

May 3, 2022

Michael Chatterley
The Department of Internal Affairs
45 Pipitea Street
Thorndon
Wellington NZ 6011

Dear Mr. Chatterley:

Thank you for requesting that S&P Global Ratings provide you with feedback through its Rating Evaluation Service (RES) on the indicative credit rating implications to Auckland Council (Auckland) and Wellington City Council (Wellington) of implementing the proposed scenarios described below. S&P Global Ratings has reviewed the scenarios you provided and the following is a summary analysis of our outcomes.

Scenarios Presented

You presented two scenarios to S&P Global Ratings involving the proposed implementation of the Three Waters Reforms. The reforms involve the creation four water service entities (WSEs) to provide water services throughout the country. The scenarios propose that the WSEs are structurally separated from local councils and the Crown, have financial and operational autonomy, borrow in their own rights, and have independent governance arrangements.

Scenario 1 – Amended base case with Regional Representative Group (RRG) approval rights

Scenario 1 is broadly the same as “updated base case” outlined in the August 2021 Information Memorandum (IM), with the following refinements:

- Shares provided to local authorities that carry voting rights only in respect of privatization and merger proposals, with one vote per share. Any merger or sale proposal would require all shareholders (100%) to agree for a privatization/merger proposal to proceed.
- Strengthening of co-governance with RRG co-chairs to consist of one council and one Iwi/hapū representative.
- RRG requiring between 12 and 14 members, split equally between local authority and Mana Whenua Regional Representatives.
- Consensus voting on RRG decisions, with 75% backstop at discretion of the co-chairs.

- Role of the RRG clarified to include issuance of Statement of Strategic and Performance Expectations (SSPE) and an approval right over the Statement of Intent. This excludes directing a WSE at a project, investment, or management level.
- Removal of the Independent Selection Panel. The RRG is responsible for appointing, monitoring and, if necessary, removing entity board members
- A single constitution that governs the RRG and WSE for each region.
- Option for the establishment of regional advisory groups (sub-RRGs) to the RRG to exist within legislation.
- A prohibition on local authorities to provide financial support to, or for the benefit of, WSEs including by way of guarantee, indemnity or security, or the lending of money or provision of credit or capital.

Scenario 2 – Amended base case without RRG approval rights

Scenario 2 will be similar to the scenario 1 amended base case. Key differences are as follows:

- The RRG does not have approval rights over the Statement of Intent, and
- The RRG will be able to comment on the Statement of Intent, and the Board/WSE must explain how it has or has not given effect to these comments and why when publishing the final Statement of Intent.

Summary of Indicative Rating Conclusion

	Auckland Council	Wellington City Council
Existing rating	AA/Stable/A-1+	AA+/Stable/A-1+
Scenario 1	AA+/Stable/A-1+	AA+/Stable/A-1+
Scenario 2	AA+/Stable/A-1+	AA+/Stable/A-1+

Scenario 1 – Amended Base Case: Auckland Council

We determined that scenario 1 would result in a long-term local and foreign rating of 'AA+' on Auckland. Our short-term rating would remain unchanged at 'A-1+'. The outlook would be stable.

We consider the structure proposed in scenario 1 would separate the water-related activities from Auckland when determining Auckland's credit rating under our methodology. Therefore, we exclude the water-related revenues, expenditures, assets and liabilities from Auckland's financial analysis. This is based on the likelihood of government support being 'moderately high', the WSE standalone credit rating, and the assumption of an 'extremely high' likelihood of support from the New Zealand sovereign.

The 'moderately high' likelihood of government support from Auckland reflected:

- A 'very important' role. While Auckland would not be legally responsible for the WSE, we believe a default of the WSE would have a major impact on the council. This is

because the WSE operates essentially as an independent not-for-profit entity and plays a very important role in the implementation of key regional water policies.

- A 'limited' link. There is no track record or policy of Auckland providing support to the WSE. While Auckland is a majority shareholder it has limited decision making capabilities and shareholder rights, and we believe it is unlikely to interfere with the WSE more than any other shareholders in regard to the WSE's strategic decisions and operations. Further, national legislation will limit the legal capacity for Auckland to provide timely financial support.

We believe the proposed structure in scenario 1 strengthens the linkages between the RRG and the WSE. This is due to the RRG approving the strategic directions of the WSE that are contained in the WSE's statement of intent, and the elimination of the independent selection panel. Offsetting this is that Auckland will have four within the 14 representatives on the RRG, with Mana Whenua making up 50% of representatives, and the legislative prohibition on Auckland providing financial support to the WSE.

Auckland's budgetary performance would improve to '2' from '4' under scenario 1 compared with our base case published in September 2021 (see Financial Statistics Table below). The key driver of this was the exclusion of water-related revenues and expenses from our analysis. This resulted in Auckland's after-capital account deficits reducing to 4.3% of total revenues between 2020 and 2024 compared to our published base case of 9.6%. This was because the reduction in total expenses (including interest expenses and capital expenditure) outweighed the loss of total revenues. Auckland's average operating balance also fell to an average 19.9% of operating revenues between 2020-2024 compared with our published base case of 22.0%, as loss of operating revenues outweighed the reduction in operating expenses.

Auckland's debt burden assessment would also improve to '4' from '5' (see Financial Statistics Table below). Total tax-supported debt would be lower under scenario 1, at about 206.7% of operating revenues in 2024 compared with 243.7% in our published base case. Interest expenses would average 9.3% of operating revenues between 2021 and 2023 under scenario 1 compared with more than 10% in our published base case. We believe the council's contingent liabilities would be unaffected by the WSE. This is because of our view that there is a 'moderately high' likelihood of support, the creditworthiness of the WSE, and the likely support from the New Zealand Sovereign should the WSE face financial distress.

We believe financial management, the economic, and liquidity assessments would be unaffected by scenario 1. While we expect Auckland's liquidity assessment to be unchanged, the debt service coverage ratio could improve given our expectations of smaller after-capital account deficits and lower interest expenses compared to our published base case.

Outlook

The stable outlook reflects our expectation that the council will successfully manage the city's growth pressures and capital expenditure requirements while maintaining deficits and debt levels consistent with a 'AA+' rating.

Downside scenario

Downward pressure might arise if we consider Auckland's financial management to be weakening. This could occur if management allows the council's budgetary performance to structurally deteriorate, driving debt levels substantially higher than our forecasts.

We would also lower our ratings on Auckland if we were to take similar action on New Zealand.

Upside scenario

We could raise our ratings on Auckland if we were to do the same for New Zealand and if there were a substantial improvement in Auckland's standalone credit metrics. The latter could be evidenced by a sustained improvement in budgetary performance, leading to a declining debt burden.

Scenario 1 – Amended Base Case: Wellington City Council

We determined Wellington's long-term and short-term ratings under scenario 1 would be 'AA+' and 'A-1+' respectively. The outlook would be stable.

We consider the structure proposed in scenario 1 would separate the water-related activities from Wellington when determining Wellington's credit rating under our methodology. Therefore, we exclude the water-related revenues, expenditures, assets and liabilities from Wellington's financial analysis. This is based on the likelihood of government support being 'moderately high', the WSE standalone credit rating, and the assumption of an 'extremely high' likelihood of support from the New Zealand sovereign.

The 'moderately high' likelihood of government support from Wellington reflected:

- A 'very important' role. While Wellington would not be legally responsible for the WSE, we believe a default of the WSE would have a major impact on the council. This is because the WSE operates essentially as an independent not-for-profit entity and plays a very important role in the implementation of key regional water policies.
- A 'limited' link. There is no track record or policy of Wellington providing support to the WSE. Wellington is a minority shareholder, has limited decision making capabilities and shareholder rights, and is unlikely to interfere with the WSE more than any other shareholders in regard to the WSE's strategic decisions and operations. Further, national legislation will limit the legal capacity for Wellington to provide timely financial support.

We believe the proposed structure in scenario 1 strengthens the linkages between the RRG and the WSE. This is due to the RRG approving the strategic directions of the WSE that are contained in the WSE's statement of intent, and the elimination of the independent selection panel. Offsetting this is that Wellington will have only two representatives on the RRG, with Mana Whenua making up 50% of representatives, and the legislative prohibition on Wellington providing financial support to the WSE.

Wellington's budgetary performance assessment would be unchanged (see Financial Statistics Table below). Wellington's average operating balance fell to an average 15.2% of operating revenues between 2020-2024 compared with our December 2021 published base case of 19.1%. This is because the loss of operating revenues outweighed the reduction in operating expenses. Wellington's after-capital account deficits would be 16.6% of total revenues between 2020 and 2024 compared to our published base case of 17.0%. This was because the loss of total revenues offset the reduction in operating expenses (including interest expenses) and capital expenditure.

We believe Wellington's debt burden would be unchanged (see Financial Statistics Table below). Total tax-supported debt would be higher under scenario 1, at about 198.4% of operating revenues in 2024 compared with 181.1% in our published base case. Interest expenses would average 5.5% of operating revenues between 2021 and 2023 under scenario 1 compared with 5% in our published base case. We believe the council's contingent liabilities would be unaffected by the WSE. This is because of our view that there is a 'moderately high' likelihood of support, the creditworthiness of the WSE, and the likely support from the New Zealand Sovereign should the WSE face financial distress.

We believe financial management, the economic, and liquidity assessments would be unaffected by scenario 1. While we expect Wellington's liquidity assessment to be unchanged, the debt service coverage ratio could improve given our expectations of smaller after-capital account deficits and lower interest expenses compared to our published base case.

Outlook

The stable outlook reflects our view that Wellington's financial management is successfully managing the challenges in the post-COVID-19 recovery period. We expect Wellington to incur large deficits over the next few years as it increases its capital expenditure and debt levels.

Downside scenario

We could lower our ratings on Wellington if the council's financial management were to weaken, as demonstrated by increasing capital expenditure without displaying revenue flexibility to help fund it. This could weaken budgetary performance with deficits larger than our forecasts and debt levels rising to more than 240% of operating revenues. It could also weaken the council's liquidity coverage.

Alternatively, our view of financial management could weaken if contingent liabilities present a growing risk to the council's balance sheet, including the budget and debt level. We would also lower our ratings on Wellington if we were to take similar action on New Zealand.

Upside scenario

We could raise our ratings on Wellington if we were to do the same for New Zealand and if there were a substantial improvement in Wellington's standalone credit metrics. The latter could be evidenced by a sustained improvement in budgetary performance, leading to a declining debt burden.

Scenario 2 – Amended Base Case Without Approval Rights: Auckland Council

We determined Auckland’s long-term and short-term ratings under scenario 1 would be ‘AA+’ and ‘A-1+’ respectively. The outlook would be stable.

We consider the structure proposed in scenario 2 would have the same analytical treatment as scenario 1. The likelihood of government support would be ‘moderately high’ for the same reasons given in scenario 1 above. We note that the linkages would be somewhat weaker than scenario 1, but this would not affect the ‘moderately high’ likelihood of support. Further, the impact on Auckland’s individual credit metrics would be the same as scenario 1.

Outlook

The outlook would be the same as scenario 1.

Scenario 2 – Amended Base Case Without Approval Rights: Wellington City Council

We determined Wellington’s long-term and short-term ratings under scenario 1 would be ‘AA+’ and ‘A-1+’ respectively. The outlook would be stable.

We consider the structure proposed in scenario 2 would have the same analytical treatment as scenario 1. The likelihood of government support would be ‘moderately high’ for the same reasons given in scenario 1 above. We note that the linkages would be somewhat weaker than scenario 1, but this would not affect the ‘moderately high’ likelihood of support. Further, the impact on Wellington’s individual credit metrics would be the same as scenario 1.

Outlook

The outlook would be the same as scenario 1.

General Assumptions

Key assumptions you have provided to us include:

- Those disclosed in the March 2022 IM. That changes in the March 2022 IM are relative to the “Updated Base Case” in the August 2021 IM, and other parameters as per the Base Case set out in the February 2021 IM. The financial adjustments from the reforms for Auckland and Wellington are disclosed in Table 8 of the March 2022 IM.
- The Local Government Act 2002 will be amended to prohibit local council’s from providing financial support to, or for the benefit of, WSEs by way of guarantee, indemnity or security, or the lending of money or provision of credit or capital, except in such circumstances that would be considered the ordinary course of business.
- Local councils will be issued with one share per 50,000 people (rounded up). Voting rights are limited to privatization and merger proposals. No other decision-making rights would flow from shareholdings. Privatization proposals would require consensus vote from RRG with 75% backstop at co-chair discretion.

- A single constitution will govern the RRG and WSE for each region. Constitutions can enable sub-RRGs. Minimum requirements for constitutions are set by legislation.
- The RRG will have 12-14 representatives equally split between local councils and Mana Whenua. In scenario 1, the RRG has approval rights over the Statement of Intent. These approval rights are limited to strategic directions only, and exclude the ability to direct a WSE at a project, investment, or management level. The RRG can amend the SSPE. In scenario 2, the RRG will not have such approval rights. Auckland will have 4, and Wellington will have 2, representatives on their respective RRGs.
- There is no independent selection panel. The RRG is responsible for appointing, monitoring, and removing WSE board members.
- Councils can comment on draft asset management plans that apply to their districts.
- WSEs will have 'bbb-' standalone credit profile and final long-term ratings of 'AA+'

S&P Global Ratings' analytical judgements and assumptions include:

- There is an 'extremely high' likelihood that the New Zealand sovereign will provide timely support to WSEs if they were in financial distress.
- Auckland and Wellington will not be able to provide financial support to WSE under any circumstances under the new legislation.
- Constitutions will not change the structure of the RRG or shareholdings and their voting rights.
- WSE board members are independent from the councils within their region.
- The RRG board appointment committee broadly represents the makeup of the RRG and isn't overly influenced by any one council.
- Iwi/Manu Whena RRG representatives are independent from the councils.
- With regard to Table 8 of the March 2022 IM:
 - Capital expenditure will be reduced by the entire amount in Table 8.
 - Interest expenses will be lowered reflecting the reduction in debt. These reduction in interest expenses are on top of the operating expenditure amount disclosed in Table 8.
- That there would be no change to liquidity and treasury management policies including use of short-term paper, pre-funding strategy, and bank facilities. We assume future borrowing requirements and debt repayments are unchanged from our previously published base case for local councils. We assume that water-related debt will be novated to the WSE and not repaid by the relevant council. There are no financial costs associated with swaps or the novating of debt.
- All water-related revenues, expenditure, assets, and liabilities are moved to the WSE from the councils without any recourse to the respective council once the reforms take place on July 1, 2024.
- That the Institutional Framework Assessment remains a '1' because the local council sector's aggregated operating balances and after-capital account deficits remain reasonably consistent with our expectations outlined in "Institutional Framework Assessment: New Zealand Local Governments," published on April 28, 2022.

Appendix

Financial Statistics Table

Auckland Financial Summary

		Rating period					Extended forecasts				Scoring ratios
		2020A	2021A	2022BC	2023BC	2024BC	2025BC	2026BC	2027BC	2028BC	
Current published basecase	Operating balance/adjusted operating revenues (%)	18.8	25.3	19.4	20.8	25.9	25.1	26.8	28.6	30.0	22.0
	Balance after-capital accounts/total revenue (%)	(17.1)	(3.1)	(13.6)	(12.0)	(2.3)	(1.1)	(0.2)	(2.1)	0.0	(9.6)
	Total tax-supported debt/consolidated adjusted operating revenue (%)	267.2	259.0	275.9	258.1	243.7	235.3	226.2	217.4	204.0	243.7
	Interest/adjusted cash operating revenue (%)	10.6	10.0	11.2	11.0	10.4	10.0	9.6	9.2	8.7	10.7
	Debt service coverage ratio (with banklines) (%)			135.0							135.0
Scenario 1 & 2	Operating balance/adjusted operating revenues (%)	18.8	24.1	16.3	17.3	22.9	21.6	23.1	24.8	24.9	19.9
	Balance after-capital accounts/total revenue (%)	(17.1)	(0.2)	(5.7)	(4.7)	6.2	9.8	13.8	11.2	8.1	(4.3)
	Total tax-supported debt/consolidated adjusted operating revenue (%)	267.2	225.8	244.5	222.7	206.7	192.9	176.0	160.8	147.5	206.7
	Interest/adjusted cash operating revenue (%)	10.6	8.8	9.7	9.4	8.8	8.2	7.4	6.8	6.2	9.3
	Debt service coverage ratio (with banklines) (%)			169.2							169.2

Wellington Financial Summary

		Rating period					Extended forecasts				Scoring ratios
		2020A	2021A	2022BC	2023BC	2024BC	2025BC	2026BC	2027BC	2028BC	
Current published basecase	Operating balance/adjusted operating revenues (%)	13.3	21.9	18.2	19.0	23.0	27.1	27.9	29.0	31.0	19.1
	Balance after-capital accounts/total revenue (%)	(18.9)	(18.9)	(19.2)	(15.5)	(12.3)	(9.2)	(1.5)	2.1	10.4	(17.0)
	Total tax-supported debt/consolidated adjusted operating revenue (%)	162.0	173.7	187.9	187.8	181.1	180.0	169.1	162.3	147.9	181.1
	Interest/adjusted cash operating revenue (%)	5.2	4.5	5.2	5.2	5.0	5.0	4.7	4.5	4.1	5.0
	Debt service coverage ratio (with banklines) (%)			145.3							145.3
Scenario 1 & 2	Operating balance/adjusted operating revenues (%)	13.3	17.5	12.5	13.8	18.9	23.9	24.8	26.3	28.7	15.2
	Balance after-capital accounts/total revenue (%)	(18.9)	(23.9)	(19.1)	(11.0)	(10.2)	(3.0)	1.1	5.4	7.4	(16.6)
	Total tax-supported debt/consolidated adjusted operating revenue (%)	162.0	174.8	198.4	201.9	198.4	203.0	192.4	185.1	169.5	198.4
	Interest/adjusted cash operating revenue (%)	5.4	5.5	5.5	5.6	5.3	5.1	4.7	3.3	2.8	5.5
	Debt service coverage ratio (with banklines) (%)			131.9							131.9

Rating Score Snapshot

	Auckland			Wellington		
	Published base case	Scenario 1	Scenario 2	Published base case	Scenario 1	Scenario 2
Institutional framework	1	1	1	1	1	1
Economy	1	1	1	1	1	1
Financial management	1	1	1	1	1	1
Budgetary performance	4	2	2	3	3	3
Liquidity	1	1	1	1	1	1
Debt burden	5	4	4	4	4	4
ICP	2.4	1.8	1.8	2.0	2.0	2.0
ICR	AA	AA+	AA+	AA+	AA+	AA+
Outlook	Stable	Stable	Stable	Stable	Stable	Stable

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If the evaluation is disclosed other than in accordance with the Engagement Letter, including the applicable T&Cs, S&P Global Ratings reserves the right to publicly comment on the evaluation and/or publish this letter.

Should you have questions, please do not hesitate to contact me.

Sincerely,

/s/

S&P Global Ratings, acting through
Standard & Poor's Financial Services LLC

cc:

Proactively released by the Department of Internal Affairs