

Role of Local Government in Community Irrigation Projects

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Preface

This Paper is one of a series of jointly funded reports commissioned investigate impediments and opportunities for the development of large scale water enhancement projects in New Zealand, with a primary focus of providing water for community irrigation schemes. Other reports cover the areas of: equity investment options, the role of central government, the role of local government, and economic and social assessment parameters. An overview and commentary document summarises the key issues raised in the reports.

The future use of water, in the South Island especially, is a critical issue for regional and central government and private investors. As water is a finite resource that has multiple uses and development requires significant, long-term, investment flows.

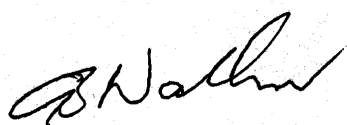
These reports, which consider the use of water for irrigation, arose from feasibility studies by a number of farmer groups (many of whom have contributed to funding of these reports) into large community-wide irrigation projects. The feasibility studies highlighted the need for information to assist co-operative action for the financing, building and running of irrigation schemes.

This paper reports on the possible contribution by local government to large-scale irrigation scheme development. The author questions whether there are extra benefits to society that would be achieved if local government made such a contribution. The researcher concludes that, because there are a variety of responses that a particular local government can afford, there are varying degrees to which central government might contribute.

The report concludes that it is particularly in the planning and initial development stages of proposed schemes that local government might be able to facilitate proposals. The author suggests that facilitation might take the form of: (a) the provision of funding for initial feasibility studies; (b) general project facilitation, including provision of information, education/training; (c) underwriting scheme revenue capacity; (d) partial funding provider: or (e) providing financial guarantees for secondary security.

The researcher suggests that if local government were to assist with the flow of information to potential users and investors particularly in the areas of feasibility and resource consent, this will enhance the participation of the private sector through the lowering of start up risk. The researcher further suggests that a second reason for assistance arises from early difficulties with financing a long-term irrigation project. To meet this need, the researcher outlines a form of government equity in schemes at early stages, which could later be withdrawn when the schemes are established.

I would like to acknowledge the experts who wrote these reports, the reviewers who made their contribution, and the many people in the farming community and local government who have made their views known. This report reflects their views and will be a useful contribution to government policy analysis.



Alan Walker
Director, Policy Information and Regions
MAF Policy

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Agricultural and Marketing Research and Development Trust (AGMARDT)*

Ashburton Water Trust

Central Plains Water Enhancement Committee

Clutha Development Board

Farmers Irrigation Group, South Canterbury

Hawkes Bay Regional Council

Marlborough District Council

Masterton Business Enterprise Board

Tasman District Council

Waimate District Council

Ministry of Economic Development

Ministry of Agriculture and Forestry

* The Agricultural and Marketing Research and Development Trust (AGMARDT), earns income from funds invested from a share of the monies arising from the winding up of the Phosphate Commission in 1987. This income is used for promoting and encouraging excellence in New Zealand's land-based industries. Grants are made for farmer projects involving grass-roots problem solving and opportunity development, industry support, conference sponsorship, doctoral scholarships and postdoctoral fellowships. Farmer groups are encouraged to seek details on AGMARDT's applications process by accessing the website on www.agmardt.org.nz or contacting the Secretary Manager, P.O. Box 399, Shortland St, Auckland, Tel. (09) 373 3370, Fax (09) 373 3488.

Contents	Page
1. Key Findings	1
1.1 Funding and Evaluation Criteria	1
1.2 Council Justification	1
1.3 Constraints	2
1.4 Role of Local Government	2
2. Objective & Scope	4
3. Council Policy Objectives	6
3.1 Council policy objectives	6
4. Council Legislation & Regulation Constraints	8
4.1 The Local Government Act 1974	8
4.2 Local Government act 2002	8
4.3 local government (rating) Act 2002	9
4.4 The Resource Management Act 1991	9
5. Criteria for Evaluation & Prioritisation of Investment Opportunities	10
5.1 Council criteria	10
5.2 Council roles	11
5.3 Best Practice	11
6. Benefits & Issues For Council Involvement	13
6.1 Benefits for Council investment and support with water enhancement schemes	13
6.2 Issues for Council investment in water enhancement schemes	14
7. Council Investment Capability	15
7.1 Internal capability	15
7.2 External capability	16
8. Recommendations – Role of Council	17
8.1 Introduction	17
8.2 Recommendation for Council	17
8.3 Indirect financial support from Council	20
Appendix 1 Christchurch City Council’s Project Eligibility Assessment Process	21
Appendix 2 Good Practice for Involvement in a Major Project Lessons from the Opuha Dam Project	23
Messages for Equity Investors	23
Messages for Lenders	23
Appendix 3 Local Government Bill 2001 - Powers of Territorial Authorities	25

1. Key Findings

Outlined below are the key findings of this study. Unless expressly stated the term “Council” refers to Regional, District and City councils.

1.1 FUNDING AND EVALUATION CRITERIA

- Council must manage finite economic development funding across competing demands for core and non-core project support from the community and region.
- Councils do not have a formal evaluation and prioritisation criteria when deciding whether to invest time or resources into a project. Projects are reviewed on a case-by-case basis.
- Each individual Council, through the adoption of a funding policy, determines its own funding capacity. There is no consistency of funding policies between Councils.
- Tangible benefits of irrigation are not fully understood by Councils so it is difficult to compare these to other project initiatives.
- Projects with Council champions (Council staff or Councillors) driving the process have a greater chance of accessing Council resources and support and a greater likelihood of future success.
- Given the lack of consistency between Councils in relation to investment evaluation frameworks, availability of Council champions, and views surrounding acceptance of funding risks, the initial success of a water enhancement project has an element of “chance” depending on the geographic location of the scheme. By way of example, projects may be undertaken in specific areas where there is an active Council promoting the project. Meanwhile, a project in a neighbouring area which has superior project fundamentals will not proceed because of the inactivity of the Council in that area. It is the role of Government (Central and Councils) to remove this element of chance and ensure that success is based on the most productive use of natural resources regardless of the preferences of the regional governing body(s).

1.2 COUNCIL JUSTIFICATION

- The common policy objectives and strategic directions from Councils in water enhancement “hot spots” relates primarily to economic, social and environmental benefits driven from employment enhancement and population growth.
- Many competing projects have the ability to provide Council with employment and population growth/stabilisation. Projects that can demonstrate the most efficient provision of these benefits will attract most Council attention.
- Local government intervention into water enhancement developments is justified where the following three requirements can be met:
 - the development will bring significant social and economic benefits to the community/region (Study 5 is expected to quantify the levels of social benefits from water enhancement developments);
 - there is an adequate economic return on the investment for Council;
 - The project is unlikely to proceed without Council intervention and therefore the benefits it brings will be lost to the region, i.e. the uncertainty surrounding the projects

long term success is difficult to determine in the early stages and, without intervention from Council, the private sector would be unlikely to progress the project in isolation.

- In a report issued by the Controller and Auditor-General on “Good Practice for Involvement in a Major Project”, three key messages were identified for Councils lending money or making equity investments:
 - ensure the investment is in line with policy objectives and long term strategy;
 - complete adequate risk assessments and risk management strategies;
 - ensure the investment generates an adequate rate of return.

1.3 CONSTRAINTS

- There are no significant legislative constraints preventing Councils from undertaking an investment role for a water enhancement scheme. There are, however, certain powers that Territorial Authorities have in respect to water schemes set out in Part XXV of the Local Government Act. It is outside the ambit of this report. The proposed Local Government Bill also extends the powers of Territorial Authorities and the implications of this are outlined in Section 4.2 of this report and further detailed in Appendix 3 to this report.
- Financial constraints however are significant for Councils. The scale of the investment required is such that Councils often do not have the ability to raise the funds to support a water enhancement scheme, or if they could raise the funds, this would significantly impact on their ability to invest in other community/regional projects.
- Internal financial constraints may be overcome if Councils were able to fund schemes outside of the requirements of their stated funding policy on the basis that the funding is for a specific purpose and that there is a designated revenue stream (also excluded from the funding policy) to meet the funding requirements (effectively off balance sheet financing). For this to be acceptable the revenue streams would need to be very secure to ensure that general ratepayers were protected against any credit risk.
- District Councils with smaller rating bases should consider partnering with City Councils to assist with scheme funding provided that there is proof of flow-on benefits for the City business community and general population.
- Current Council attitudes will provide a constraint given that they are generally not in favour of committing long-term funds to water enhancement developments. They see Councils role being a facilitator therefore allowing them to provide lower levels of assistance to many competing projects.

1.4 ROLE OF LOCAL GOVERNMENT

- The role of Council in supporting water enhancement schemes is likely to be different for each scheme within each region based on the following variables:
 - The community/regional economic and social benefits provided by the individual development (how these compare to competing projects).
 - The level of funding and support provided to the scheme by private sector investment, and the additional funding required.
 - The financial capability of Council to provide support given competing projects.
 - The expected return on Council investment.
 - Economic return that can be generated from the land in the region.
- There is a clear role for Council in championing and facilitating water enhancement development within the region. This support should include:

- Provision of funding for initial feasibility studies (this should be repayable or convertible into equity if the project is eventually implemented).
 - General project facilitation, including provision of information, education/training, opening project to Council networks and bringing potential stakeholders together.
 - Assisting with community/regional consultation, education and awareness of water enhancement schemes in relation to the Resource Management Act in an effort to improve the speed and certainty of the application result.
 - Conducting a study to determining the benefits (economic and social) expected to be derived from the scheme to provide the basis for determining the level of additional project support (if any).
- A concurrent study by the author¹ concluded that the most appropriate funding option for a water enhancement development was “project finance”. Therefore, the most appropriate role for Council is to assist a scheme to meet the “project finance” requirements. This can be achieved through one or a combination of the following roles:
 - *Underwriting scheme revenue capacity*
The risks associated with this role need to be managed carefully. This role is only appropriate where a scheme development cannot be staged to meet market demand. Agreeing a formal exit strategy is critical for this role.
 - *Partial funding provider*
The most appropriate form of Council funding is the provision of hybrid equity (subordinated loans, redeemable preference shares, or convertible notes). This strengthens the equity position of the scheme but allows Council to generate a fixed return with a clear exit strategy. Council funding should be provided on a short-term basis and transferred to a private party when key risks have been ameliorated.
 - *Providing financial guarantees for secondary security (if required)*
Financial guarantees are appropriate where secondary security is required from private investors. Guarantees are likely to be required over the initial start up phase (i.e. the first 5 years of operation).
 - Prior to providing assistance to a scheme, exit strategies must be considered and formalised by Council. It is Councils role to realise the Community benefits provided by the scheme. As these benefits will have been achieved when the scheme has been developed and is operational, Council should look to the private sector to takeover and manage the investment for the long term.

¹ Gamble 2002a Review of equity funding options Technical Paper 2002/10; MAF, Wellington.

2. Objective & Scope

The objective of this study is to outline the involvement of local government in the development of water enhancement projects to date, and to identify the benefits and issues associated with various types of involvement. The investigation will review the basis that local government might currently use for prioritising investment, investment capability, exit strategies, and constraints imposed by legislation and regulation.

The scope of our work, as outlined in the terms of reference for this study, will be to address the following questions:

- *What are the benefits and issues for local government investment and support for large water enhancement projects involving irrigation development as a major component?*
- *How robust is the proposition that the development of these enhancement projects involving irrigation introduces considerable social and economic benefits to local communities by way of increased annual expenditure in local areas, and renewal of rural communities driven by age and population changes?*
- *What has been the experience and rationale of Council investments, particularly in regard to long-term investments?*
- *What is the current basis for prioritising investment?*
- *What has been the experience of large-scale irrigation developments on the need for and financing of additional supporting infrastructure that is the responsibility of Council?*
- *What are the constraints under current and likely future Council legislation and regulations to investment, management or ownership options in these projects?*
- *What is the investment capability of Council bodies in key areas where water enhancement projects are proposed?*
- *If investment by Council is considered justified and feasible, what form should this investment take and what exit strategies should be considered?*

2.2 PROJECT PARTICIPANTS

The following local authorities provided information for this study:

Councils with existing irrigation infrastructure

- Waimakariri District Council
- Ashburton District Council
- Timaru District Council
- Mackenzie District Council

Councils from high demand irrigation areas

- Masterton District Council
- Tasman District Council
- Marlborough District Council
- Christchurch City Council

- Selwyn District Council
- Waimate District Council

Other

- Local Government New Zealand

3. Council Policy Objectives

3.1 COUNCIL POLICY OBJECTIVES

Discussions were held with individual Councils to determine specific regional policy objectives, in particular, relating to economic development, employment generation and council investment.

The key points from Council policies and directions are outlined as follows:

- The following verbs were consistently used by Councils to describe their role within business development policy initiatives – “facilitate”, “identify”, “promote”, “encourage”, “stimulate”, “attract”, “and investigate”.

These terms reflect a general Council view that their role within economic development (including water enhancement) is facilitation, providing information, resource, credibility and networks. The terms “invest”, “fund”, or “financially support” were not included within any Council policies reviewed. Councils will require a shift in philosophy if water enhancement schemes are to receive substantial Council financial support beyond facilitation.

- Generation of employment is the key driver across Council economic development policy. Common themes focused on employment stability within existing businesses and employment growth from attracting new business initiatives.

The results of previous economic studies provide clear evidence that water enhancement schemes bring significant employment opportunities to the region, both on-farm and downstream (this will be further quantified within study 5). There is however a concern regarding the availability of people with the skills and/or desire to fill the jobs brought about through the introduction of a water enhancement scheme. Attracting students and other staff to this vocation is an issue for the agriculture industry as a whole in New Zealand.

- Facilitating the provision of business training and education was a common policy objective through regional development initiatives.

This is a critical role for Councils to take in relation to water enhancement developments. Many of the key funding issues (i.e. availability of water user equity, price of water at the farm gate, initial water user take-up commitment and environmental concerns) can be overcome by educating water users and the general community regarding the benefits of water enhancement to the region and further analysis of environmental concerns. Strong up front community consultation and education will be a key advantage for a water enhancement scheme when resource consent applications are filed.

- Another common Council policy objective relates to stabilising and/or growing the population base of the region. Councils impacted by water enhancement development are primarily rural communities and are focusing on reversing migration to urban areas.

This policy is obviously strongly linked to the employment initiative above. Study 5 will demonstrate the positive impact that water enhancement schemes have had on population numbers in rural communities. Population brings many social and community benefits which are often difficult to measure.

- Council policy application must be consistent across industries. If financial support is made available to a project on the basis that it provides employment, population growth and other community benefit, then this should also be available to other projects generating the same benefits.

To access additional financial support water enhancement schemes need to prove that this development is a more efficient method of generating employment and community benefit than other competing projects.

4. Council Legislation & Regulation Constraints

The key legislation impacting on Council involvement with large-scale infrastructure development is as follows:

4.1 THE LOCAL GOVERNMENT ACT 1974

This Act is currently under review (see Local Government Bill below). One of the key principles of the Act is that the costs of any expenditure are recovered from the person that accrues the direct benefit. If Council were to incur costs in relation to supporting water enhancement development, then these would need to be recovered from those receiving direct benefit. Determining the direct beneficiaries from a scheme is a difficult issue for Councils. Clearly land users in the irrigation district receive an immediate benefit by way of capital appreciation in land values through additional productivity, however, identifying and quantifying off-farm community benefit is more difficult. Study 5 addresses some of these issues by providing an assessment criteria framework to assist in determining the community socio-economic benefits provide by water enhancement development.

The Act allows Council investment in a range of business structures (companies, trusts, partnerships) provided the investment is for the purpose of performing a Council duty, function or power under the Act. Council functions incorporate community and regional development powers and therefore allow debt and/or equity investment in water enhancement schemes provided these remain within the parameters set by Council investment and funding policies.

Councils are required to set funding and investment policies and then sign certificates of ongoing compliance at the end of each financial year. While these policies provide constraints on Council borrowing and investment, the policies are developed by individual Councils and may be altered through Council resolution. As a result, there is no consistency in these policies and parameters between Councils.

The Act allows Council to give financial guarantees to external organisations with the exception of LATEs. This effectively means that Council cannot give a financial guarantee to a company in which it holds 50% or more of the equity or controls a majority of the company. Depending on the legal and funding structures selected this may include a water enhancement development. This is not a significant constraint as Councils are able to circumvent this restriction by issuing uncalled capital to LATEs, and effectively using the “call right” as a guarantee for private debt.

The Act allows Council to use rates as security for borrowings. This is a critical provision given that the new Rating Powers Bill (see below) allows for more specific rating within a region. Council may secure borrowings, for provision of debt or equity to a water enhancement scheme, against the future rate takes from the area of benefit to limit financial exposure.

The Act prevents Councils from borrowing in foreign currency. This is not considered a significant constraint given that overseas lenders were not considered an appropriate source of funding for water enhancement schemes within Study 2 – Equity Funding Options.

4.2 LOCAL GOVERNMENT ACT 2002

This Act, which comes into force on 1 July 2003, provides more discretion for Council to invest in external business provided the investment enables Council to promote and action the social, economic, environmental and cultural well-being of the community in the present and the future.

All other provisions relevant to water enhancement schemes as discussed above, remain largely unchanged i.e. Council is still required to have a funding and investment policy, rates may still be used as security, LATE guarantees are still excluded as is foreign currency borrowing.

4.3 LOCAL GOVERNMENT (RATING) ACT 2002

This Act takes effect on 1 July 2003. The key thrust of the new provisions is to more closely align those receiving the benefits of Council services with the cost of funding that benefit. The Act allows more flexibility for Councils to set targeted rates for service beneficiaries and gives Council the power to levy a rate targeted to users of a water enhancement scheme. This gives Council additional freedom when considering funding options for these schemes.

Firstly this allows Council to secure any funding provided to a scheme (debt, equity, guarantees and underwriting) against future rates of a targeted benefit area. Secondly this allows Council the option of funding and owning the scheme with the ability to rate water users with a targeted rate to recover the cost of debt and administration.

When setting targeted rates, the area of benefit needs to be considered carefully. Water users are clearly the primary beneficiaries of a scheme, however the wider community also benefits, particularly other businesses². An equitable rate would need to address this issue.

The Act provides that different rates can be attached to different categories of property i.e. rateable categories may include:

- property within the irrigation district – to recognise benefit to land owners;
- commercial property – to recognise benefits to local business;
- general property – to recognise general community benefit.

The Waimakariri District Council went through such an exercise when it provided a guarantee for the scheme debt. This guarantee was secured 80% by a special rate over the scheme area and 20% by general rates. This was an estimate used to reflect the wider community benefit from irrigation.

4.4 THE RESOURCE MANAGEMENT ACT 1991

The RMA does not specifically constrain investment in water enhancement, but does provide a significant hurdle for attracting investment. Private investment (i.e. debt and non-landowner equity) is very difficult to source prior to a scheme receiving resource consent. This is primarily due to the uncertainty surrounding the result of the consent process and the extent of time required completing the process.

The earlier a scheme can secure resource consent in the development process, the sooner private investment will be interested.

The outcome of the consent process can be critically dependent on the consultation undertaken by the promoter. This has been evidenced in the recent granting of water consents for the Barrhill Chertsey scheme following goodwill negotiations and co-operation prior to the consent hearing. Facilitating the consultation process is a key role that Councils can and should play to assist schemes at this phase. Council can assist schemes by removing some of the uncertainty and time delays in the consent process therefore providing a more attractive investment environment for private sector participants.

² See Ford 2002 *Economic and Social Assessment of Community Irrigation Projects* Technical Paper 2002/13; MAF, Wellington.

5. Criteria for Evaluation & Prioritisation of Investment Opportunities

5.1 COUNCIL CRITERIA

Councils generally do not have formal investment criteria to apply to the evaluation and prioritisation of competing investments.

Councils evaluate all potential projects and investments on a case-by-case basis weighing up social and cultural benefits of a project with the requirement for financial return on investment.

There are however many similarities in the general criteria applied by Councils when evaluating investment options relating to new business initiatives. As expected the criteria for investment evaluation is linked strongly to Council objectives discussed in section 3.

Provided Council has the funding available, the general investment criteria used to determine the level of investment into a new project is based on a projects' ability to:

- create sustainable quality jobs for the region;
- sustain or increase regional populations;
- generate a financial return for Council investment;
- provide wide community benefits and a stronger social structure for the region;
- comply with environmental legislation.

The weighting applied to each of the criteria is different depending on the individual project (case-by-case assessment). For example a project that provides significant community and social benefits may have a lower financial return requirement.

Christchurch City Council (CCC) has developed a draft investment evaluation criterion, which has been included within appendix 1 as an example. This is still under debate and has not yet been used to formally assess a project.

Water enhancement schemes clearly meet the criteria in relation to employment, population, and community benefit and have the potential to generate a financial return. However, Council funds are limited and many other investment opportunities also meet the above criteria.

Council justification for providing additional investment into water enhancement, as apposed to other competing projects, must be based on:

- **Community Benefit**

It must be demonstrated that the public benefits (Social, environmental and economic) provided by water enhancement schemes are greater than other projects and are provided at a lower cost to Council. Results of study 5 will be important here.

- **Positive Financial Return for Council**

Schemes must be able to show financial stability to prove to Council that they can generate a return for any investment sort, but more importantly, that they will not require additional Council funds to prop them up in the future.

- **Lack of Private Sector Investment**

Although not formally included within Council criteria, Council is more likely to support a project in a situation where the private sector will not/cannot fund the scheme without the requested Council intervention and therefore the significant community benefits will be lost from the region. By way of example, a scheme may not reach fruition (even though it is fundamentally viable) because of uncertainty surrounding the resource consent process. In this situation, the private sector would want to share some of this early “start up” risk with the Local Council.

One of the key issues/barriers for Council when determining/justifying their level of investment commitment to a water enhancement development is the lack of understanding of economic and social benefits provided to a community from this investment. It is therefore difficult to compare this investment with other competing projects. Study 5 will provide Councils with this evidence and a framework for quantifying this investment.

5.2 COUNCIL ROLES

By applying the above criteria Council has made investments into economic development projects in the past, including water enhancement. The types of assistance provided include:

- Provision of financial guarantees – Waimakariri District Council
- Equity investment (partial funding) – Timaru District Council
- Provision of debt (partial funding) – Mackenzie District Council
- Provision of hybrid equity (partial funding) – Waimate District Council
- Underwriting revenue streams – Canterbury Regional Council
- Provision of subsidy – Christchurch City Council

The following key points can be made:

- Generally the roles undertaken by Council have been the result of negotiations related to the specific project and therefore may not be conventional assistance relevant to other projects with different circumstances. The role ultimately needs to satisfy the requirements of both Council and the private sector.
- Each investment was justified on the basis that:
 - The project was perceived to provide significant economic and social benefits for the community (Although in most cases these benefits had not been quantified or evaluated after the project was complete).
 - The private sector would not fund the project without Council providing assistance.
 - There was adequate financial return for Council in supporting the project. “Adequate return” differed for each type of project, but needed to be a positive return.
- Agreeing formal exit strategies (rather than intended exit strategies) is key to Council managing risk effectively.

5.3 BEST PRACTICE

In February 2001, the Office of the Auditor General (OAG) issued a report titled “Good Practice for Involvement in a Major Project, *Lessons from the Opuha Dam Project*”. The report outlines “Key Messages” for a public authority (local and regional government) when considering making an equity investment or lending funds to a major project. An extract of the key messages from the OAG report is included at Appendix 2.

Essentially, the report identifies three areas of focus for a public authority to consider prior to making an equity or debt investment in a major project:

- ensuring the investment is in line with policy objectives and long term strategy;
- completing adequate risk assessments and risk management strategies;
- ensuring the investment generates an adequate rate of return.

5.3.1 Policy Objectives and Long-Term Strategy

The OAG concluded that the equity investment by Timaru District Council (TDC) and the debt lending from McKenzie District Council (MDC) met expectations regarding Councils rational for investing in the project. The basis for this conclusion was that Council had made an investment decision based on:

- the benefits accruing to the community in the form of securing a long term supply of drinking water for the community, providing development opportunities for the district and increased economic activity with the district estimated to be in the order of \$80 million;
- ensured that it was within its statutory powers to invest/lend the money;
- disclosed the proposed financial involvement within the Council annual plan.

5.3.2 Risk Assessment

The OAG concluded that TDC and MDC met expectations in assessing the risks of investing equity capital and lending to the Opuha project. This conclusion was based on the following risk management arrangements:

- A fixed price contract was negotiated for the design, building and maintenance of the scheme. The contractor was also required to put up a performance bond of \$5 million to ensure completion.
- Both project designer and contractor had experience with earth dams. A principle project manager was appointed to oversee the contract, along with three peer reviewers, and a supervisory mentor (principle peer reviewer).
- Contractor had to indemnify the principal against all losses and claims for injuries or damage that might arise out of construction, and insured against any liability in respect of the construction.

5.3.3 Rate of Return

OAG expected that public authorities would have taken steps to satisfy themselves that they would receive an adequate rate of return on their investment.

What constitutes an adequate rate of return was not specified, however, the OAG concluded that TDC as equity provider and MDC as lender, met expectations in relation to rate of return as follows:

- External advice indicated that TDC investment in Opuha would have after tax returns of 8% - 8.24% over a 50-year project life.
- MDC negotiated commercial interest rates based on the 90-day Bank of New Zealand bank bills bid rate.

6. Benefits & Issues For Council Involvement

6.1 BENEFITS FOR COUNCIL INVESTMENT AND SUPPORT WITH WATER ENHANCEMENT SCHEMES

- Water enhancement development matches Council policy objectives in relation to economic development and therefore is justified as an appropriate use of Council funds.
- Irrigation will allow a more productive use of regional resources. The ability to convert dry land farming to higher yielding activities, such as dairying, horticulture etc. maximises productivity for the region.
- Supporting larger scale water enhancement allows Council to better manage their scarce resources (water) for the greater community, rather than ad-hoc private micro development jeopardising a greater regional benefit.
- More intensive farming (requiring more labour) will lead to population stabilisation or even increasing population in the rural communities. This provides social benefits to the community, i.e. secures school roles, medical and other community services.
- New water enhancement development will encourage new business into the region by creating a demand for support services to the industry.
- The increase in population assists existing business to grow and thrive i.e. in the retail and service industries.
- Certainty and stability of water resources provides farmers with a more secure basis on which to plan their growing season, which in turn can lead to increased efficiencies and output. Security for farmer leads to security for the community.
- Provides recreational opportunities i.e. boating on lakes and fishing.
- Ability to secure a domestic water supply for the future i.e. as Timaru District Council has done with the Opuha scheme.
- Council would also expect to generate a financial return on the investment.
- Council is able to offer a scheme the following benefits:
 - Support through high-risk feasibility stages.
 - The ability to make schemes more financially feasible by allowing and/or equity funding.
 - Credibility for the project amongst the community and other potential funding providers.
 - Councils' experience with the management of large projects.
 - The ability of Council to contribute resources i.e. staffing, research and administrative support.
 - Opportunities to capitalise on and create synergies with existing Council assets/infrastructure such as existing raceways, road reserves and access through private land.
 - The ability to enforce water user support through statutory rating.

6.2 ISSUES FOR COUNCIL INVESTMENT IN WATER ENHANCEMENT SCHEMES

Councils need to be aware of and manage the following issues:

- Investment in irrigation may limit Councils' ability to invest in other economic development projects. Funding is a scarce resource for Councils and needs to be managed across competing demands.
- Scheme requires a "dedicated" project manager who is able to focus on driving the project ensuring that key requirements are met and issues addressed immediately. It is important that political agendas are not allowed to influence project management as this can negatively affect the overall outcome of a development.
- Negative public reaction to the use of public monies for the direct benefit of a defined section of the community.
- Providing funds to these schemes sets a precedent for other industries to approach Council for similar support or investment funds.
- The need for Council to provide additional funds for supporting infrastructure such (i.e. roads and other water treatment facilities) as a result of the development of water enhancement schemes.
- Subsequent to the asset being completed, there may be a community expectation for continuing financial support from Council in the event that the scheme cannot support itself in the future. For example, CCC invested in the convention centre expecting no financial return from the investment, but no further costs either. The centre is generating losses but is now considered a community asset that is required by the city, therefore CCC must provide an ongoing subsidy to keep this facility operating.
- The impact on the social fabric of the community. With irrigation development, market forces effect changes in land uses that inevitably result in changes in land ownership. Large-scale changes in land ownership effects the existing community inter-relationships. Filling of lakes for storage facilities also requires compulsory acquisition of land, which may be traumatic for landowners.
- Environmental impacts which would require ongoing management and monitoring (such as soil testing to ensure the containment of nitrate levels, which are expected to increase as farming intensifies).
- There is high risk associated with a water enhancement investment at the start-up phase of the scheme. This ultimately puts general ratepayer funds at risk.
- There is low or nil financial return expected from such investments during the initial years.
- Some water users have expressed the view that the bureaucratic nature of Council has resulted in a cumbersome and restrictive approach.

7. Council Investment Capability

Currently the investment capability of a Council is determined by considering both internal and external lending ability.

7.1 INTERNAL CAPABILITY

Under the requirements of the Local Government Act 1974, each Council has to have a funding policy that governs the level of borrowings that a Council is able to make. The funding policy imposes quantitative restrictions generally based on the underlying value of Council assets or ability to rate.

Where a Council wishes to borrow in excess of the treasury policy, a Council must pass a resolution.

The Local Government Act provides high-level guidance on the content of what should be included within a funding policy, however, each individual Council sets their own quantitative funding restrictions. Each Council therefore has a different basis for determining the level of funding available for investment into economic development or Council initiatives.

Following are some examples of the quantitative restrictions applied by a sample of Councils:

- Debt servicing costs as a % of revenues – This ranged from 8% to 15%
- Term debt as a % of total assets – This ranged from 3.5% to 12%
- Total debt not to exceed a stated % of income – This ranged from 20% to 60%

Each Council also had their own unique measures that could not be compared with other measures.

A lack of uniformity in funding and investment policies has potential to significantly impact on a Councils ability to fund a water enhancement development. A scheme that is located in a region with conservative Council policies is less likely to access Council support than a scheme that is located where Council policy towards investment is more aggressive. This is an element of chance that must be addressed by Government (Central or local) to ensure that schemes with the best potential to maximise value receive the support, rather than having this based on a random geographic location.

One opportunity to overcome the internal constraint of meeting funding policy requirements would be to allow Councils to exclude certain investment borrowings (i.e. water enhancement projects) from the funding policy on the basis that the funding is for a specific purpose and that there is a designated revenue stream (also excluded from the funding policy) to meet the funding requirements. (Effectively off balance sheet structuring and financing) For this to be acceptable to Council, the revenue stream would need to be secure or guaranteed through the use of a targeted rate to ensure that general rate payers were protected against any credit risk.

A key driver of investment capability of a Council is the size of the rating base. Small rural Councils will find it difficult to raise large volumes of funding for such significant projects. To overcome this issue rural Councils may consider partnering with the main centre Councils with much larger rating capacity. Urban Councils may be attracted to a water enhancement scheme in the region given the downstream benefits that can flow to ratepayers and businesses within the city district. An example of this is the proposed Central Plains scheme,

where the irrigation district is located within the Selwyn District Council, but Christchurch City Council have been providing financial support on the basis that the scheme will also benefit businesses within the city region, will increase port revenues and bring additional population to the main centre.

7.2 EXTERNAL CAPABILITY

In addition to the above, any financial institution lending to Council for the purposes of funding water enhancement development will undertake their own assessment of Councils capability to lend.

It is our experience that the internal lending capability will be more conservative than the external assessment, therefore, this is not an additional constraint to those outlined above in section 7.1.

8. Recommendations – Role of Council

8.1 INTRODUCTION

There are many options available to Councils considering a support role with water enhancement schemes.

There is clearly a role for Council initially championing and facilitating the project to get it moving. This role includes community liaison and education along with provision of some feasibility and resource consent funding (provided by way of loan or convertible equity to recover the investment in the event that the scheme is successfully implemented).

Subsequent to initial facilitation it is difficult to recommend a specific role for Council given that each scheme has different characteristics and requirements, as does each Council.

The role that Council will ultimately take should be based on the answers to the following issues:

- **The level of private sector participation**
What level of debt and equity can be provided by the private sector? Have users signed long term-supply agreements? What type of funding mechanism does the private sector require from Council?
- **Social and community benefits available**
Do the social and community benefits expected by the scheme justify Council investing significant funds or taking a significant risk to support the scheme?
- **Council capacity to provide funding**
Does Council have the capability to provide the required funding considering other competing demands for money? Is the return on the investment sufficient to cover the risks being undertaken?

8.2 RECOMMENDATION FOR COUNCIL

Appropriate Funding Options

Study 2 – “Review of equity funding options” concluded that the most appropriate funding option for a water enhancement development was “project finance”.

The key requirements of project financing are:

- high revenue security – through secure long-term supply contracts with customers;
- high revenue quality – credit worthy customers with affordable contracts;
- lower levels of equity required (20% to 50%);
- security requirements secondary.

Therefore in order for Council to assist a scheme to meet project financing requirements the following roles may be appropriate.

- under writing revenue capacity (8.2.1);
- providing funding for equity requirement (8.2.2);
- providing financial guarantees for secondary security (if required) (8.2.3).

As stated above the actual role(s) undertaken by Council is likely to be different for each scheme depending on:

- the level of private sector support within the region;
- the level of social and community benefit provided by the scheme and therefore the level of justification for Council support;
- the cost to Council for providing the support relative to the benefits provided;
- the financial capability of Council to provide the support required.

Each role assumes that the project can satisfy RMA provisions and therefore is environmentally sustainable.

8.2.1 Revenue Underwriting

Where a scheme has not been able to encourage the required level of water user take-up Council may need to underwrite scheme revenue in order to secure project financing.

Revenue underwriting involves Council committing to purchase all unsold shares in a scheme, with the intention of on-selling the shares to water users when demand increases. This undertaking would commit Council to an up front equity contribution and then an on-going take-or-pay commitment for each share that it eventually purchased.

The intention would be for Council to lease the water rights to users over the period of ownership to recover the take-or-pay contract costs, and generate a return by building a premium into the water charge. This needs to be approached with caution. If water users know that they will be able to access Councils water rights in perpetuity without making the upfront capital commitment, this may reduce the incentive for them to commit equity funds or sign long-term take or pay contracts. This is also a risk to the users, given that the rights could be on-sold to another party for personal use removing these rights from the lease market.

Risk and Exit Strategy

Undertaking this role can expose Council to a high level of risk if there are no risk strategies in place to address or manage this exposure. The key risk management strategies relate to scheme selection criteria prior to acceptance, limiting the potential share purchase exposure and ensuring there is an efficient exit strategy in place.

The following table outlines key risk management and exit strategies:

Risk	Risk management	Details
Underwriting agreement signed with a high-risk scheme increasing Councils loss exposure.	Scheme must meet strict selection/evaluation criteria prior to agreement being signed.	Criteria includes: <ul style="list-style-type: none"> • Scheme equity payment and water charge is financially viable but the conservative nature of current landowners is hindering development. • Scheme has a large command area serviced by a limited number of rights. • Development cannot be effectively staged to meet shareholder demand. • Scheme has exhausted all options in relation to private sector investment (water users and non-users)
Water user is take-up is very low and Council is required to make a significant financial commitment to the scheme.	Conditions to be applied to the agreement to limit Council exposure.	Conditions include: <ul style="list-style-type: none"> • Scheme complying with minimum private sector commitment levels (i.e. 70%) before underwriting will be provided. • Ensuring water rights are tradable on a short term water market to allow recovery of take-or-pay commitment
Council is unable to exit the scheme and continues to be exposed to financial risk through take-or-pay commitments for an extended period.	Agree exit strategy prior to signing agreement. Include provisions in the agreement to accelerate Council exit.	Exit provisions include: <ul style="list-style-type: none"> • Ensuring water rights are permanently tradable through an active water trading market. • Restrict private permanent water trading until Council has been able to sell down ownership (with an adequate return). <p>Include a formal exit strategy in the agreement. i.e. repayment of outstanding shares required at year X (including a financial return), or take-or-pay commitment ceasing at year X and equity balance transferred to a loan for repayment.</p>

8.2.2 Partial Funding Provider

Where customer commitment is high, but water users are having difficulty raising the upfront equity balance, Council assistance may be in the form of providing funding support to the scheme. Type of support provided would largely be determined by the private sector requirements but will include one or a combination of the following:

- debt;
- equity;
- hybrid equity.

If Council is to provide funding assistance, the most appropriate type of support is likely to be the provision of hybrid equity³.

The key advantages of Council providing hybrid equity are:

- It acts as equity for the scheme - It strengthens the financial position of the scheme by lowering the gearing ratio allowing the scheme to access additional debt funding or more favourable funding terms.

³ Examples of hybrid equity include: subordinated loans, redeemable preference shares and convertible notes

- It acts as debt for the Council - It allows the provider (i.e. Council) more flexibility to set the terms and conditions of the funding in relation to return on investment and exit/repayment provisions as if the funding related to debt.
- Risks with providing this funding can be largely mitigated by securing the equity balance over a future targeted rate and therefore ensuring the financial commitment can be recovered, including a return commensurate with the risks undertaken.

Exit Strategy

Although provision of debt and hybrid equity provides a defined exit strategy (i.e. through repayment terms), this is likely to be spread over a long period (up to 20 years). Council focus should be on exit as soon as practically possible. Once the scheme is operational with strong user commitment the majority of investment risk has been ameliorated and Council should attempt to transfer the investment to the private sector.

This exit arrangement can be formalised prior to development. For example, subject to a number of key performance indicators, a private sector party agrees to take the investment over from Council. These indicators are likely to include minimum customer take-up rates, financial performance indicators and service delivery indicators.

8.2.3 Provision of Financial Guarantees

- Provision of a financial guarantee is an efficient form of funding assistance for Council to provide to a scheme. There are minimal costs for Council associated with this arrangement provided the guarantee is not called. As discussed earlier Council is able to structure a guarantee in such a way that it is secured over a future targeted rate and therefore ensures any financial commitment can be recovered, including a return commensurate with the risks undertaken.

Exit Strategy

- Limiting the time period of the guarantee provides Council with a route for exiting the risk of exposure from a financial guarantee. These guarantees can expect to be limited to a five-year period.

8.3 INDIRECT FINANCIAL SUPPORT FROM COUNCIL

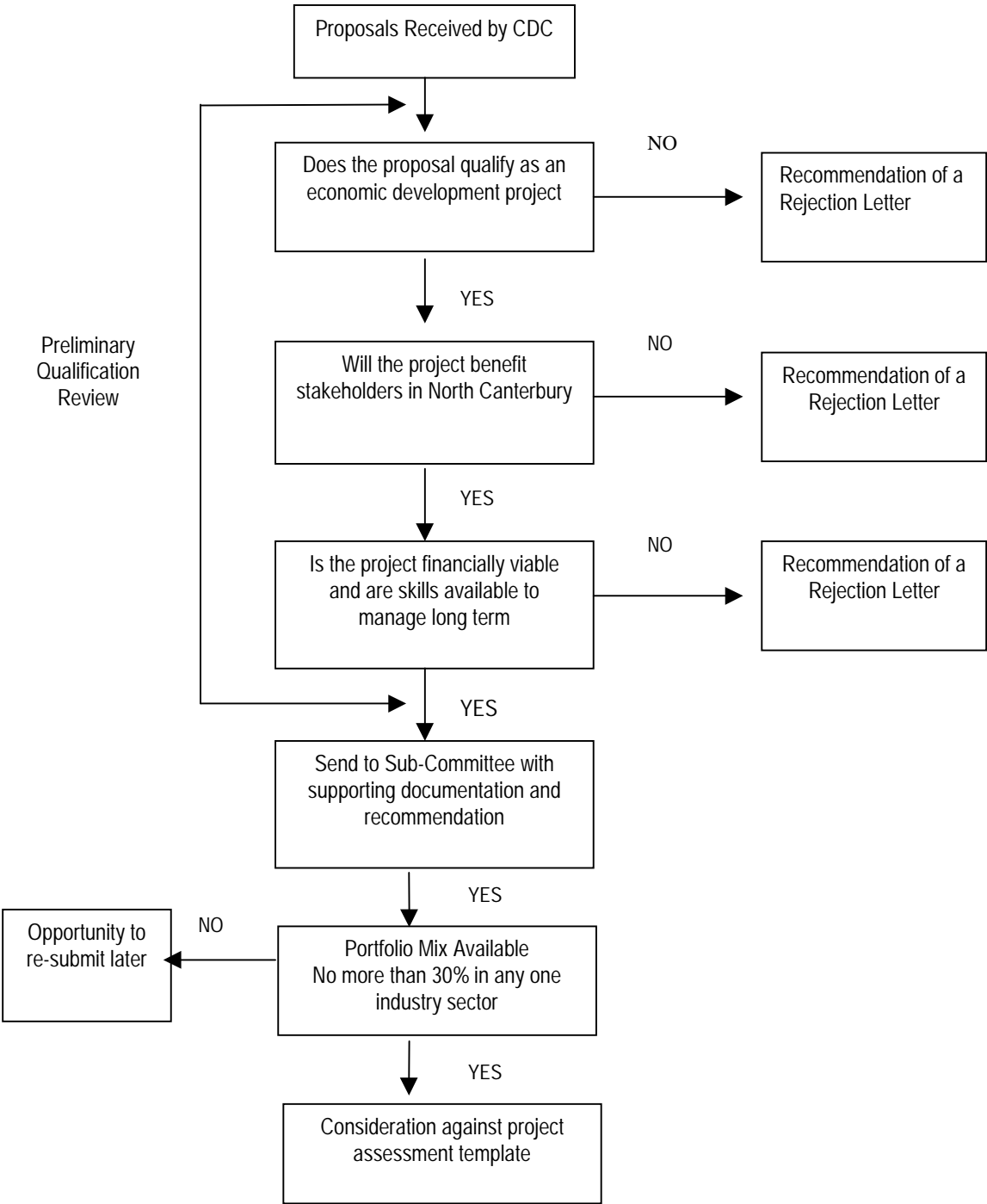
8.3.1 Supporting infrastructure/general requirements from Council

Provision of Council support in the form of additional development and maintenance of public infrastructure (e.g. roading, drainage, water and sewerage) required to support a more intensified land use and population increases as a result of water enhancement is a critical issue to be factored into Councils decision on the level of support that they are able undertake for a water enhancement scheme.

As discussed early, the key justification for Council support is the level of net economic, social and environmental benefits provided by the scheme as compared to other competing projects. When Council is determining net community benefits, the additional costs relating to infrastructure development and maintenance will be a critical component.

Providing this infrastructure therefore has a direct impact on the level of funding support that Council is justified in committing to these developments.

Appendix 1 Christchurch City Council’s Project Eligibility Assessment Process



Weightings are attached to those projects that meet the eligibility criteria, to determine their priority. CDC's draft weighting document is reproduced below.

Level 1	Weighting	Level 2	Weighting	Assessed Score
PRE CONDITION EVALUATION				
Financial Viability	50	Return on Investment	25	
		Proposer Commitment Inkind	15	
		Financial Management Competency	10	
Pre Condition	50	(minimum 35)	Total	
MAIN EVALUATION				
Major Economic Transformation Impact	50	Global Technology Transfer	20	
		Sustainable Competitive Advantage	20	
		Public Good Factor	10	
Employment/ Workforce Capability Impact	20	Family Wage Jobs	10	
		Multiplier Impact	10	
Social	30	Variety of employment opportunities	30	
Environmental		Neutrality at worst of impact on natural state.		
Vision/Visibility/ Attitude		Impact on Central City/Suburbs Acts as a lighthouse Reinforces/enhances image & attitudes		
Main Evaluation	100		Total	
Required to proceed – Minimum 75 points With Minimum 55 from Economic/Employment/Workforce				

Appendix 2

Good Practice for Involvement in a Major Project Lessons from the Opuha Dam Project

This report issued by the Controller and Auditor General in February 2001 outlined the following key messages for public authorities (City, District and Regional Councils) making equity investments or lending funds to major projects.

MESSAGES FOR EQUITY INVESTORS

“Before investing equity capital in a project, a public authority should:

- Identify and document its objectives and the rationale for purchasing an ownership interest in the project, and ensure that these are in line with its long term strategies, investment policies and statutory powers.
- Satisfy itself that the risk of losing its investment is minimised. For major projects this includes ensuring that the project has:
 - Sound and effective contractual arrangements;
 - A sound overall project management structure; and
 - Adequate insurance cover.
- Satisfy itself that it will receive an acceptable rate of return from the investment over a defined period.

Having invested equity capital in project, a public authority should:

- Obtain sufficient information from the controlling body for the project to determine that the body is overseeing progress of the project in a responsible manner.
- Monitor its investment to establish that:
 - The return on the investment (either being received and/or likely to be received) remains consistent with what is considered acceptable; and
 - The value of the investment is being maintained
- Monitor its investment for continuing consistency with its objectives and rationale for investing, and, when circumstances change, reappraise its financial involvement in the project.

MESSAGES FOR LENDERS

Before advancing money by way of loan for a project, a public authority should:

- Establish that the investment in the project is in line with its long term strategies, investment policies, and statutory powers.
- Satisfy itself that the risk in relation to the investment is minimised.
- Satisfy itself that it will receive an adequate rate of return from the investment.
- Having advanced the money by way of loan for a project, a public authority should:
- Monitor its investment to establish that:
 - the interest due is received; and
 - the value of the investment is being maintained.

- Monitor its investment for continuing consistency with its long term strategies, investment policies, and statutory powers, and, when circumstances change, reappraise its financial involvement in the project.”

Appendix 3 Local Government Bill 2001 - Powers of Territorial Authorities

1. One of the main effects of the Bill is to give local authorities a power of general competence. This is a significant expansion of their existing powers and enables them to undertake a wide range of activities that were previously outside their scope. In general terms local authorities will have much the same powers as companies under the Companies Act. However, at the same time communities will have much greater control over the activities that their local authorities undertake on their behalf. This will occur through the consultation and accountability provisions of the new Bill.
2. The Bill contains new provisions that regulate asset management planning. Under the current Act there is no specific statutory obligation to prepare an asset management plan. In practice local authorities have included asset management plans in their long term financial strategy. However, currently there is very little obligation on local authorities to be explicit with their communities about asset management planning. In practice there is no consistent approach taken to asset management planning among local authorities.
3. Under the Bill there is now a formal requirement set out in clause 83(1) that requires that:

“A local authority must, in order to provide predictability and certainty about sources and levels of funding, adopt the funding and financial policies described in subsection (3)”.
4. Subsection (3) sets out a number of different policies local authorities will be required to develop. These policies include:
 - (a) a financing policy;
 - (b) a policy on the contribution of council funds to joint ventures or other initiatives involving the private sector;
 - (c) an asset management policy; and
 - (d) an investment policy
5. All these policies must be prepared and adopted as part of the long term council community plan which effectively replaces the long term financial strategy.
6. Any proposal to invest in water enhancement projects would need to be consistent with the policies set out in clause 83.
7. Clause 82 sets out certain principles of financial management. There is an emphasis on outcomes. The principles include identification of:
 - (e) the community outcomes for the group of activities to be funded; and
 - (f) the impact of any mix of mechanisms on the social, economic, environmental and cultural wellbeing of the community.
8. These principles tie in with the new purpose of local authorities, as set out in clause 8 of the Bill which provides:

“The purpose of local authorities is to enable local decision-making, by, and on behalf of, individuals in their communities, to democratically promote and action their social, economic, environmental, and cultural well-being in the present and for the future”.

9. The implication of all of these provisions is that there will be a shift to an outcome focus. The critical issue will be defining the impact that will arise from a proposed activity. Thus before investing in a water enhancement project a local authority will need to define the environmental and other outcomes which will result from the proposed investment in the water enhancement project.

The asset management programme will have quite a different focus. Primary considerations will be matters such as the social, environmental, cultural and economic outcomes.