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Report to the Policy and Finance Sub Committee
from Greg Schollum, Chief Financial Officer

Investments – Financial Forecasts 2002-2010

1. Purpose

To provide a summary of the returns expected from the Council's investments over the next eight years.

2. Background

The investment area of the Council includes:

- Bank Deposits
- WRC Holdings Group (including dividends from CentrePort)
- Investment Properties
- Administration Properties (e.g. Depots)
- Treasury Management
- Forestry and Business Unit dividends
- Regional Stadium

It is important to appreciate that Council's investments (excluding the Stadium) contribute \$5.7m towards the rate line. This equates to approximately 11% of the total level of Regional rates.

3. Overall Financial Summary of Investment Area

The focus of this report is primarily on the 2002/03 year (the Council's next Annual Plan).

The tables below detail the projected 2002/03 rate line impact of the investment area, compared with both the 2001/02 budget (table 1) and the 2002/03 budget which was set 12 months ago (table 2).

In terms of the remaining seven years the contribution from investments is expected to significantly increase as the Council debt associated with the WRC Holdings Group is programmed to be repaid (by 2005/06) and as the requirement to retain sinking funds is eliminated on maturity of all remaining WRC local authority stock (debt). This means that Council's investments will become an even more significant contributor to the rate line in future.

TABLE 1

	2001/02 budget (\$000)	2002/03 'New' budget (\$000)	Difference (\$000)
Bank Deposits	(2,574)	(2,244)	330
WRC Holdings Group	681	578	(103)
Investment Properties	-	-	
Admin Properties	(83)	(111)	(28)
Treasury	(3,531)	(3,691)	(160)
Forestry & Business Unit Dividends	(275)	(275)	-
Sub Total	(5,782)	(5,743)	39
Regional Stadium	2,676	2,676	-
Total	(3,106)	(3,067)	39

() denotes contribution to the rates line

As can be seen from table 1 the net contribution to the Regional rate line from the investment area is \$39,000 lower than the 2001/02 budgeted level.

The major changes relate to:

- Reduced budgeted returns from Council's bank deposits as a result of reducing market interest rates.
- Increased budgeted returns from the WRC Holdings Group as a result of reducing interest costs and as a result of Port Investments Ltd increasing its assumption in relation to CentrePort dividends. (Now based on 60% of CentrePort's Net Profit After Tax of \$6.0 m rather than \$5.5 m.) CentrePort has indicated that paying out dividends at a rate of 60% of NPAT is creating pressure on its debt levels which will need to continue to be closely monitored.

These increased returns have been partially offset by an increase in planned refurbishment costs in Pringle House Ltd.

- Increased budgeted returns from the Council's Treasury function as a result of updating the assumptions in the Treasury budget.

Comparing the contribution from investments with what was planned this time last year (i.e. what returns are already built into Council's existing numbers) shows:

TABLE 2

	2002/03 'Old' budget (\$000)	2002/03 'New' budget (\$000)	Difference (\$000)
Bank Deposits	(2,794)	(2,244)	550
WRC Holdings Group	1,041	578	(463)
Investment Properties	-	-	-
Admin Properties	(116)	(111)	5
Treasury	(3,612)	(3,691)	(79)
Forestry & Business Unit Dividends	(275)	(275)	-
Sub Total	(5,756)	(5,743)	13
Regional Stadium	2,676	2,276	-
Total	(3,080)	(3,067)	13

The major changes between the 'old' budget for 2002/03 and the updated budget for the 2002/03 year (the 'new' budget) relate to changes in market interest rates. Rates are now assumed to be much lower than was the case 12 months ago. As a result Council's projected return from bank deposits is down whereas Council's projected return from the WRC Holdings Group (which is a net borrower as a result of acquiring Council's interest in CentrePort) is up.

In addition the projected contribution from Council's Treasury function is up slightly on what was planned this time last year.

4. Explanation of each Investment area

4.1 Bank Deposits

This activity contains the budgeted income on Council's bank deposits (currently \$44 million) which was established as part of Council's restructuring of its ownership of CentrePort. As the Committee is aware, direct ownership of Council's interest in CentrePort is held by Port Investments Ltd, a 100% owned subsidiary of WRC Holdings Ltd.

Because of the size of the deposit, returns to the rate line are sensitive to even small changes in interest rates.

4.2 **WRC Holdings Group**

As noted in section 4.1 above Council's interest in CentrePort continues to be held by Port Investments Ltd, a 100% owned subsidiary of WRC Holdings Ltd. The budgeted contribution to/from rates from the WRC Holdings Group incorporates all projected revenue (by way of dividends etc) from CentrePort.

The other investment within the WRC Holdings Group is Pringle House Ltd which owns Council's head office building - The Regional Council Centre.

4.3 **Investment Properties (ex Wellington Harbour Board)**

The majority of Council's investment properties have now been disposed of. There remains only Council's interest in Shelly Bay which, in recent months, has become the subject of a challenge by the Wellington City Council. It has been our practice over many years not to factor into the budget any sale proceeds from the sale of investment properties and this policy has again been followed this year.

4.4 **Admin Properties**

Although grouped under the broad category of "investments" Council's interests in the Upper Hutt and Mabey Road depots and the Masterton office building could hardly be considered to be prime investments. (i.e. Council would not own these properties if it didn't occupy them.) Nevertheless, rentals are charged to internal tenants based on market rates and the properties are run on a commercial basis.

4.5 **Treasury**

The Committee may be aware that the Treasury area within the Council manages the total debt portfolio of the Council along with Council's day-to-day cash flow requirements. In addition, Treasury manages the financial investments and reserves of the Council.

In summary, the Treasury area acts as the 'internal bank'. All departments that have debt or require debt funding, incur that debt with the internal bank. The external debt requirements are then negotiated by Treasury with external financial institutions, including maintaining Council's external credit rating through Standard and Poor's.

Interest is charged to departments by Treasury based upon the budgeted average cost of funds of the Council. The rate is set annually during the planning process. This year I propose to apply a rate of 8.25% for the 2002/03 year, which is down by 0.25% on the rate applied in 2001/02. All departments have budgeted financial costs for 2001/02 using 8.25%.

The broad approach of Treasury is to hold and where possible "average down" the weighted average cost of debt as existing debt matures, depending on the market rates at that time. The Council has historically taken a position of being heavily hedged against interest rate changes. As a result it is not always possible to take advantage of reductions in short term interest rates. The budgeted weighted average cost of funds for the Council is approximately 7.75% and Treasury applies a margin currently 0.5% on top of the budgeted weighted average cost of funds. The margin includes the recovery of the costs of running the Treasury function.

On the flip side, Treasury pays interest on reserves at 7.75% (the budgeted weighted average of funds) on the basis that debt would be higher if such reserves were fully funded. To earn 7.75% on reserves is a very good return for departments particularly given what the Council is earning on its bank deposits (currently less than 6%).

The Treasury area has significantly more internal loans than external loans. This has occurred as a result of past Council surpluses and other inflows of funds being applied to debt. The current difference is approximately \$45 million. This creates a Treasury surplus which is available to apply against projected rate requirements. The projected Treasury surplus across the eight years is shown in **Attachment 1**.

The overall Treasury funding surplus in 2002/03 is projected to be \$3.7 million which is slightly higher than what has previously been budgeted for this area.

4.6 **Forestry and Business Unit Dividends**

The 'quasi commercial' operations of Council are all required to return an internal dividend to the rate line as follows:

Plantation Forestry (Metro)	150,000
Reserve Forests (Wairarapa)	75,000
Akura Conservation Centre	35,000
Wairarapa workshop	<u>15,000</u>
	<u>\$275,000</u>

These dividends are unchanged from those budgeted in 2001/02.

The rationale behind the internal dividend is as follows:

- ⇒ It ensures intergenerational equity in those investments such as Forestry where the large % of positive cashflows occur at the end of the asset life
- ⇒ It provides good commercial discipline into commercial operations and while the dividends are not set purely on net assets employed, it does resemble a cost of capital charge (this is considered important in such discretionary activities)

The level of dividends will continue to be reviewed annually. This is done not only at planning time but also as part of the Council's annual report at the end of each year when officers recommend whether such dividends should be paid.

4.7 **Regional Stadium**

While the Council's advance is interest free the advance is still considered to be an investment which will ultimately be repaid (otherwise it will need to be written off). Clearly this needs to be monitored in future, but at this stage it is too early to tell when repayment might be completed.

The level of Stadium Rate is unchanged from 2001/02 and is not expected to change within the remaining eight years of the Long-Term Financial Strategy.

5. Recommendations

- (1) *That the report be received and the contents noted.*
- (2) *That the following proposed financial forecasts be approved in principle:*
 - *Bank Deposits*
 - *WRC Holdings Group*
 - *Investment Properties*
 - *Administration Properties*
 - *Treasury*
 - *Forestry and Business Unit Dividends*
 - *Regional Stadium*
- (3) *That the draft eight year financial forecasts for the above activities be recommended to the Policy and Finance Committee for inclusion in the Council's proposed Long-Term Financial Strategy 2000-2010: 2002 Update (incorporating Council's 2002/03 Annual Plan).*

GREG SCHOLLUM
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Attachment 1: Investments Financial Forecast