5. INVESTMENT STRATEGY NEXT STEPS

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5.1 Purpose of Report

The purpose of this report is to obtain a decision from the Council on a proposal to establish a Council Controlled Trading Organisation (CCTO) to manage Napier City Council's (NCC) core financial investments and to consult on its establishment through the 2024-34 Long Term Plan.

Officer's Recommendation

The Prosperous Napier Committee:

a. **Receive** the report titled "Investment Strategy Next Steps".

b. **Explore** the establishment of a Council Controlled Trading Organisation for the management of Council's Investment Portfolio being Parklands development, development sites, commercial and residential leasehold properties, investment related deposits and managed investment portfolios.

c. **Include** the proposal to create a Napier City Council investments trading organisation within its 2024-34 Long Term Plan to fulfil the statutory requirements in creating a Council Controlled Trading Organisation.

d. **Endorse** Council building investment capability within it's team to address immediate investment activity needs.

5.2 Background Summary

NCC has activities/assets whose sole function is to supply a revenue stream to offset rates. This includes a collection of investment assets for commercial return and property development.

There are other revenue generating activities within NCC, however they don't have the single focus on generating financial return (i.e., do not share the same corporate intent).

It is common for councils to generate income from non-ratepayer sources. The Productivity Commission review of Local Government Funding in 2019[1] indicated an average of 6% of Council revenues across New Zealand comes from assets where the sole function is to provide a revenue stream, or investment income.

Council assets such as, Parklands, leasehold property are Council's *'family silver'*. This paper looks at how Council can ensure that it both maximises the potential of these assets,

[1] **The New Zealand Productivity Commission**. *Local government funding and financing*. November 2019. Chapter 3. p.44.

and how the value of these inherited assets can serve as an endowment for both the current and future generations of ratepayers.

In this paper, Council's investment assets for commercial return and development assets are referred to collectively as the *'Investment Portfolio'*.

Investment Assets for Commercial Return

Council holds a number of assets that are commercially focussed. The list includes land development sites, commercial and residential leasehold properties and term deposits.

The core of these revenue generating assets are the Parklands land development and the leasehold land portfolio.

These two assets were bestowed on the Napier City Council largely as a consequence of land created during the 1931 earthquake, and the 1989 reorganisation of local government; which dissolved the harbour board and vested leasehold land with Council in exchange for managing the inner harbour.

Current Situation

Council's leasehold land portfolio earned $1.6 million (cash before expenses) on a $103 million asset value in 2023.

Legislative changes such as the Hawkes Bay Endowment Land Empowering Act 2002 gave Council greater discretion over its inherited land. However, Council process, and it's own policies have not changed to allow Council to benefit fully from the assets it has. Management of investment assets within Council continue to be undertaken as a small part of broader responsibilities around delivering core council services and support functions.

Therefore, the endowment assets that Council has are not benefiting from a commercial focus on returns and ensuring that Council has the right asset mix to manage it's own risks and exposures - to provide both income and resilience for current and future generations.

Land Development

Council commenced land development activities in 2005 with the development of Area 1 of Parklands Residential Development. This land was received as part of the 1989 local government reorganisation.

Since 2009, over $94 million has been realised by Council through the sale of land at Parklands. Council has also incurred significant costs to develop this land and realise these sales.

Council has, since the commencement of Parklands, acquired other land blocks including Pirimai education land and the Mataruahou reservoir site; which may also hold future development potential.

The budgeted net benefit of land development to Council is estimated at around $3 million per annum.

Current Situation

Parklands development has commenced for Area 4. This is the final Area of the initial Parklands development, with all sections anticipated to be sold by 2028.

Council can, and has, successfully delivered infrastructure and development of the Parklands residential development through it's own infrastructure and teams. Although Council has expertise in land development delivery, there is little development pipeline beyond the completion of Parklands Area 4.

A lack of commercial ownership within Council means that the returns achieved by Council for ratepayers on development is lower than that the commercial market would target.

Parklands is run as a finite financial resource, with the proceeds of sales being used at Council's discretion, and little consideration given to reinvestment. This means that the legacy of Parklands benefits this generation of rate payers only.

Workshop Outcomes

Council's investment assets are not geared toward sustaining or achieving growth of the asset base. The assets are also managed internally and individually.

NCC currently lacks a governance vehicle to manage core investments in a strategic and transparent way. Indicators to measure performance and assist with strategic decisions (either for individual investments or the portfolio as a whole) are also required. Developments such as Parklands are siloed as an activity, dedicated to developing a certain number of sections each year. The Leasehold land portfolio is treated as a fixed legacy of properties. Leases are sold periodically to occupiers meaning the leasehold asset base dwindles.

Council's overall investment strategy is in transition. Two workshops focussed on strategic direction for Council's Investment Portfolio. At these workshops Council indicated a desire for change – namely:

- In setting rates Council exercises an intergenerational view. Council's commercial assets should realise a similar intergenerational benefit.
- To ring-fence commercial investments and manage them with a financial return focus (maximise returns). Ensure the best use of those assets.

This report concludes by recommending that the establishment of a Council Controlled Trading Organisation (CCTO) be considered in the 2024–34 Long Term Plan.

5.3 Issues

The leasehold portfolio and Parkland development are currently not managed in a focused way. Council is currently unable to make strategic decisions to acquire land or buildings, or maximise profits according to market conditions.

There are three main issues with the current situation:

1. Land development as an income stream is currently managed as a finite resource.
2. The return objectives from Councils investments is inconsistent and lacks a commercial strategy and an intergenerational focus.
3. Land development and investment assets for commercial return require greater commercial expertise to realise their full potential for Council.

The current approach to these revenue-generating assets does not recognise an inter-generational value that can sustain Napier City into the future. Both the Parklands estate and leasehold land were gifted to Napier City Council. The value of these assets is fundamentally financial (i.e. not social, cultural or environmental), and it follows that there is a legacy consideration to ensure that the financial benefit is felt by current *and* future ratepayers.

The Long Term Plan provides an opportunity for Council to address these issues and to provide a greater long-term benefit for ratepayers from it's Investment Portfolio. This includes:

1. A review of Investment Policy, to enable Council the flexibility to derive appropriate returns from it's commercially-focused Investment Portfolio.

2. A review of Council's Strategic Assets under it's Significance and Engagement Policy, to ensure the right assets are protected under the Act. This may include any position Council wishes to take on protecting the value of the Investment Portfolio for future generations.
3. Determining how to best achieve the commercial objectives associated with Council's Investment Portfolio. This paper recommends accessing commercial expertise through the establishment of a Council Controlled Trading Organisation (CCTO).

5.4 Significance and Engagement

The Local Government Act 2002 provides guidance as to the steps that are required to form a CCTO. The approach recommended within the report will satisfy those requirements.

5.5 Implications

Council is required to give effect to the purpose of local government as prescribed by Section 10 of the Local Government Act 2002. That purpose is to meet the current and future needs of communities for good quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost–effective for households and businesses.

To be cost-effective, Council seeks to sustainably maximise returns from financial investments so that services can be delivered for current, and future, generations.

Council investments are not currently geared toward growing the asset base. Financial returns from investments will dwindle over time and provide a declining rates offset for future generations. This is best illustrated by the Parklands development which is being developed as a finite resource, and forecast to be completed by 2028. Council has used revenue from Parklands as it has been generated – this benefits the current generation of ratepayers only.

A prudent approach would encourage financial growth of the overall asset base. Increasing financial return would enable Council to continue in delivery of it's social, infrastructural environmental, and cultural agenda.

In order to achieve a positive outcome for Council, the expectations (Statement of Intent) for financial performance of the asset base need to be clear and free from any potentially conflicting social or environmental objectives. The assets need to be tradeable (as required) within a strategy that grows the financial asset base.

The Office of the Auditor General has identified the benefits of a holding company as follows:

"A holding company can be effective for monitoring the performance of operating subsidiaries. In our view, essential elements of an active and informed monitoring function are:

- *consideration of draft Statement of Corporate Intent by the boards of operating subsidiaries;*
- *detailed analysis of quarterly, six-monthly and annual reports from operating subsidiaries; and*
- *regular strategic reviews of individual investments and of the local authority's trading portfolio as a whole.*
- *regular reviews are essential for proper management of a local authority's investments in commercial trading enterprises. Holding companies are well placed to perform these reviews on behalf of the local authority parent.*

The value of the holding company role was well illustrated in the case of one local authority we visited. The local authority had made a commitment in its Borrowing Management and

Investment Policy to periodically review the rationale and status of its equity investments against strategic and financial parameters. The holding company was:

- *acting as the investment vehicle, responsible for managing the local authority's investments in a professional and commercial manner; and*
- *commissioning regular valuations of its three subsidiary companies, measuring movements in value over time.*

Estimates of market value provided the local authority shareholder with a valuable benchmark against which to assess the ongoing costs and benefits of each investment, including alternative investments or opportunities for expenditure in the community.

Effective monitoring and liaison requires analysis and support. The holding company may have this expertise or may employ a contractor. Each holding company we reviewed had access to resources to perform these tasks. Two of the three holding companies used parent local authority staff for advice and support, reflecting the local authority's close working relationship with its holding company. This arrangement can also provide a useful means of integrating the financial strategies of the holding company and the parent local authority."[2]

Introducing a CCTO structure can:

- Preserve the operating autonomy of the local authority's commercial investments;
- Apply business disciplines to the professional management of the local authority's commercial investments;
- Act as a channel of communication between the local authority and the subsidiaries/partners;
- Promote best practice in corporate governance; and
- Provide a source of information and analysis for local authority review of investment options.

For Napier City Council, provided the CCTO has the scope and associated Statement of Corporate Intent, a CCTO can assist to:

1 Maximise land endowments

- Further land developments
- Actively manage the leasehold land portfolio

2 Develop Income streams

- Managed funds
- Mclean Park housing

3 Expand on core strength of Parklands

- Land development
    - Residential land
    - Commercial land
- Vertical builds

4 Collaborate with Investors for the benefit of Napier City

- Mana Ahuriri
- HBRIC

[2] Internet article: **Office of the Auditor General**. *Local Authority Governance of Subsidiary Entities*, Part 7: Commercial Trading Enterprises. 2001. https://oag.parliament.nz/2001/local-auth-governance/part7.htm (Accessed 2024-01-18)

- Other

Financial

As discussed, the financial implications of continuing with the current approach mean that the Investment Portfolio is likely to shrink.

The current investment management and governance system has opaque objectives, and lacks the agility and single financial return focus to realise opportunities within the Investment Portfolio. For these two reasons the status quo is not considered tenable.

The financial modelling of returns assumes that some existing land assets may be sold and reinvested into other investment assets as part of the management on the Investment Portfolio. This continues a current practice, where both land at Parklands is sold, and some leasehold land is sold annually as part of Council operations. Assets that are deemed *Strategic* under the Local Government Act are not proposed for any type of asset sale but will be subject to greater commercial oversight.

The financial model for the Investment Portfolio is based on the following Council assets, leasehold land, Parklands, land development, residential rental properties (not social or pensioner housing), and selected undesignated bare land sites. The assets are currently valued by Council at $160m.

Social & Policy

There are a number of consequential amendments required dependent to some degree on whether or not the community supports a CCTO approach to the management of Council's core financial investments. These are (among others):

Investment Policy: at present the policy primarily allows Council to invest for strategic purposes. Additional amendments are required to expand the type of property Council can own (i.e. investment property and development property), and emphasise holding investment for the purpose of deriving income and capital returns.

Significance and Engagement Policy: the assets listed in Schedule 2 are too broad. Relabelling and providing additional sub-categories will allow the treatment of some assets without triggering a review of the whole asset group (e.g. housing broken down into housing sub-groups).

Investment Property Portfolio Policy: a change in the approval process is required to reduce the burden on Council. Changes in delegations for Council officers and Council-owned entities (i.e. CCOs/CCTOs) recommended to streamline the process. Further due diligence and reporting will be required once an approach has been agreed.

Risk

<u>Ratepayer Risk</u>

The risk of eroding an intergenerational endowment asset by continuing the current approach to investment management is high. Moving to an intergenerational approach will ensure benefit to ratepayers of both current and future generations.

<u>Asset Risk</u>

Council currently holds most of it's Investment Portfolio in single investment asset classes (such as leasehold land). As an example, through the sale of some leasehold land and reinvestment of the proceeds into other investment assets, Council can retain investment value, create alternate sources of income, and lower it's overall risk exposure (concentration risk).

<u>Focus</u>

The current piece-meal management approach lacks commercial focus. There is a high risk that opportunities to increase revenue are not being realised.

Mixed Governance objectives
Governance is currently structured within the general Council framework and community well-being agenda. There is a risk that this governance arrangement places greater emphasis on well-being over revenue generation for investment assets.

Risks associated with a CCTO
There is a risk that a CCTO operates in a way that is misaligned to Councils objectives for the assets that it holds. Clarity of purpose through a Statement of Intent (SOI) is essential to ensure both parties remain on the same page.

There is a risk that assets placed under the responsibility of the CCTO have different objectives and different management needs. Whilst this can be addressed through specific provisions in the SOI, the risk is best mitigated by ensuring that the activities and assets held reflect a single SOI as much as possible.

Mixing elected members with a professional board also poses a risk to the success of the CCTO. Because the CCTO will be focused on inter-generational financial returns, it will require independence from Council, and an ability to attract the right expertise to the board.

5.6 Options

Status Quo Council (i.e. NCC today)

- Resourced in-house on a “part of role” basis.
- Each investment is managed separately within an unintegrated long term plan framework.
- Few available levers to grow the overall asset base.
- In-house governance through general committee structures and reporting
- Revenue from investments used for social returns.
- Dwindling asset base and inconsistent returns
- Mixed commercial returns, strong social returns

Enhanced Status Quo

- Resourced in-house, with focus on commercial returns.
- LTP provides an integrated framework to manage core investments for financial return that can be sustained over time
- In-house dedicated management, integrated reporting.
- Passive diversification of asset base
- Unlikely to be fully mandated to protect the value asset base, or provide a consistent return to Council over time
- Average commercial returns and some social returns

Independent Operations CCTO

- In-house resource (active and commercially driven)
- Mixed majority independent governance with a financial performance objective
- Active diversification of asset base to enhance returns and manage overall risk
- Fully mandated to protect the value asset base to provide a consistent return to Council over time

	Analysis
Strategic Considerations	
Strategic focus on inter-generational financial performance	• Assets are looked at on an asset-by-asset basis, not as a portfolio. • Approach to asset management is reactive. • Limited likelihood of replacement of Parklands revenue stream when Area 4 development is completed. • Council policies target protecting the status quo, rather than seeking opportunities. • Core financial investments have not been clarified for single focussed financial performance. • Council ownership and wellbeing objectives often override commercial objectives. • Mixed objectives and influences make Council an unlikely partner.
Risk Management	• Current SIPO is balanced, potentially resulting in lower long-term return outcomes. • Council current risk appetite for reinvestment in new assets is contrary to its risk view on inherited assets. • Passive and unconsolidated performance monitoring • The lack of a portfolio approach means little consideration is managing risk through building resilience through diversifying leaving an over reliance on Napier property as the core investment
Ownership and Controls	• Council has 100% ownership of all Investment Assets • Council has 100% ownership of all Development Assets • Controls in LTP are functionally restrictive and insufficiently flexible or agile to enable decisions to buy sell or reinvest. • Council through policies and delegations influences control over asset management.
Operating Considerations	
Governance Skillset	• Councillors have ultimate decision-making authority. • Councillors' greatest collective strength is in the delivery of community services, not strategic investment decision-making. • Role of Councillor is wide ranging, and often involves competing priorities.
Operating Skillset	• Council management of investment assets and development assets is spread across the Executive Leadership Team and based on service delivery. • Parklands has been delivered to plan by experts in service delivery. Limited commercial oversight is applied. • Management of investment and development assets are a small part of a wider service or operational role. • Conflicting objectives result in higher social benefits at the expense of commercial income for Council.
Net Operating Income	• Investment assets provide an indicative cash return of 1.3% to Council. • The operating cost to derive this return is unknown; given the method of delivering services. • Development income is focused on sales rather than development margin.
Other Operating Considerations	• Development income has significant volatility, ranging from $0m to $20m per annum. • In NCC's 2022 Annual Report, the greatest income and expenditure variances were related to investment assets.

Enhanced Status Quo

	Analysis
Strategic Considerations	
Strategic direction on inter-generational financial performance	• Assets are reviewed individually, not as a portfolio. • Approach to asset management is reactive • Limited likelihood of replacement of Parklands revenue stream when Area 4 development is completed. • Council policies reviewed as part of LTP to ensure that Council can take opportunities. • Core financial investments have not been clarified for single focussed financial performance. • Council ownership and wellbeing objectives often override commercial objectives. • Potential for mixed objectives and influences make Council an unlikely partner.
Risk Management	• Renewed SIPO permitting risk reward commensurate with Council's position as an intergenerational investor. • Passive and unconsolidated performance monitoring • Greater risk management awareness, but limited skillset to change. • The lack of a portfolio expertise means little consideration is managing risk through building resilience.
Ownership and Controls	• Council has 100% ownership of all investment assets. • Council has 100% ownership of all development assets. • Council, through policies and delegations, influences control over asset management. • Investment committee and internal financial oversight reports to Council.
Operating Considerations	
Governance Skillset	• Councillors have ultimate decision-making authority. • Investment committee would have some independent representation but would likely be a minority influence and remain subject to Council politics and process. • Councillors' greatest collective strength is in the delivery of community services, not strategic investment decision making. • Role of Councillor is wide ranging, and often involves competing priorities.
Operating Skillset	• Greater awareness of investment assets will bring focus. Greater use of internal committees and projects to manage value and costs. • Council management of investment assets and development assets is spread across the Executive Leadership Teams based on service delivery. Oversight may change. • Parklands has been delivered to plan by experts in service delivery. Increased commercial oversight will add initial value. • Current operating structure with no single owner creates and influencing role, rather than a specialist managing role. • Some management of conflicting objectives result in higher social benefits at the expense of commercial income for Council.

Net Operating Income	• Investment assets return will grow, but slowly. • Additional operating costs likely to compensate for lack of specialist skills. • Development income is focused on development margin, not just land sales.
Other Operating Considerations	• Development income volatility will reduce with a focus on returns not just sales.

Investment and Development Assets Managed Through a CCTO:

	Analysis
Strategic Considerations	
Strategic Direction on inter-generational financial performance	• Strategic focus and core financial investments articulated in a Statement of Corporate Intent (SCI) • Investment assets are managed as a collective portfolio for return and risk management. • Approach to asset management is proactive. • Land development focus moves to an enduring workstream, seeking new development blocks from new land investment and existing Council land. • Council policies reviewed as part of LTP to ensure that Council / CCTO can take opportunities. • CCTO provides a degree of independence from Council and clarity of mandate for management of assets.
Risk Management	• Renewed SIPO permitting risk reward commensurate with Councils position as an intergenerational investor. • Staggered diversification of non-strategic assets to grow both income and lower overall portfolio risk. • Focussed performance monitoring as per SCI and board • Strategic approach to building resilience through asset management and consistency of income.
Ownership and Controls	• Council owns 100% of CCTO. • Letter of Expectation and Statement of Intent define mandate and parameters for CCTO. • Ability for CCTO to acquire its own commercial assets in time. • Council through policies and delegations (to CCTO) influences investment management, including status of strategic assets. • CCTO interface into Council through Council, Deputy CEO and Council presentations. • Board of CCTO delegated decision-making responsibility.
Opportunity for partnerships	• Partnership and co-investment potential with iwi, developers, or similar organisation through commercial CCTO interface. • Future expanded partnership if CCTO eventually owns assets directly.
Operating Considerations	
Governance Skillset	• Councillors have ultimate decision-making authority through delegations, Letter of Expectation, and Statement of Intent. • CCTO often have a governance structure targeting a majority independent board, and bringing in commercial (specialist) expertise. • Clear separation of Council function and investment function.

Operating Skillset	• Commercial investigation, decision, and ability to procure specialist resources as required • Commercial decision process leads development and sale of Parklands Area 4 and future developments. • Council staff continue to deliver function services, as requested. • Focus of investment assets is in growing and diversifying the investment return.
Net Operating Income	• Investment assets targeted towards long term cash return of 3% per annum to Council. • Development assets moved towards profit target (preserving the value of the inherited land asset) and annual growth over life of Long Term Plan (including beyond 2028). • Establishment costs and operating costs provide net annual cash benefit from year 3, steadily growing net revenue to Council by a targeted 60% over the LTP.
Other Operating Considerations	• Development income smoothed through reserving to ensure Council has steadily growing revenue stream. • Portfolio approach creates size and scale to attract skilled staff, governors, and partners. • Existing assets continuance of Council ownership retains current taxation status.

5.7 Development of Preferred Option

The preferred option has been developed through workshops with Councillors, assistance from external specialists, research into the operations of other councils around New Zealand, and Government reports concerning local government funding streams.

The preferred option is to include the proposal to establish the CCTO within the 2024-34 Long Term Plan for consultation.

Given the issues and risks around the financial implications for Council, status quo is not seen as a viable option; meaning that enhanced status quo and CCTO options may be pursued in tandem.

5.8 Attachments

Nil