

Marohi matua 3 | Key proposal 3

Te whakahaere tūraru inihua, haumitanga hoki Manage insurance and investment risks

**Waihangahia tētehi
pūtea penapena motu kore
ki ngā hokonga toha a te
taunga rererangi.**

Create a perpetual investment fund through sale of airport shares.

The purpose

The Council has two financial challenges that it needs to manage: the increasing difficulty and cost to insure our assets means we are significantly underinsured, and the lack of diversification of our investment portfolio means all our investments are exposed to the same kinds of risk – in other words, all our eggs are in one basket. A summary of the challenges is outlined below with more information available in our Financial Strategy.

The scale of the challenges cannot be ignored – doing nothing leaves the Council exposed to unnecessary risk and any solution needs to address both the insurance and diversification problems. We think the Council's proposed solution achieves this result.

We are proposing to set up a new Perpetual Investment Fund through the sale of our minority 34 percent shareholding in Wellington International Airport Ltd and reinvesting all the proceeds into the fund. We will also use money from the future sale of some property ground leases to further increase the fund. This will be a publicly owned fund that is intended to continue forever and support generations of Wellington ratepayers by ensuring funding is available to support the city's recovery from natural disasters, including by covering an insurance gap. The proceeds from the sale of airport shares will not be used to pay for Council

related projects or pay down debt. The fund will become a strategic asset in the Council's Significance and engagement policy, meaning if significant changes were proposed, we will need to consult with the community.

Other councils have successfully taken similar action to manage their portfolios and diversify their investments. Examples are the New Plymouth District Council Perpetual Investment Fund, the Dunedin City Council Waipori Fund, and the Hawke's Bay Regional Council Future Investment Fund. Auckland Council is also consulting with the community on a similar proposal in its current Long-term Plan.

Tell us your feedback on this issue and the proposed solution in your submission.



Challenge 1: Cost and availability of insurance

The Council's assets are exposed to significant risk due to Wellington's seismic profile. It is becoming harder to get insurance to cover our assets, with coverage either unavailable, limited or with extremely high premiums. The effects are being felt by private and public property and asset owners and we expect this trend to continue. The value of our buildings and infrastructure has also increased, meaning higher costs to replace them, further increasing the cost of insurance.

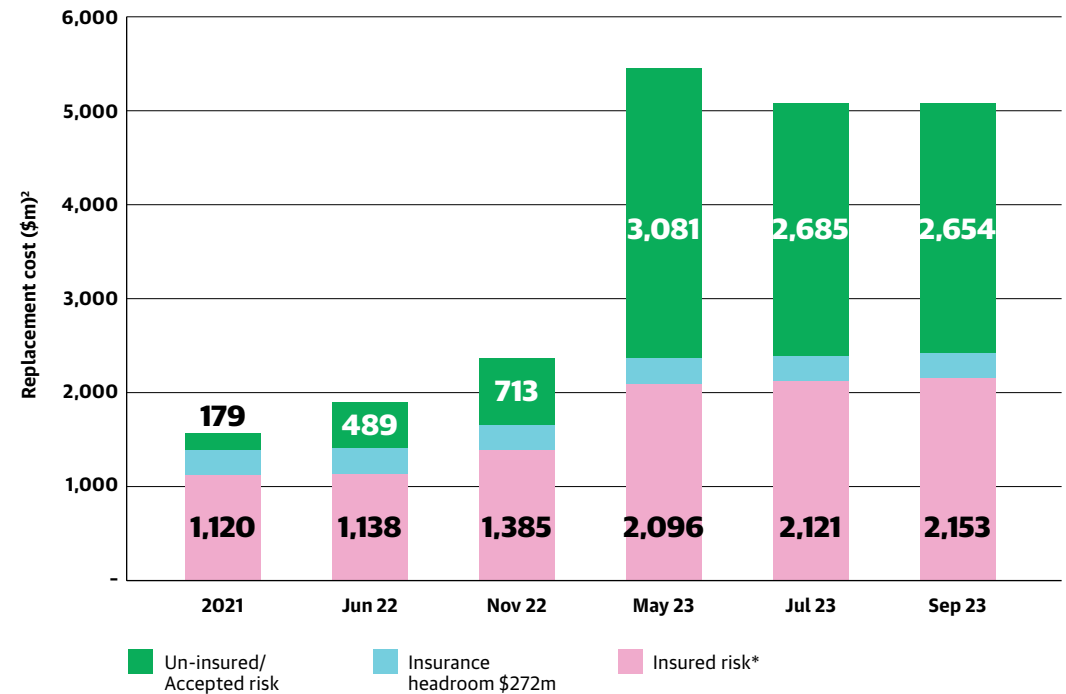
The release of the 2022 National Seismic Hazard Model has increased the maximum amount an insurer is likely to need to pay out in response to a major earthquake for many of the Council's assets. This means the financial impact of a major earthquake is much greater for the Council than previously thought. Additionally, recent weather events across New Zealand have highlighted the reality of climate change impacts.

All these changes have led to the Council assuming a significantly greater and unsustainable level of uninsured risk in the past two years, as shown in the graph below - we now have an approximately \$2.6b insurance shortfall. The \$272m debt headroom the Council has been holding to cover uninsured risk is now far from sufficient to cover expected losses after a major event. So we need to take a different approach.

Notes to graph:

1. A 1-1,000 year loss describes the loss expected from an event which has probability of 0.1 percent of occurring in any one year.
 2. The total replacement cost of all insurable Council assets is \$14.8 billion.
- * Insured risk - The amount of funding the Council expects to receive from external sources after.

1-1,000 year loss funding sources¹

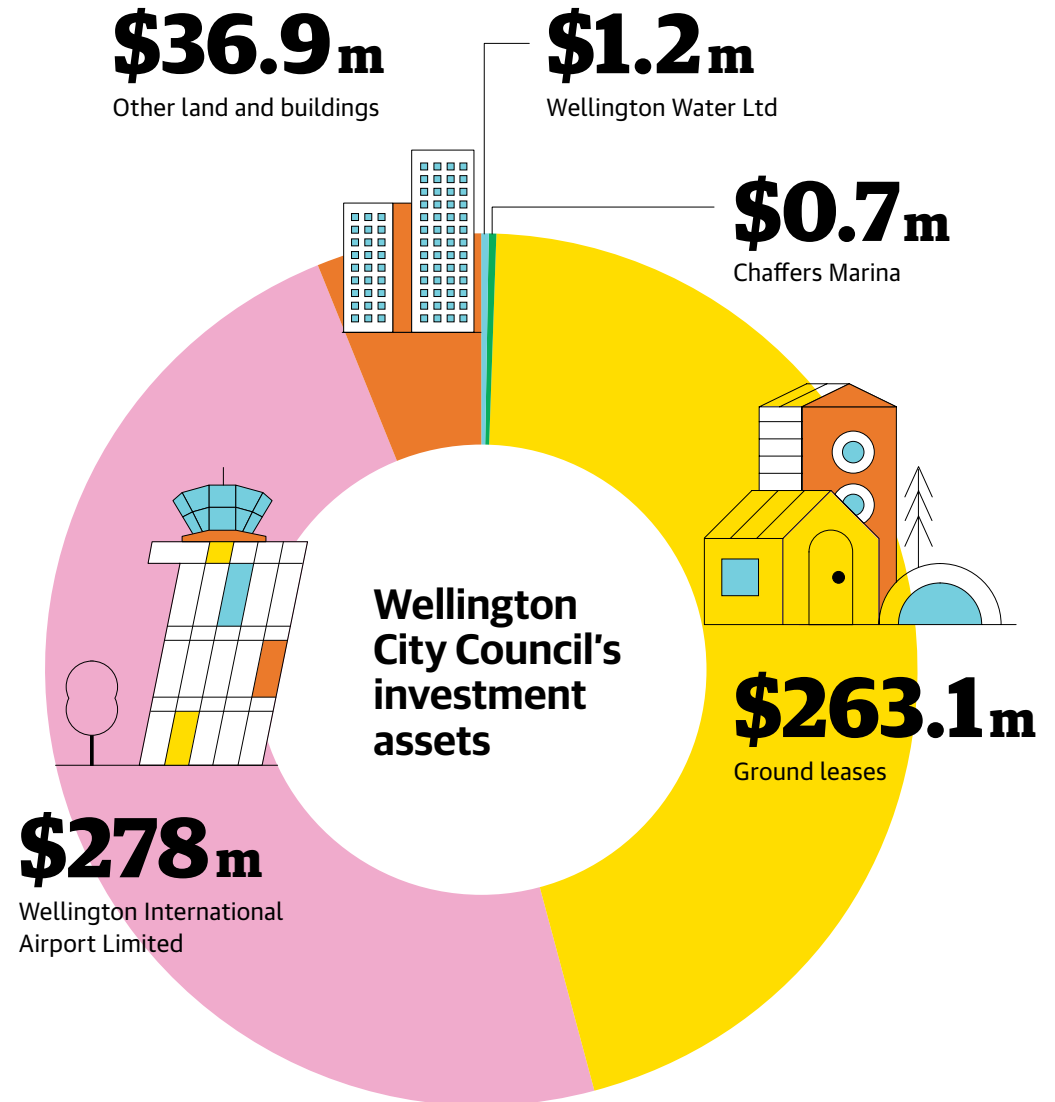


Challenge 2: Lack of diversification in the investment portfolio

The Council's investments are predominantly property assets and are concentrated in Wellington – 93 percent of our investment portfolio is our Wellington International Airport Ltd minority shareholding and property ground leases. This means our investments are all exposed to the same sorts of risks and disruptive events, particularly natural disasters and market disruptions, meaning our portfolio can be significantly impacted by a single event. This means it is unlikely we'd be able to sell our investments to raise cash in an emergency as their value could be significantly impacted and/or it could be difficult to undertake a sale at that time. These disruptive events can also mean the loss of a key revenue stream if dividends are not paid or the amount we receive in dividends is lower than we planned.

It is important to be clear that the problem we have is a lack of diversification in our investments, not a problem with the quality of our investments. The airport shares have been a good investment for the city, with a return over the past 10 years of approximately 11 percent (made up of returns achieved through revaluations and dividend payments).

Additionally, changes to natural hazard modelling (as discussed above) means there is an increased likelihood that we will need to raise cash following a natural disaster because the financial costs of a major event are likely to be much higher than we previously anticipated.



How will it work?

The Perpetual Investment Fund will be set up in the next two years through selling an investment we already have (our 34 percent shareholding in Wellington International Airport) and reinvesting that money in other ways. It will be a financial asset, which diversifies our investments away from Wellington-based property, and will be publicly owned by the Council. The intent is for the fund to be built up over time and, until it is up and running, we will retain the \$272m debt headroom as a mechanism to cover our risks.

All the money in the fund will be 'ring-fenced', meaning funds can only be withdrawn and used for the purposes for which the fund is established. It will not be able to be withdrawn by the Council for other purposes (eg to pay back debt or pay for other Council projects). The fund will be a strategic asset in the Council's Significance and engagement policy, meaning if significant changes were proposed, we will need to consult with the community. The fund will be used for the long-term benefit of the city by providing a regular revenue stream through an annual dividend, like the airport shares do now. It will also provide critical, accessible funding in the event it is needed (eg for covering the cost of an insurance gap or meeting other recovery costs in response to a natural disaster). In setting up the fund,

the Council will decide how much of it can be withdrawn in response to a single event. For the fund to remain perpetual, it will not be possible to withdraw the whole balance in any situation.

The book value in our financial statements for the airport shares was \$278m at 30 June 2023, but the market value could be higher. The Council will undertake a full, formal market valuation prior to beginning the sale process. Based on currently available broker reports, we anticipate the fund's starting value could be \$492m (a midrange estimate of \$500m market valuation for the shares and \$8m to sell the shares and set up the fund). Importantly, this is a very preliminary value, and the actual market value will be based on many factors – the size of the Council's shareholding and how much of it is sold will be a key driver of value. The modelling also assumes the sale of a small number of ground leases over Years 5 to 10 of the Long-term Plan, at a total value of \$50m, with the proceeds transferred into the fund.

The Council will develop a strategy with clear parameters to direct how the fund works, including the arrangements for how to govern, manage and grow the fund (eg the strategy will guide how conservatively or aggressively the money will be invested along with any other criteria to pursue alongside consideration of financial returns). The Council's current

assumption is that the fund will have an investment focus on environmental, social and governance factors, subject to further advice from an investment manager. Council will appoint a fund manager to invest in assets and grow the size of the fund according to the strategy put in place by Council.

The return generated by the fund will depend on how conservatively or aggressively it is invested. For the purposes of modelling the financial impact in the options below, we have assumed the fund generates a 7 percent annual return, which is similar to returns achieved by other comparable investment funds, as well as the mid-range returns of growth-focused KiwiSaver funds. The return may well be higher. The New Zealand Superannuation Fund, another appropriate benchmark, has returned approximately 11 percent over the past 10 years, similar to the overall return (reevaluations plus dividends) from the airport shares – although we have opted to include a more conservative estimate for modelling purposes.

The Council needs to decide how much of the return is reinvested into the fund to enable it to grow and how much goes to the Council. For the options below, we have assumed a hypothetical 5:2 split of the 7 percent annual return mentioned above, meaning approximately 70 percent of any investment proceeds

will be returned to the Council with the remainder being reinvested back into the fund enabling it to grow over time. This split ensures the Council gets revenue from the fund that approximately matches the forecast dividends from the airport. The Council could choose a different split, for example if it wanted more of the return to be reinvested to enable the value of the fund to grow more quickly.



The options

Option A

Sell full holding of airport shares



Costs

This option will have no impact on Council rates or levels of service as, based on the assumptions above, the new investment fund will produce a dividend similar (or higher) to the one currently received from WIAL. The forecast WIAL dividend offset rates by approximately 2.0 percent in 2024/25. However, the exact dividend amounts received by the Council varies year on year.

This option frees up \$272m of headroom held in our debt to revenue ratio. It has no impact on the amount of debt Council has.

The Council will sell its **full holding of airport shares** and create a new publicly owned financial asset by reinvesting the proceeds in a perpetual investment fund. Proceeds from future ground lease sales could also be transferred into the fund (if/when these leases were considered for sale).

Under this option, we have assumed sale proceeds from Wellington International Airport Limited (WIAL) shares of \$500m (based on the midrange valuation), with an \$8m cost for the sale. This leaves a starting fund balance of \$492m. We have also assumed \$50m in ground lease sales, spread over Years 5 to 10 of the LTP, with proceeds being invested in the fund.

What this means

- Selling all the airport shares provides the greatest benefits in how we can mitigate the financial risks outlined above, including increasing diversification to better manage risk, providing security of revenue stream via diversification of investments, and increasing access to funds for rebuilding or providing financial relief after a natural disaster.
- While we will no longer have a dividend from the airport shares, expected returns have been assumed at 7 percent and could be the same or greater than our airport dividend. This means we can use some of the return on the fund as revenue for the Council and use some to reinvest in the fund to enable it to grow.
- In the event of a disaster we could use some of the fund to help cover the insurance shortfall we are exposed to. The level of funding we expect to draw down would be agreed within the fund's charter.
- Enables the Council to invest in line with its strategic objectives eg environmental and climate objectives.
- Enables the Council to no longer need to hold \$272m debt headroom/capacity for increased borrowing in the event of a natural disaster, which frees up the Council's borrowing capacity.
- As the Council will no longer be a shareholder, it will not be called on to contribute capital funding to the airport in future (or face dilution of its shareholding if others invested in the company), including if the airport needed funding to rebuild after a natural disaster.



Preferred option

Option B

Sell some of its airport shares



Costs

This option will have no impact on Council rates or levels of service as the new investment fund and the smaller shareholding in WIAL will produce a dividend similar to the one currently received. The forecast WIAL dividend offset rates by approximately 2.0 percent in 2024/25. However, the exact dividend amounts received by the Council varies year on year.

This option frees up some of the \$272m of headroom held in our debt to revenue ratio, but not as much as Option A. It has no impact on the amount of debt Council has.

The Council will sell **some of its airport shares** and create a new publicly owned financial asset by reinvesting the proceeds in a perpetual investment fund. Proceeds from future ground lease sales could also be transferred into the fund (if/when these leases were considered for sale).

Under this option, we have assumed sale proceeds from WIAL shares of \$250m (based on the midrange valuation for half the shareholding), with a \$4m cost for the sale. This leaves a starting fund balance of \$246m. We have also assumed \$50m in ground lease sales, spread over Years 5 to 10 of the LTP, with proceeds being invested in the fund. The Council also retains half its WIAL shareholding.

What this means

- Selling some of the airport shares provides some diversification in the Council's investments to

help mitigate the financial risks outlined above and provides some improved access to funds for rebuilding or providing financial relief after a natural disaster. This is less than Option A, but more than Option C.

- The Council may receive a lower value per share, if we sell a smaller shareholding.
- While we will receive a smaller dividend from the airport (due to our smaller shareholding), expected returns from the fund have been assumed at 7 percent and could be the same or greater than the reduced airport dividend. This means we can use some of the return from the fund as revenue and some to reinvest in the fund to enable it to grow.
- The Council can invest in line with its strategic objectives eg environmental and climate objectives. This is less than Option A but more than Option C.
- The Council can reduce the \$272m debt headroom/capacity held for increased borrowing in the event of a natural disaster, which frees up the Council's borrowing capacity. The amount of headroom that can be reduced depends on the amount of shares sold. In this option the Council will hold less debt headroom than Option C but more than Option A.
- As the Council will still be a shareholder, it will be called on to contribute capital funding to the airport in future if it was required of shareholders (or face dilution of its shareholding if it chose not to provide funding and/or if others invested in the company). This includes funding any rebuild of the airport after a natural disaster and/or funding any capital investment plans. If capital works or access to capital are constrained, this may also affect the value of the Council's expected dividend.
- Compared to Option A, the value of the fund will be lower, meaning in the event of a natural disaster, the Council may need to borrow more to fund recovery.

Option C

Retain all its current airport shareholding



Costs

This option will have no impact on Council rates or levels of service (unless a dividend is not paid) as we will continue to receive a dividend from WIAL. The forecast WIAL dividend offset rates by approximately 2.0 percent in 2024/25. However, the exact dividend amounts received by the Council varies year on year.

This option means we will need to retain the \$272m of headroom held in our debt to revenue ratio.

Under this option, the Council will **retain all its current airport shareholding** and will not establish the investment fund. Proceeds from any future ground lease sales will be utilised for other purposes.

What this means

- This option does nothing to address the balance sheet challenges outlined above – the Council will continue to hold an undiversified portfolio and have the same exposure to financial and insurance risks and the Council will need to borrow more to fund recovery from an unexpected event.
- The Council will continue to receive revenue via the dividend on its current shareholding, which helps keep rates lower than they will otherwise be (noting the Council has not received a dividend every year).

- As the Council will still be a shareholder, it will be called on to contribute capital funding to the airport in future if it was required of shareholders (or face dilution of its shareholding if others invested in the company). This could include the need to fund any rebuild of the airport after a natural disaster.
- The Council will need to continue to hold debt headroom and maybe increase this amount over time to enable it to be able to borrow to fund recovery, given the extent of the Council's uninsured risk. This limits our ability to fund other projects.
- This option does not provide the Council with the option to invest its assets in line with its strategic goals eg environmental and climate objectives.

