



KordaMentha

Review of aspects of the financial position of Christchurch City Council

Final report

17 April 2014

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1 Introduction

In June 2013 Christchurch City Council ('CCC') produced a Three Year Plan ('TYP'). The TYP contained estimates of the costs CCC would have to meet as a result of the Canterbury earthquakes (the 'Rebuild Costs'). The Rebuild Costs cover:

- The immediate response to the earthquakes, known as 'Emergency & Response Costs'.
- Repairing the properties CCC owns, ranging from large assets like the Art Gallery and Town Hall to small facilities like community halls, libraries and CCC's social housing stock.
- CCC's contributions to the Anchor Projects (e.g. Stadium, Metro Sports Facility, etc.).
- Repairing infrastructure, such as roads, fresh and waste-water, sewerage, etc.
- Revenue that has been lost because there are less properties paying rates or rates have been reduced when buildings are demolished, and because CCC is not earning as much from parking and other services.

The TYP also set out how CCC would pay for the Rebuild Costs, from a mix of:

- Rates;
- Contributions from the Crown¹;
- Insurance claims; and
- Debt.

Together the costs and the plan to fund them formed CCC's 'Financial Strategy'. The Financial Strategy starts on page 46 of the TYP.

As is explained in Section 2, CCC appointed KordaMentha to review this Financial Strategy.

We note that this report was prepared before the flooding that affected Christchurch in the week of 3 March 2014. No allowance for any effects of this flooding has been made in our analysis.

¹ This includes cash contributions and money paid by the Crown to purchase land for redevelopment projects and other reasons.

2 KordaMentha review

2.1 Stage 1

In November 2013, CCC appointed KordaMentha to review the Financial Strategy, as part of the newly elected councillors' 'opening the books' exercise. CCC's instructions were to:

- Review the TYP plan to identify key assumptions relating to the financial implications of the earthquakes;
- Review the reasonableness of those assumptions, in the context of the current project status, cost and phasing expectations;
- Assess the robustness of the estimates and areas of risk for Council;
- Assess the impact these risks may have on Council's position; and
- Identify areas where Council could focus to address those risks.

We completed this first stage of our review in December 2013. We presented a summary of our findings to the councillors and some of CCC's senior managers. We also issued a brief summary of our findings that was made public, which is dated 19 December 2013.

Our review identified that the TYP was based on the information available when it was issued but many of those cost estimates were no longer reliable. This was mainly because of one of three reasons:

- Some of the estimates were very old and preliminary high-level assessments;
- Some of the work that needed to be done was different to what was first planned and costed; and
- In some areas, CCC had not or could not determine exactly what needed to be done so it could not work out an accurate cost estimate.

We recommended CCC should do more work to come up with more accurate estimates of the Rebuild Costs.

We also told CCC that the Rebuild Costs would be higher than the estimates contained in the TYP. We recommended they start working to identify how the additional costs would be funded.

2.2 Stage 2

In February 2014, CCC asked us to:

- Review the updated information it had produced since our first review in relation to some of the Rebuild Cost estimates;
- Review the reasonableness of the updated assumptions, in the context of the current project status, cost and phasing expectations, with a particular focus on the extent to which the issues raised in the Stage 1 review have been addressed;
- Across that updated information and the other assumptions contained in the TYP, identify areas of financial risk for CCC;
- Assess the impact these risks may have on CCC's position; and
- Identify areas where CCC could focus to address those risks.

This report summarises our findings based on the information available at the date of this report.

It is important to note that our findings are based on the information CCC has provided. We have not independently verified any of that information. CCC is still working to confirm many of the Rebuild Cost estimates. Some of the Rebuild Costs are still preliminary estimates. The actual final cost of the rebuild work will be different to the costs that we have been provided to prepare this report.

3 Executive summary

Financial strategy in the Three Year Plan ('TYP')

Overview

- In June 2013 CCC produced a TYP that included estimates of the cost to repair damage from the earthquakes and how the cost would be funded (at a macro level the 'financial strategy').
- CCC faced a significant challenge to prepare the TYP and the financial strategy. It had to identify the damage that needed to be repaired, assess what repair work would be needed, estimate the cost of that work and work out how to fund that cost. The scale of this task should not be underestimated. There are thousands of individual things CCC has to fix and there are very large issues that have to be considered. All of this work has had to be done by existing CCC staff, on top of the normal day-to-day functions of a council.
- At an 'all-of-Council' level, the financial strategy was put together by CCC's former CEO and former GM Corporate Services. To conduct this review we had to speak to a lot of different people to obtain information supporting the TYP estimates. No-one person had a detailed understanding of the basis for the various cost estimates in the TYP and the accuracy of those assumptions at the time of our review.
- The lack of detailed understanding represented a big financial risk for CCC. It was no doubt not assisted by the CEO and GM Corporate Services departing within a short time of each other.
- A lot of work has been put in to reassessing the key components of the Rebuild Costs to ensure that CCC has a good understanding of them. CCC did not establish a centralised control point for dealing with the rebuild work. The organisational restructuring CCC is currently undertaking is, in part, aimed at achieving this. There would otherwise have remained a very real risk CCC would not have always had an accurate understanding of the status of all the rebuild work and its financial implications.

TYP Rebuild Cost estimates and funding

- The TYP estimated total Rebuild Costs of \$4.431 billion (including a contingency of around 5%), of which CCC would have to pay \$1.618 billion:

	TYP
	\$ million
Total cost	4,431
Less Government subsidy	(1,800)
Less Insurance	(1,004)
Less Other contributions	(9)
Net cost to council	1,618

- CCC appointed KordaMentha to identify whether:
 - \$4.431 billion remains an appropriate estimate of the Rebuild Costs, and, if not, what CCC currently estimates the revised cost to be; and
 - \$1.618 billion remains an appropriate estimate of what CCC will itself have to pay.
- CCC essentially had three options to raise the \$1.618 billion:
 - Increasing rates, which it did by charging a special earthquake levy.
 - Maximising the return CCHL generates from its assets or, perhaps, selling some. It did neither.
 - Borrowing. CCC planned to borrow around \$1 billion.
- CCC borrows money via the LGFA. The TYP showed that the amount CCC was planning to borrow was within the two key LGFA covenants but very close to the upper limit of the net debt:total revenue ratio. We estimated that, all other things being equal (especially CCC's revenue), based on the TYP CCC could borrow another \$100 to \$150 million before it breached the net debt:total revenue covenant.
- It would be risky for CCC to borrow the maximum amount it could at any point in time because that would leave no flexibility in the future. We consider it has no practical ability to borrow more (based on the TYP assumptions).



Horizontal Infrastructure

- The TYP contained \$3.178 billion for HI, to be undertaken by SCIRT (70%) and CCC (30%).
 - \$1.8 billion (60%) to be paid by the Crown, per the Cost Sharing Agreement signed in June 2013. We understand this is the maximum the Crown would agree to pay when the Cost Sharing Agreement was signed.
 - \$1.378 billion (40%) to be paid by CCC.
- When the TYP was issued, CCC thought the total cost would be \$3.576 billion. CCC's view is that HI work was underfunded from the beginning because the Crown would only pay \$1.8 billion and CCC would only pay 40% of the total budget.
- The current cost estimate is \$3.591 billion. In so far as CCC was concerned, there always was a funding shortfall and that is now estimated at \$413 million. Based on the most recent priority assigned to projects, this would result in 83 projects not being undertaken and Christchurch's HI not being restored to its pre-earthquake standard.
- The Cost Sharing Agreement states that the cost of fixing Christchurch's HI will be assessed by someone independent by 1 December 2014, and that the Crown and CCC will then again discuss funding. If the 60/40 funding split between the Crown and CCC remains and the current cost estimate is correct, CCC will have to pay another \$159 million. CCC has not budgeted for this additional expense.
- If the Crown does not agree to pay more than \$1.8 billion, CCC's options will be to:
 - Pay the full amount itself, which it would have to find.
 - Not complete some of the work. The Horizontal Infrastructure Governance Group ('HIGG') is running a process to prioritise all the projects and identify what should and should not be done. CCC staff recommend against cancelling any projects.
 - Secure cost savings. We are advised that the HIGG is focused on reducing cost, where possible.
 - Complete the work to a lower standard so the cost fits within the budget. This would mean Christchurch's HI will not be restored to the same standard as before the earthquake.

Buildings and facilities rebuild programme

- This category covers the Anchor Projects, other major facilities owned by CCC (such as the Art Gallery), the approx. 1,000 smaller buildings CCC owns and its social housing stock.
- The TYP provided \$1.059 billion to cover all categories and estimated the net cost to CCC would be \$423 million after insurance recoveries.
- CCC has to pay \$783 million for the Anchor Projects regardless of how much it gets from its insurance (although it does have some flexibility around what is spent on parking). The Crown pays the rest. The TYP assumed CCC would only have to pay \$413 million because the rest would be covered by insurance. This is a significant financial risk for CCC because it is far from certain how much its insurers will pay. CCC could have to pay more for the Anchor Projects than it can afford.
- There are no updated cost estimates for the remaining major facilities. There is a very real risk the current budget will be exceeded unless CCC shows an appropriate level of discipline and restraint in designing these projects. It needs to be recognised that there are very real limits to what can be afforded.
- The TYP assumed CCC would only have to pay \$10 million to fix the 1,000 smaller properties to their pre-earthquake state, on the basis insurance would cover the rest of the cost. The TYP estimate was very preliminary and the actual insurance recoveries are running around 45% of total cost because the previous council decided all buildings should be rebuilt to 67% NBS ('New Building Standard') (which is an improvement on their pre-earthquake state). The latest estimate is that the programme will cost \$121 million more, which may include an element of betterment that may be funded by the Improvement Allowance. CCC staff propose only repairing the buildings that are currently closed to the minimum 34% NBS to reduce the cost overrun.
- Social housing is self-funding so CCC can only repair what it can afford from whatever insurance payouts it receives. CCC does not yet know what that will cover but it is also considering many other options (which are commercially sensitive) to ensure the entire social housing stock is properly repaired.

Insurance

- CCC is insured by LAPP, a company that is owned by councils. LAPP did not have a lot of money itself so it was only ever going to be able to pay CCC what it received from its own reinsurers.
- CCC's insurance was arranged by a broker and the amount of its insurance was supported by valuations. CCC does not believe the terms of its insurance are what it understood but this is irrelevant now to the financial outcome because it can only claim what the policies allow.
- The TYP assumed \$1 billion would be recovered from insurance. \$356 million has already been received. CCC will have to pay more than it budgeted for the rebuild if it gets less than \$1 billion in total.
- CCC's insurance position is very complicated. There are many issues that need to be resolved:
 - Some relate to the amount CCC can claim. Some assets are not insured, some are insured for too little and CCC and the insurers disagree about what should be paid for some of the large assets.
 - Some relate to the amount LAPP can pay. LAPP and its reinsurers are arguing about what has to be paid under LAPP's own insurance cover.
- CCC's insurance position remains a very big financial risk for CCC.
- It is most likely CCC will receive less than the \$1 billion it estimated. It would not be sensible for us to speculate about how much CCC will be paid but all these issues need to be resolved before CCC will know how much money it has.
- Given the importance of the insurance position to the rebuild, we advised CCC that it would be sensible to appoint people with appropriate experience to take control of and oversee the insurance process. We understand this is happening.

Summary and options

- On the information currently available, the Rebuild Costs are presently estimated to be \$534 million higher than the TYP estimate before allowing for insurance recoveries to be lower (which is likely):

\$ million (variances only)	TYP estimate	Current estimate	Difference
Horizontal infrastructure - total	3,178	3,591	413
Buildings & facilities (inc. Anchor Projects) - net cost to CCC	423	544	121
Net cost to Council - TYP	3,601	4,135	534

- Some of the Buildings and Facilities cost may be eligible for funding from the Improvement Allowance but CCC has not yet assessed the amount.
- In reality, the cost over-run will most likely be much higher than \$534 million because:
 - The amount CCC's insurers will pay is a large risk. It is likely to be lower than the \$1 billion estimated.
 - Many of the cost estimates are still works in progress so the total estimated cost will change.
- CCC needs to plan for the funding shortfall to be much higher than \$534 million, to ensure it has a plan in place to deal with any eventuality. It needs to urgently develop a new financial strategy.
- Based on the TYP estimates, we do not believe CCC can borrow any more money so it has five options:
 - Reducing the Rebuild Costs. CCC needs to consider not doing some of the work it has planned and we understand the HIGG is attempting to reduce the overall cost of the HI work;
 - Negotiating for the Crown to pay more money, or for CCC to pay less toward the Anchor Projects;
 - Increasing core CCC revenue, via rates;
 - Cutting spending in other areas, such as the capital programme; or
 - Improving the performance of investments/assets or disposing of them.
- A mix of all these options will be required, in conjunction with a reassessment of the availability of the original contingency amount.
- In the longer-term CCC has included an assumption that operational savings of \$30 million per annum will be achieved from the 2016/17 financial year. We understand CCC has made good progress at identifying how this will be achieved but it will be another financial risk for CCC if it is not.