Open Meeting

To	Water Governance Board
From	Ian Cathcart General Manager Service Delivery
Date	15 February 2019
Prepared by	Ian Cathcart
Chief Executive Approved	Y
Reference #	GOV1318
Report Title	Franchise background, benefits and current position in discussions with Watercare.

1. EXECUTIVE SUMMARY

This report is to inform the Water Governance Board (WGB) of the options considered for transition of our Three Waters business to Watercare Services Ltd ("Watercare"). The report briefly summarises the options considered and reasoning for the current progression towards a long term franchise contract (with two year initial operational transition phase) from 1 July 2019.

2. DISCUSSION

The concept of the WGB was created from the Council Controlled Organisation ideas once held by joint councils in the Waikato. With the demise of that idea came the need for Waikato District Council (WDC) to give meaning to the WGB in the proposed new relationship with Watercare. This approach was consulted in 2018 and approved as part of the LTP process.

It was felt by staff that a purely transactional role for the WGB was inappropriate. This was supported by internal communication with the Executive Leadership Team and the Waters Steering Group. To enable strategic oversight of the proposed agreement the following were considered important in the relationship/contract structure:

- Ownership of the assets
- Control of price
- Control of strategy
- Reduction in the WDC risk profile
- Reduction in price of water services to WDC communities

To enable water governance for WDC a more complex long term contract was envisioned. Various options within the industry exist with some more pertinent to the WDC situation than others.

Option	Primary Application	Average Term (years)
Operate and Maintenance Contract (O&M)	New or existing systems	3 - 10
Alliance	Existing systems	10
Design-build-operate (DBO) or O&M with design/build	New or existing systems	15 -25
Design-build-finance operate	New systems	20
Concession/lease	Existing systems	10 – 20+
Build-operate-transfer (BOT)	New systems	25

Historically public entities and private firms that have entered into public-private partnerships have identified several guiding principles to foster trust:

- Contract scope clearly defined by the client
- A procurement process that is stable, reliable, and predictable to actual and potential proposers, procurement officials, and the public
- A system open to technological change and improvements
- Sound financial analysis over the life of the contract
- Clearly defined roles, responsibilities, and risk-sharing frameworks
- Open communication among all stakeholders
- A specific methodology for evaluating performance.

Although the terms public-private partnership and privatization are often used interchangeably, they are not the same. Privatization involves the sale or transfer of ownership of public assets to the private sector. In sharp contrast, under all public-private partnerships, the public partner:

- Owns the assets
- Controls the management of the assets
- Establishes and controls the price of services

The private partner provides the services specified in a contract with the public partner. Those services typically entail operating and maintaining water and wastewater facilities and systems. The agreements also can include design and construction; meter reading, billing and customer services; maintenance and replacement of distribution and collection infrastructure; operation and maintenance of biosolids facilities; and various other public works functions.

Over several years prior to the decision to contract with Watercare there have been many potential structures for management of water for WDC. Below is a comparison of the relative benefits considered against the WGB strategic objectives defined at the workshop held in January 2019. Some additional considerations have been added to build perspective.

Strategic Objectives	***Status Quo In House***	***Traditional O&M contract***	***Alliance***	***Lease, Concession, Franchise***
Efficiency (Low/med/high)	L	L	M	H
Affordable Service		✓	✓	✓
Customer outcomes	✓	✓	✓	✓
Economies of Scale (Low/med/high)	L	L	M	H
Managing Growth	✓		✓	✓
Safe Water	✓	✓	✓	✓
Iwi Co-management			✓	✓
Capability		✓	✓	✓
Whole of Catchment approach	✓		✓	✓
Regulatory compliance	(✓)	✓	✓	✓
Asset ownership	✓	✓	✓	✓
Other Considerations				
Asset condition obligations (Low/med/high)	H	M	M	H
Price control in scope of contract/delivery	✓			✓
Discussed with Watercare		✓		✓
Risk transfer (Low/med/high)		L	M	H
Building Resilience (Low/med/high)	M	L	M	H
Driving Innovation	L	L	H	H

The preferred franchise/lease/concession model is not new to New Zealand and there is one in place with the old Papakura District Council area in Auckland. This commenced in 1997 for a period of 30 plus 20 years.

The franchise/lease/concession usually includes a payment by the private firm to the public owner for the right to manage the facilities. The partner can be responsible for capital upgrades, expansion, and a broader, or complete range of functions. In the case of the 'social franchise' as proposed there is a unique public to public arrangement where the focus is on a fair return to Watercare with a resounding improvement in the services to the WDC community at the lowest cost.

"*An agreement to maintain ownership and protect the assets, cap price, protect the environment and maintain public health and customer service aspirations*"

3. CURRENT STATUS

The approach taken to date is to:

- Establish control of the strategic aspects of water service delivery (with bright-line back to the WGB)
- Give the WGB strong oversight of water delivery while passing sufficient independence to WSL to improve efficiency and innovate

The approach considers the recommendations of the Report of The Controller and Auditor-General on the PDC Water and Wastewater Franchise April 1998.

While the contract draft terms (and risks) are the immediate key focus, concurrently data collection, sharing and analysis is underway. Detailed work has been undertaken to draft a Terms Sheet encompassing key items with details of agreement or discussion status.

It is intended that this will underpin a contract by 31 March 2019 (or some form of enabling agreement) for Watercare to continue mobilisation in order to meet the 1 July 2019 deadline.

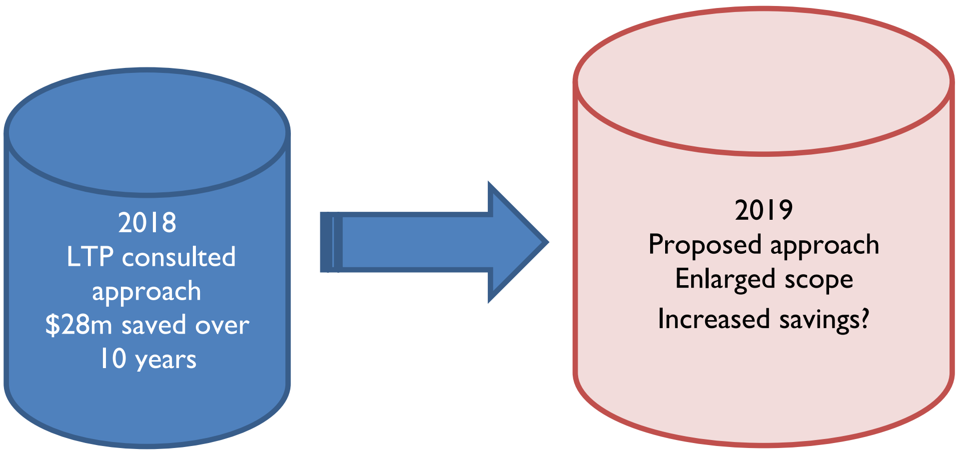
Financial considerations:
Watercare are building a financial model which has been shared with WDC staff and is based on data supplied by WDC. A workshop was held on 12 February to discuss assumptions on all aspects of the model and how WDC runs its current water business. The model is based on 10 year LTP price path for the first two years within the transition phase. This collaborative approach to transparently build an accurate model will continue. The benchmark for the cost to deliver services is the long term plan price path which factors in the $28m savings over 10 years.

During the transition phase the asset condition position will be confirmed and the asset management plan reviewed to ensure the future investment profile allows for compliance and growth at an affordable rate. The price for the service to customers will be derived from a process in line with that of the OFWAT price review model in the UK. The two year period allows for this to be built with full engagement of the WGB who have ultimate sign off on these key aspects of the contract.

Risk assessment:
A detailed risk assessment has been undertaken. In December 2018 the Finance and Audit committee completed a "deep dive" on the approach taken to date. The detailed risk assessment:

1. Informs the approach taken in the mobilisation streams towards 1 July 2019
2. Is reviewed periodically to ensure the project is on track with covering risks. The next review and consideration will be at the joint meeting at Hopuhopu on 19 February.

A test of the new model against the proposed delivery back in 2018 is considered as part of the development of the contract and financial model. The consulted approach in 2018 had a more limited operational scope against that of the proposed new long term delivery model. There is an expectation that the savings could be increased. This is provided that the risk allocation between Watercare and WDC is with the party best able to manage it.



With the aim of establishing control for the WGB within the proposed contract structure the project team has undertaken the approach to cover specific issues as below. This aligns key objectives and control points for the WGB with contract terms.

Recommendations from the appended Report of The Controller and Auditor-General on Papakura District Council: Water and Wastewater Franchise, April 1998 have also been included where applicable given the non-standard procurement of the proposed contract.

Element of Contract	Controls
Pricing	• Set district price & sign-off via agreed methodology • Use global best practice pricing methods (e.g. OFWAT) • Potential alignment with industry approach in NZ long term • Overall objective is to meet Auckland water price (plus a rural margin) • Move to volumetric wastewater charging to align with Auckland
Renewal of contract	• Performance related and at key points • Linked to WDC LTP cycle
Assignment	• Change in "ownership" of WSL triggers WDC to consider options.
Term	• To get the best for the WDC community considering WSL investment to improve LOS and reduce risk. • A range of durations to be modelled in order to extract the best value for the community
Asset Ownership	• WDC always own the assets
Asset Condition	• Baseline of asset condition set at start of the contract (critical item) • Possibly do 2 iterations in first two years to cement assessment methodology • Annual audit of maintenance and new assets vesting processes • 6 yearly condition assessment linked directly to AMP and pricing • WDC own the methodology to ensure sustainable management of the assets • Assets required to be in an equal or better condition at the end of the contract
Asset Management Plan	• AMP is critical part of the contract • WGB ultimate sign off • Direct link to the price setting • To NZ and industry standard and subject to audit • Use WDC AMP in first 2 years tied to LTP funding and price path
HIF Fund Te Kauwhata	• Contract requires mechanism to allow this investment to fund growth assets • Method to access similar future funds needs consideration
Resource Consents (Water and Wastewater Treatment plants)	• Maintain ownership of the process in the contract. • Co-management arrangement • WDC as Resource Consent owner and applicant, stakeholder manager • WSL as technical expert and operator perspective

	• Linked to pricing methodology
Extreme events	• Disaster Recovery Plan • Risk Management Plan • Drought Contingency Plan
Community Engagement	• Set target % of workforce that are local people • Set target % for local procurement • WSL required to have a local depot
Customer response & performance	• KPIs in contract (linked to Water NZ Benchmarking and Australian Industry standards) • Customer charter • Customer contract
Asset & customer information	• Asset and customer information remains property of WDC
Innovation	• Mechanism in contract to incentivise (latitude within actual contract structure allows for this) • Consider the creation of an innovation forum
Non Performance	• Contract clause considering failure to meet asset condition requirements • Contract clause for performance failings • Contract clause for compliance failings • Contract clause for health, safety and wellbeing failings
WDC branding	• Co-branding to be defined
Liability	• Clauses to reflect WGB requirements • Clauses to cover minimum insurance requirements
Flexibility	• Change management clauses in the contract • Use of schedules attached to contract for detailed conditions
Growth Infrastructure	• Funded by development • Process mapped and agreed • To be aligned with WDC District Plan and any relevant structure plans

Transparency	• Reporting requirements clearly defined • Audits scope and frequency defined • Pricing methodology clearly defined • Condition assessments methodology defined and applied early in the contract • Resource consents gained or renewed within a co-creation model
Operations Manuals	• Define detailed procedures for key exchanges/transactions/interfaces between the Parties and stakeholders (consistency of approach across generations) • Examples: Annual audit process; Asset vesting and data capture.

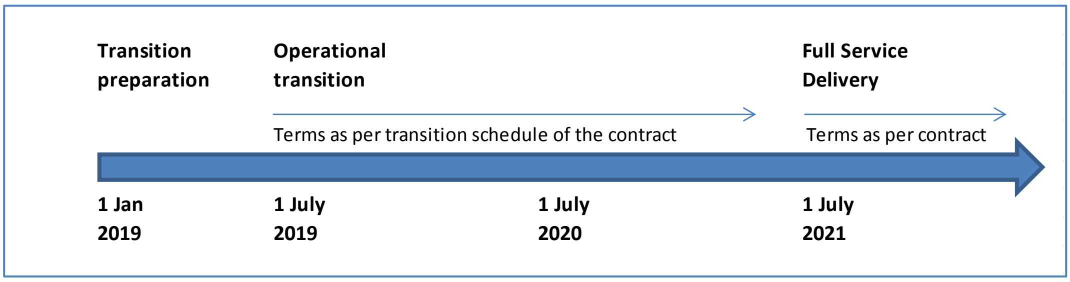
The culmination of detailed asset management and operational review by WSL will inform the price setting methodology (based on a business plan) that will take effect every 6 years. The operating term will be for 36 or 42 years. This is linked to the three year Long Term Plan cycle in Council. The key contract control points of price setting, asset condition and the asset management plan are outlined chronologically in the table below.

Contract Year	Contract Review	Yr Start 01 July	Fin Year End	LTP Year	Activities	Price
Transition Period (2 Years)						
1	5	2019	2020	2	Condition Assessment AMP Review	Use LTP WDC Price
2	6	2020	2021	3	Price Setting	Use LTP WDC Price
						Price Adoption
Full contract starts (BAU)						
3	1	2021	2022	1		
4	2	2022	2023	2		
5	3	2023	2024	3		
6	4	2024	2025	1		
7	5	2025	2026	2	Condition Assessment AMP Review	
8	6	2026	2027	3	Price Setting	
						Price Adoption
9	1	2027	2028	1		
10	2	2028	2029	2		
11	3	2029	2030	3		
12	4	2030	2031	1		
13	5	2031	2032	2	Condition Assessment AMP Review	
14	6	2032	2033	3	Price Setting	
						Price Adoption
15 onwards until contract year 26, 32, 38 or 44.						

Transition
The short time frame to I July 2019 has concerned both Watercare and WDC. The pending local elections could give a platform for significant criticism if the delivery of services by Watercare is less than the current level of service, The risk has been mitigated by delaying significant risk items such as systems and billing. This also will help reduce transition costs.

Mobilisation will take place pre I July 2019 with 80% plus of the business moving across to Watercare. This will move to readying for the remaining transfer of business to WSL within two year Transition Phase. From I July 2021 we will enter the Full Operating term.

- I July 2019 to 30 June 2021
  - Finalise consultation with community
  - Finalise pricing methodology
  - Finalise condition assessment and AMP
  - Migrate IT systems to WSL
  - Move to volumetric wastewater charging
  - Consolidate process for charging for growth infrastructure



A detailed joint transition plan has been drafted and will accurately inform the parties of obligations moving into and through the two year transition. There are key milestones critical to the commencement of the full operational part of the contract from I July 2021. These centre on asset, condition, the asset management plan (AMP), price setting, completing consultation with WDC community and ensuring all policy and process in WDC enables the operation of the long term agreement. Only when all milestones are met will the move from transition to full contract delivery occur.

Some key short term milestones.

DATE	Item	Detail
19 February	Joint transition streams meeting at Hopuhopu	Meeting to continue detailed planning and migrate ownership of the mobilisation to Watercare.
20 February	WGB meeting	
26 February	Joint Board workshop	To develop common understanding of the relationship between the parties. Develop memorandum of understanding (Charter) at Board level to inform how the relationship will take shape.

5 March	Water staff update	Next in the regular status updates for the whole team
27 March	Council meeting to sign off enabling letter/MOU/ heads of agreement with WSL	WSL indicate that unless a signed contract is in place by 31 March then the mobilisation plan particularly around the People stream and procurement cannot proceed as the risk is too high. A letter of commitment underpinned with some financial and term provisions and a draft term sheet have been suggested.
31 March	Signing of contract with WSL	(Contract can be enabling document for mobilisation to continue)
1 July 2019	Transition Period begins	Majority of water business moves to Watercare management

The two following items are for discussion and the project team seek direction to enable further development of the relationship with Watercare.

1. <u>WGB requirements for branding of the Watercare team.</u>

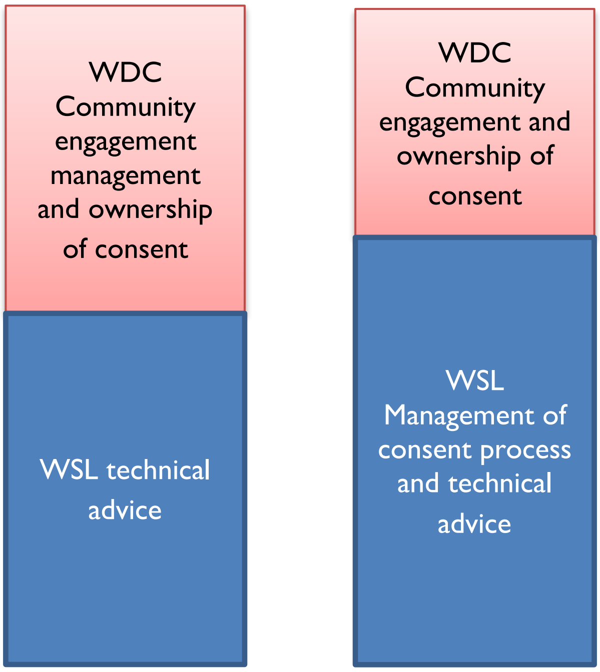
Direction is sought on the preference of the WGB for how the desired "Waikato Brand" is reflected. This is with regards:

- Uniforms
- Vehicles
- WDC asset signage
- Written/printed communication

2. <u>Resource consent ownership options:</u>

A co-creation solution to gaining the discharge or water take resource consent is proposed. WDC as owner of the consent will have high level control of the process but once gained the consent obligations will be transferred to WSL as asset operator to manage. Any asset and pricing implications will be resolved through AMP development and the concomitant price setting methodology.

Option 1 Option 2



4. Recommendation

THAT the report from the General Manager Service Delivery be received for consideration and that the Project Team continue to develop the relationship with Watercare based on the mobilisation to 1 July 2019 and 2 year transition period through to long term contract starting 1 July 2021.
And, THAT the Waters Governance Board confirm their support for the franchise model to be fully operational by 1 July 2021.

5. ATTACHMENTS

- Report of The Controller and Auditor-General on Papakura District Council: Water and Wastewater Franchise, April 1998.