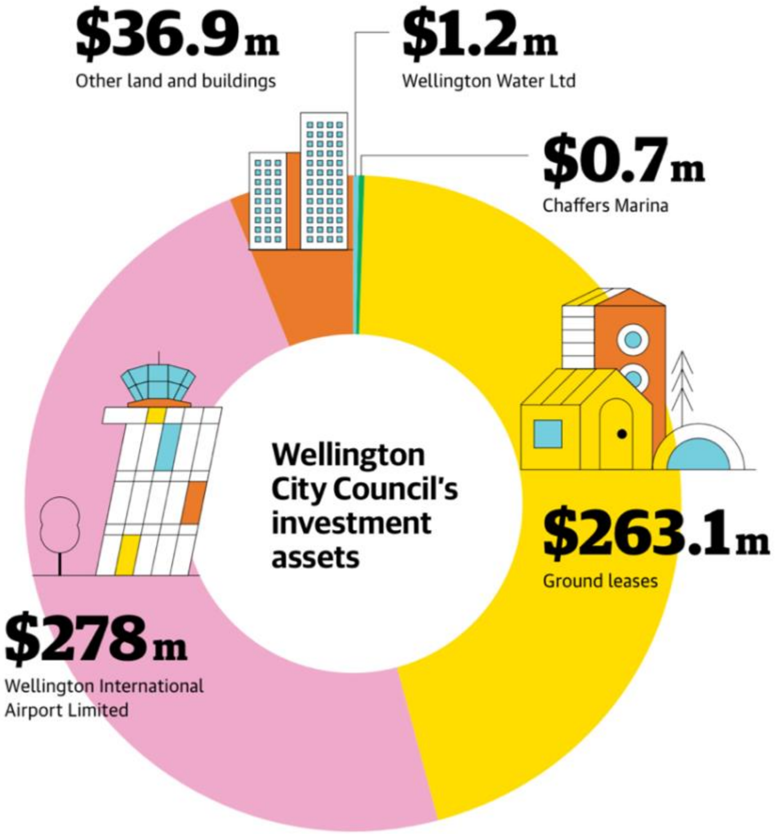
Notes to graph: 1: A 1-1000 year loss describes the loss expected from an event which has probability of 0.1% in any one year. 2: The total replacement cost of all insurance Council assets is $14.8 billion. * Insured risk – The amount of funding the Council expects to receive from external sources after an event.

Challenge 2: Lack of Diversification in the Investment Portfolio

Currently, 93% of the Council's investments are tied up in Wellington-based assets, primarily through WIAL shares and property ground leases. This concentration exposes Council to significant risk from local market disruptions or natural disasters. A single adverse event could drastically reduce the value of these investments, making it challenging to liquidate assets for cash if needed. Additionally, the Council relies heavily on dividends from WIAL, which could be reduced or suspended following a disruptive event, thereby threatening a crucial revenue stream.

Proposed Solution: Establishing a Perpetual Investment Fund

To mitigate these risks, the Council proposes setting up a Perpetual Investment Fund. This fund would be created by selling the Council's 34% shareholding in WIAL and reinvesting the proceeds, along with future sales of certain property ground leases, into a diversified portfolio. The fund is intended to be a publicly owned, enduring financial asset supporting the city's recovery from natural disasters and addressing the insurance gap. Importantly, the proceeds from the sale of WIAL shares will not be used for other Council projects or to pay down debt.



Benefits of the Perpetual Investment Fund

Diversification: The fund will diversify the Council's investments away from Wellington-based property, reducing exposure to local risks and providing a more stable revenue stream.

Financial Security: The fund will provide accessible funding for recovery efforts following a natural disaster, covering insurance shortfalls and other unexpected costs.

Public Ownership and Accountability: As a strategic asset in the Council's Significance and Engagement Policy, any significant changes to the fund will require community consultation, ensuring transparency and public involvement.

How the Fund Will Work

The Perpetual Investment Fund will be set up over the next two years through the sale of the Council's WIAL shares. The initial fund balance is estimated to be around $492 million, based on a midrange valuation of the shares and after accounting for sale costs. Additionally, future sales of property ground leases, estimated at $50 million, will be invested in the fund over the next five to ten years.

Investment Strategy

The Council will develop a comprehensive strategy to govern the fund, including investment guidelines and criteria for withdrawals. The fund will be managed by a professional investment manager, focusing on environmental, social, and governance (ESG) factors, subject to further advice. The Council assumes an annual return of 7% for modelling purposes, a conservative estimate compared to the returns of similar funds and benchmarks like the New Zealand Superannuation Fund.

Revenue and Reinvestment

The Council needs to decide how to split the returns between reinvestment and revenue generation. For modelling purposes, a 5:2 split is assumed, with 70% of returns reinvested to grow the fund and 30% used as revenue for the Council. This approach aims to match the current dividend revenue from WIAL, ensuring no immediate impact on rates or levels of service.

Options for Consideration

The Council has three options:

Option A: Sell Full Holding of WIAL Shares

Pros: Provides maximum diversification, reduces risk, and ensures a stable revenue stream. Frees up the entire $272 million debt headroom and eliminates future capital funding obligations for the airport.

Cons: The Council will no longer receive dividends from WIAL, though the fund's returns are expected to compensate.

Option B: Sell Partial Holding of WIAL Shares

Pros: Offers some diversification and risk mitigation while retaining some dividend income from WIAL. Reduces, but does not eliminate, the need for debt headroom.

Cons: Less diversification and risk mitigation compared to Option A. The Council retains some future capital funding obligations for the airport.

Option C: Retain All WIAL Shares

Pros: Maintains current dividend income, keeping rates lower.

Cons: Does not address diversification or insurance challenges. The Council continues to hold significant uninsured risk and future capital funding obligations for the airport. Debt headroom must be retained and potentially increased.

WCC's assessment of options and implications

	Full sale	Partial sale	No sale
Wellbeings			
Social wellbeing	✓	?/✓	✗
Economic wellbeing	✓	?/✗	✗
Environmental wellbeing	✓	✓	✗
Cultural wellbeing	✓	✓	✗
Section 14 LGA principles			
Give effect to priorities and outcomes in an efficient and effective manner	✓	?/✗	✗
Take into account interests of future, as well as current, communities	✓	?/✓	✗
Assess the expected returns from investing in a commercial activity and satisfy itself that the returns outweigh the risks inherent in the activity	✓	?/✗	✗
Ensure prudent stewardship of its resources, including by planning effectively for the future management of its assets	✓	?/✓	✗
Have regard to the views of its communities	✓ ?	✗ ✓	✓ ✗

Current Status

Councillors voted to progress the proposal, instructing officers to test the market and bring recommendations back to Council by December 2024

Bay of Plenty Regional Council – Port of Tauranga to Perpetual Investment Fund 2024

The Bay of Plenty Regional Council is considering reducing its shareholding in the Port of Tauranga Limited (PoTL) from 54.14% to a minimum of 28%.

This proposal is managed by Quayside Holdings Limited (Quayside), which oversees the Council's investment in PoTL. Currently, Quayside's investment portfolio, heavily concentrated in PoTL shares valued at $2.1 billion, generates significant dividends that reduce regional rates.

Current Situation

Quayside owns 54.14% of PoTL, providing substantial dividends to the Bay of Plenty Regional Council, accounting for 24% of the Council's annual revenue. This reduces average household rates by $380 annually. The PoTL shareholding, identified as a strategic asset, is crucial for the region's economy, providing employment and driving economic activity.

Issues with the Current Portfolio

Independent financial experts suggest that Quayside's current investment portfolio is not optimal for long-term, intergenerational sustainability. The portfolio's heavy reliance on PoTL shares limits the ability to realise capital gains and poses concentration risks. Diversifying the portfolio could mitigate these risks and ensure a more stable and sustainable income stream.

Benefits of Reducing Risk

Diversification would reduce financial risks associated with heavy reliance on PoTL shares. This is important as the Council faces increasing demands for services and infrastructure, climate risks, insurance uncertainties, and rising costs due to interest rates and inflation.

Diversifying the portfolio would:

- Increase resilience to financial shocks and climate change.
- Provide a reliable and growing dividend stream.
- Allow Quayside to adjust its investment portfolio for continued growth.
- Ensure continued rates subsidies for households.

Proposed Actions

The Council has proposed selling some PoTL shares, reducing the shareholding to no less than 28%. This would keep PoTL as a strategic asset, preventing any potential takeover. Proceeds from the sale would be used to repay $200 million in Perpetual Preference Shares (PPS), with the remaining funds invested in a diversified portfolio. Quayside would continue to pay annual dividends from this diversified portfolio, enhancing long-term financial stability.

What is Quayside Holdings Limited?

Quayside, established in 1991, is the investment arm of the Bay of Plenty Regional Council. It manages a significant investment portfolio, aiming to support regional growth and prosperity through long-term returns.

Perpetual Preference Shares (PPS)

Issued in 2008, PPS raised $200 million for funding regional infrastructure projects. The cost of PPS has risen and repaying it could save $9.6 million annually. Selling PoTL shares below 50.1% requires PPS repayment.

Financial implications of managed sell-down

The proposal assumes that returns from a diversified portfolio will match or exceed current dividends from PoTL shares. Quayside also has a policy to protect against short-term investment downturns, ensuring stability.

The Cameron Partners modelling suggested that selling $1.1 billion worth of PoTL shares could increase the QHL dividend to Council by $7 million in the year after sale and by a cumulative $185 million over the following 10 years. This modelling is based on multiple assumptions including that:

- The proceeds of the PoTL managed sell down are used to repay the PPS with the remainder reinvested based on the current QHL Statement of Investment Policies and Objectives.
- The current Dividend Distribution Policy is used to set QHL dividends to Council, which smooths changes to dividends over time.

The current Distribution Policy includes the concept of a dividend reset. If a dividend reset were applied after managed sell-down of the PoTL shares, the QHL dividend to Council would increase by $11 million in the year after sale, based on the Cameron Partners modelling.

Therefore, as a rule of thumb, selling $100 million of PoTL shares could result in an immediate increase of the QHL dividend to Council of around $1 million, which would continue to increase over time subject to investment performance.

These dividend estimates were used to illustrate one potential benefit of the managed sell down, which could include options other than increased dividends to Council.

Implementation of the Sell Down

If the proposal proceeds, the sale of shares would be managed to optimise financial returns while maintaining a minimum 28% shareholding. The proceeds would be reinvested, considering the need to repay PPS. Council and Quayside would revise the investment strategy accordingly.

Accountability and Monitoring

Council will continue oversight of PoTL through existing regulatory frameworks. No additional accountability measures are proposed for the publicly traded shares.

Conflicts of Interest

Any conflicts of interest arising from the sell-down process will be managed according to the Council's current processes, ensuring no inappropriate financial gains for advisors involved.

Option One – Status Quo

The status quo option would see Quayside retain the existing 54.14% shareholding in PoTL.

Option Two - Preferred Option

The Council prefers the option to reduce PoTL shareholding to a minimum of 28% for better financial management and long-term benefits. This managed sell-down aims to balance immediate financial needs with future sustainability and growth, ensuring continued support for regional initiatives while maintaining financial prudence.

BOPRC's summary of options and implications

Scenario	Strategic			Financial			
	Ownership and Control of Port	Port Strategic Outcomes	Retains flexibility	Diversifies financial exposure	Cash return to QHL	Liquidity	Debt (PPS) repayment
Option 1 54.1% Shareholding Status Quo	✓✓✓ Controlling stake	Yes	✗	✗	✓	✗	No
Option 2 Council Preferred Reduce Shareholding to no less than 28%	✓✓ Negative control*	Yes	✓✓✓	✓✓✓	✓✓	✓✓	Yes

KEY: ✓ = Positive ✓✓ = Strong positive ✓✓✓ = Very Strong Positive ✗ = Negative

*Negative control: When a minority shareholder has the ability to block action by the board or shareholders – for example it could block any takeovers.

Outcome

Council decided to progress a managed sell down of its 54.14% shareholding in PoTL to a minimum of 28%, to repay the Perpetual Preference Shares valued at $200 million and to invest the remaining proceeds of the divestment into a diversified investment fund.