



Item No: 16.1.2
 File No: 5.65.1.1
 Date: 20 March 2017
 Attachment: A

Meeting: Council

Title: ERA Water – BRM Holdich Report to City of Burnside

Responsible Manager: Chief Executive Officer, Kiki Magro

Author: Chief Executive Officer, Kiki Magro

Key Focus Area 3: Transparent and accountable local tier of Government that is respected for its forward thinking approaches and cross-Council collaborations.

Type of Report: **Decision Required**

Pursuant to Section 83(5) of the *Local Government Act 1999*, the Chief Executive Officer indicates that the matter contained in this report may, if the Council so determines, be considered in confidence pursuant to Section 90(2) of the *Local Government Act 1999* on the basis that the information contained in the attached report is information of the nature specified in subsections 90(3)(d) of the Act being to prejudice the commercial position of the person who supplied the information, or to confer a commercial advantage on a third party.

Recommendation Public

Pursuant to s90(3)(d)

Pursuant to section 90(2) of the *Local Government Act 1999* the Council orders that all members of the public, except the Chief Executive Officer Kiki Magro, General Manager Heather Barclay, Protocol Governance & Compliance Officer Deb Bria be excluded from attendance at the meeting for Agenda Item [...] ERA Water – BRM Holdich Report to City of Burnside.

The Council is satisfied that, pursuant to section 90(3)(d) of the Act, the information to be received, discussed or considered in relation to this Agenda Item is commercial information of a confidential nature (not being a trade secret) the disclosure of which could reasonably be expected

*to prejudice the commercial position of the person who supplied the information,
 or to confer a commercial advantage on a third party*

In addition, Council has further considered that the information would on balance be contrary to the public interest because the disclosure of this information could reasonably be expected to prejudice the commercial position of the person who supplied the information. Disclosure of this financial information could reasonably be expected to provide the market competitors with sensitive financial and pricing policy information and would work to the detriment of the Council's subsidiary, ERA Water.

Recommendation (Confidential)

1. That the BRM Holmic report commissioned by the City of Burnside be received and noted; and
2. That Council provide the following comments / feedback to ERA Water Board:
 - Walkerville Council supports the existing terms of the Charter in which any operating surplus is distributed in proportion with the equitable interest in the subsidiary, rather than according to the underpinning financial contribution being made by each of the Constituent Councils (through commitment to water volumes);
 -
 -

Recommendation (Confidential)

Pursuant to s.91(7)

That having considered Agenda Item [...] ERA Water – BRM Holdich Report to City of Burnside in confidence under section 90(2) and (3)(d) of the *Local Government Act 1999*, the Council, pursuant to section 91(7) of that Act orders that report and attachments relevant to this Agenda Item be retained in confidence for a period of 12 months excepting that Council authorises the release of the minutes to substantive party/parties to enable enactment of the resolution and that pursuant to Section 91(9)(c) of the *Local Government Act 1999* the Council delegates to the Chief Executive Officer the power to review and revoke this Order

and

That Council resolves to end its confidential deliberations pursuant to Section 90(2) of the *Local Government Act 1999* Council and re-admit the public.

Summary

ERA Water Board at its meeting held on Friday 17 February 2017 resolved:

MOVED: B Cant (CoB)
SECONDED: J Minney (NPSP)

ERAW46/16-17

That the Holdich report to Burnside Council be received and noted and the Board recommends to the other Member Council's that they should present an in confidence report to their respective Councils

and

That the Board prepare a response to the Member Council's once the matter has been considered and responses provided back to the Board.

This report is presented to Council in response to ERA Water Boards recommendation.

Background

On 22 November 2016, the City of Burnside at its ordinary meeting resolved

C10961

1. *That the report be received.*

2. *That a robust report of the financial health of ERA Water be presented to the 13 December 2016 Council meeting in addition to recommendations for immediate action to address any issues raised.*

In response to the resolution, the administration of Burnside engaged BRM Holdich to report on the financial health of ERA Water in the context of the Burnside Prudential Report considered by Council (Burnside) in May 2015 and to make recommendations where appropriate to address any identified issues.

Discussion/Issues for Consideration

The BRM Holdich independent report of the financial health of ERA Water was presented to the City of Burnside on 13 December 2016. Burnside Council at that meeting resolved:

C10981

1. *That the Report be received.*
2. *That Council remains committed to the ERA Water project.*
3. *That Council endorses the recommendations from the ERA Water BRM Holdich December 2016 Report and requests that Administration engage with the Mayors and CEOs of the other constituent Councils and the ERA Water Board to seek ERA Water acceptance and implementation of the recommendations or written explanation of reasons for not accepting the recommendations.*
4. *That the Administration requests of ERA Water:*
 - 4.1 *Finalisation of the ERA Water LTFP using the same assumptions as contained in the Financial Model, where these assumptions are to be varied a detailed explanation be provided.*
 - 4.2 *Consideration should be given to supplementing the expertise on the ERA Water Board with those who have commercial experience and / or experience in operating a water infrastructure business.*
 - 4.3 *ERA Water plans for driving water sales to third parties should be documented and provided confidentially to Constituent Councils to provide some comfort around ERA Water's ability to deliver in this vital area.*
 - 4.4 *Resolution of the issue of the equitable distribution of ERA Water operating surpluses / deficits be addressed to ensure there is clarity in the expectation of each Council, either:*
 - 4.4.1. *the subsidiary operates as outlined through the Prudential Report i.e. the available volume of water is 'sold' firstly to the ERA Councils at a price which is directly comparable with the price charged by SA Water or which is lower than the forecast SA Water price when the subsidiary is able to recover all of its operating costs and net of any income received from the sale of water; or*
 - 4.4.2 *the Constituent Councils agree to vary the basis on which the subsidiary was intended to operate.*

4.5 Regular briefings be brought to Constituent Councils by the Independent Chairperson.

In line with the above resolution, the CEO and Mayor of Burnside Council met with the CEO of Walkerville and Acting CEO of Norwood Payneham and St Peters (NPSP) on Monday 30 January 2017 to provide them with a briefing on the outcome of the Burnside Council resolution. Unfortunately the Mayors of Walkerville and NPSP were not available.

A copy of the report and Council resolution was **not** provided to the CEO of Walkerville and Acting CEO (NPSP). The briefing was presented in confidence and focused on the issues concerning Burnside. Notwithstanding item 3 above, no commitment, acceptance or request for implementation was sought.

Subsequent to the briefing on 30 January 2017, the CEO Burnside emailed a copy of the report and the above resolution to the Mayor’s and CEOs of the Constituent Councils and ERA Water Board members on 1 February 2016. In that email the CEO Burnside stated *“I now provide this report and Council resolution to the ERA Water Board for its information, consideration and future action. I would appreciate if the ERA Water Board could consider this matter at its next meeting and provide the City of Burnside with a response to the issues raised both in the report and in the resolution.”*

The CEO Burnside has not requested any formal response from the Constituent Councils.

The ERA Water Board considered the BRM Holdich report in confidence at its meeting held on Friday 17 February 2017 and resolved:

MOVED: B Cant (CoB)
SECONDED: J Minney (NPSP)

ERAW46/16-17

That the Holdich report to Burnside Council be received and noted and the Board recommends to the other Member Council’s that they should present an in confidence report to their respective Councils

and

That the Board prepare a response to the Member Council’s once the matter has been considered and responses provided back to the Board.

Options for Consideration

Option 1

1. That the BRM Holdich report commissioned by the City of Burnside be received and noted; and
2. That Council provide the following comments / feedback to ERA Water Board in response:
 - Walkerville Council supports the existing terms of the Charter in which any operating surplus is distributed in proportion with the equitable interest in the subsidiary, rather than according to the underpinning financial contribution being made by each of the Constituent Councils;
 -
 -

Option 2

That Council receive and note the BRM Holdich report commissioned by the City of Burnside.

Analysis of Options

BRM Holdich was prepared specifically for Burnside Council in response to criticism from a few of elected members that they have not been provided with up to date information. The report will be considered in detail by the Board, who has resolved to provide responses back to the Member Councils.

Financial Implications

The BRM Holdich reports provides analysis of the financial health of ERA Water. There is no direct financial cost to Council in receiving this report.

Community Implications

The ERA Water project is a significant project for our region. Once fully realised it will provide a substantial irrigation source for the Constituent Councils parks, gardens and reserves. It has noteworthy environmental and economic benefits. Regular updates on the project are provided via the ERA Water website and through Councils weekly roundup.

Governance Implications

ERA Water Board has requested that its Member Councils consider the BRM Holdich report prepared for Burnside Council, in confidence. This report satisfies that request. Council is also invited to provide feedback on said report, should it so wish.

Preferred Option & Reasoning

Option 1

Council has been asked to consider the BRM Holdich report prepared for the City of Burnside in confidence. This has now been achieved. ERA Water Board will be considering the report in detail at a future meeting and provide response back to its Member Councils. ERA Water should consider the recommendations presented in the report in the first instance.

Attachment

Attachment A	City of Burnside ERA Water December 2016 – BRM Holdich report
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City of Burnside
ERA Water
December 2016





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1. INTRODUCTION

1.1 Background

- 1.1.1 ERA Water is a regional subsidiary established on 21 July 2015 under Section 43 of the Local Government Act by its Constituent Councils, the City of Burnside (Burnside); the City of Norwood Payneham & St Peters (NPSP); and the Corporation of the Town of Walkerville (Walkerville).
- 1.1.2 The Charter identifies that ERA Water was established for specific objects and purposes; these are shown in full at Attachment One.
- 1.1.2.1 These objects and purposes include a provision (clause 1.8.1) “to implement, oversee and manage the Project”.
- 1.1.2.2 The Project to be undertaken by ERA Water is defined in the Charter as “the collaborative long-term joint undertaking of the Constituent Councils to implement a stormwater capture, treatment and distribution system in eastern Adelaide through, amongst other things, the linking and aggregation of small aquifers and storages via a regional aquifer storage and recovery system and the development of a cross- catchment, cross-council stormwater supply pipeline around eastern Adelaide”.
- 1.1.3 Given the amount of capital expenditure involved in the Project exceeded the threshold identified in Section 48 of the Local Government Act, each of the Constituent Councils was required to consider a Prudential Report, prepared in accordance with the requirement of Section 48.
- 1.1.4 Each Prudential Report was based on a common financial model (Financial Model) and a common set of assumptions on how the regional subsidiary would operate, principally that:
- 1.1.4.1 The subsidiary would not operate at a deficit.
- 1.1.4.2 Over the Project life (defined as 70 years) the Constituent Councils would not pay the price for water that exceeded the forecast SA Water price.
- 1.1.4.3 The Constituent Councils collectively committed to take 214.67ML, with each Council committing to the following amounts.
- Burnside 110ML;
 - NPSP 76.7ML; and
 - Walkerville 28ML.
- 1.1.4.4 The sale price of water to the Constituent Councils would be calculated according to the following formula.
- “Operating Costs less the Revenue derived from sales to customers other than the Constituent Councils, divided by the volume of water sold to the Constituent Councils.”

1.2 Governance

- 1.2.1 Consistent with the Charter, a Board of Management has been appointed to administer the affairs of the subsidiary and to ensure that ERA Water acts in accordance with the Charter and all relevant legislation.
- 1.2.2 The Board consists of four members, an independent Chairperson, and one person from each of the Constituent Councils, who may be the Chief Executive Officer of that Constituent Council.
- 1.2.3 Burnside is the only Constituent Council that has a person other than the Chief Executive Officer as the Constituent Council Board Member.
- 1.2.4 An independent Chairperson, Mr John O'Brien, was appointed by the Constituent Councils.
- 1.2.5 ERA Water has prepared a draft ERA Water LTFP (LTFP). It has been recognised that a number of the assumptions used in the preparation of the LTFP require further review. This review is being undertaken by representatives of each of the Constituent Councils.

1.3 Terms of reference

- 1.3.1 Our instructions are set out below.
 - 1.3.1.1 To report on the financial health of ERA Water in the context of the Prudential Report considered by the City of Burnside, in May 2015.
 - 1.3.1.2 To make recommendations where appropriate to address any identified issues.
- 1.3.2 As a regional subsidiary, pursuant to clause 31 of Schedule 2 of the Local Government Act, the liabilities incurred or assumed by ERA Water are guaranteed by the Constituent Councils.
- 1.3.3 The Constituent Councils therefore guarantee the “financial health” of ERA Water.
- 1.3.4 However, the Charter also sets out in clause 1.8.15 that ERA Water is “to be financially self-sufficient as far as possible”.
- 1.3.5 The Financial Model used in the Prudential Report demonstrated that ERA Water was capable of being financially self-sufficient and deliver water at a price which was lower than the forecast SA Water price over the life of the Project.
- 1.3.6 The focus of this report is to examine the impact of the operations of ERA Water since formation and how this impacts their ability to deliver water at a price lower than the price of SA Water in each year of the Project and to be financially self-sufficient.

2. ERA WATER FINANCIAL MODEL ASSUMPTIONS

In order to assess the financial health of ERA Water in comparison with the expected position as detailed in the Prudential Report it is important to understand the assumptions on which the Financial Model used in the Prudential Report was based. The key assumptions are shown below.

2.1 Capital Expenditure

2.1.1 The Total project investment of was estimated to be \$22.85 million.

2.1.1.1 Given there had been a considerable amount of time and a number of feasibility studies prepared in the development of the Project, Wallbridge & Gilbert (W&G), engineering advisors to ERA Water, identified that expenditure with a value of \$6.0 million did not directly relate to productive assets and should be written off as Sunk Costs.

2.1.1.2 As a consequence of this treatment, on-going depreciation was based on a lower capital value than the total Project expenditure.

2.1.1.3 Construction was assumed to be completed within 12 months to comply with the conditions of the Commonwealth grant.

2.2 Water Volumes

2.2.1 The harvest potential of the Project was estimated to be 540ML in full production.

2.2.2 The water available for sale was estimated at 458ML in full production.

2.2.3 Based on information provided by W&G it was assumed that the extensive commissioning and testing of the constructed water infrastructure would commence in Year 2, with the percentage of the asset base completed, commissioned and available for productive use shown below.

- Year Three – 50%;
- Year Four – 80%; and
- Year Five – 100%.

2.2.4 The Financial Model assumed that ERA Water would take the available supply up to its needs and then the balance would be sold to other customers.

2.2.5 Water produced and sold over the first 10 years of the Project is shown below, along with the volumes forecast to be taken by ERA Water Councils and other customers.

Water (ML)	1	2	3	4	5	6	7	8	9	10
Produced	0.00	27.00	270.00	432.00	540.00	540.00	540.00	540.00	540.00	540.00
Available	27.00	270.00	432.00	458.00	458.00	458.00	458.00	458.00	458.00	458.00
Sold to ERA	27.00	214.67	214.67	214.67	214.67	214.67	214.67	214.67	214.67	214.67
Sold to Other	0.00	55.33	217.33	243.33	243.33	243.33	243.33	243.33	243.33	243.33

2.3 Revenue

2.3.1 Sales to other customers (non-ERA Water Councils) are forecast to occur 12 months after construction is complete. The Commonwealth was not specific in relation to sales of water assets other than meeting the production demand of up to 494ML. The customer specific allocations were not nominated.

2.3.1.1 The commencing 2016 SA Water price was \$3.24 per Kilotitre.

2.3.1.2 The SA Water price was indexed to rise by CPI 2.5% per annum broadly consistent with the indices used by the Constituent Councils in their long term financial modelling at that time.

2.3.1.3 The volume of water produced in excess of the Constituent Councils commitments is to be sold at 80% of the forecast prevailing SA Water price.

2.3.1.4 The cost of connecting to the network is to be borne by the customers.

2.4 Operating Expenses

2.4.1 The two components to the Operating Expenses, are:

2.4.1.1 Operating Costs

2.4.1.2 Fixed Operating Costs

2.4.2 Operating Costs are: Maintenance; Electricity; Licencing; Interest Expense; Depreciation; and Amortisation.

2.4.3 As a consequence the accounting treatment relating to the availability of the asset for productive uses, the Financial Model capitalised all Operating Costs up to Year Five in the same percentage as the asset value is brought into productive use.

2.4.4 Fixed Operating Cost are the administrative expenses to run the Subsidiary. The forecast Fixed Operating Costs were set out in the financial model as shown below.

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
100,000	101,700	126,061	141,198	144,728	174,666	212,147	234,421	240,282	246,289

2.5 Project Financing

2.5.1 Investment in the Project was financed by grant funds of \$11.5 million from the Commonwealth government and the Adelaide and Mount Lofty Ranges Natural Resource Management Board, with the balance provided by ERA Water using borrowed funds.

2.5.1.1 The Financial Model was based on the assumption that the construction works for the water infrastructure would be undertaken and completed in Year 1 (FY2016) to comply with the conditions of the Commonwealth government grant.

- 2.5.1.2 The financial model assumed that ERA Water would use a Cash Advance Debenture (CAD) as the financing instrument. A recent paper to the ERA Water Board recommended a Credit Foncier facility with a 20 year fixed interest rate of 4.3% over a 25 year loan term. This had a higher interest rate than a CAD but it required no cash payments to be made within 2 years from the execution of the loan.
- 2.5.1.3 Upon consideration of the impact of adding loan interest amounts to the Credit Foncier loan principal (i.e. reducing the overall borrowing capacity against the \$12.0 million loan cap) the Board resolved that an initial CAD style loan be taken out with LGFA. This is in line with the recommendation of the Prudential Review and at a lower indicative interest rate of 3.4%. This matter will be reviewed at each Board meeting.

2.6 Project Financial Risks

- 2.6.1 The key financial risks identified in the Prudential Report were as follows.
 - 2.6.1.1 Long term commitment to 'take or pay' contract
 - 2.6.1.2 Demand risk i.e. no binding agreements within ERA Water Councils to commit to specified volumes of water
 - 2.6.1.3 Lower SA Water prices
 - 2.6.1.4 No contracts for sale of water
 - 2.6.1.5 Securing customers or sale of volumes of water for the duration of the Project
 - 2.6.1.6 Increases in Fixed Operating Costs
 - 2.6.1.7 Increases in capital costs
 - 2.6.1.8 Potential cost of supply in event of system failure
 - 2.6.1.9 Interest rates

3. ERA WATER OPERATIONS

3.1 Capital Expenditure

- 3.1.1 ERA Water has commenced the Project capital works.
- 3.1.2 We understand practical completion is scheduled for March 2017 with connection to the constituent Councils to occur over a six months period to September 2017.
- 3.1.3 The capital costs were estimated in the Financial Model at \$22.85 million.
 - 3.1.3.1 The current forecast provided by ERA Water is that the Project will cost \$21.60 million to complete. The recent tender submissions for the construction of the Civil Engineering works at Felixstow Wetlands and Bio Filters at Felixstow and Hamilton Reserve have identified potential cost savings of \$0.820 million. Allowing for a likely cost penalty for the disposal of low level contamination waste at Hamilton Reserve, the revised project contingency is now approximately \$1.50 million.
 - 3.1.3.2 The lower capital costs should result in lower depreciation expense and lower financing costs, these would reduce the price of water to the Constituent Councils. However, this requires detailed financial modelling regarding the timing of expenditures and the asset type.
 - 3.1.3.3 A reduction of \$1.250 million (\$22.85 million to \$21.60 million) would have an annual impact on depreciation of approximately \$0.025 million per annum
- 3.1.4 Capital expenditure of \$6.0 million was identified by W&G as a Sunk Cost to be written-off in the year of construction.
 - 3.1.4.1 To date none of the capital expenditure appears to have been categorised as a Sunk Cost and written-off. This accounting treatment is currently under discussion with the ERA Water Auditor for clarification.
 - 3.1.4.2 If the Sunk Costs are not identified and treated in that way then the annual depreciation expense will be higher than forecast in the Financial Model. This will increase the cost of water to the Constituent Councils.
- 3.1.5 The Financial Model was based on the assumption that the construction works for the water infrastructure would be undertaken and completed in Year 1 (FY2016) to comply with the conditions of the Commonwealth grant. This has not occurred and an extension of time to comply with the Commonwealth grant conditions has been received. The “practical completion date” for the project is 31 March 2017 for the Trunk Mains (not Feeders), Pump Stations and Civil Works. The project as defined is to be completed by 30 June 2017. It should be noted that landscape and connections can occur after this date.
- 3.1.6 We note that the current draft ERA Financial Statements have (correctly) only brought to account that portion of the Commonwealth grant that was expended during the year.

- 3.1.7 We understand that discussions are underway to acquire a disused pipe from SA Water that was not provided for in the Financial Model. This will extend the reach of the network and open access to an increased number of customers. There may however, be maintenance or upgrade cost implications that need to be accounted for.
- 3.1.8 Based on information provided by Wallbridge & Gilbert it was assumed that the commissioning and testing of the constructed water infrastructure would commence in Year 2, with the percentage of the asset base completed, commissioned and available for production shown below.
- Year 3 – 50%;
 - Year 4 – 80%; and
 - Year 5 – 100%.
- 3.1.9 The availability of the assets for productive purposes was a key consideration when determining that it would be an acceptable treatment to capitalise a portion of the Scheme Costs in Years 3 and 4.
- 3.1.10 The potential sale of water earlier than forecast means that various expenditures which were capitalised in the Financial Model would not be able to be capitalised if the asset is available for productive use. This will have an impact on the Operating Statement and is likely to produce an Operating Deficit which is contrary to the basis on which the Financial Model was prepared.

3.2 Water Volumes

- 3.2.1 The Financial Model identified that viability depends on commitment of Councils to volumes and on securing sales to third parties. As part of the Prudential Report identified demand was 300ML, from the following sources.
- 3.2.1.1 DECD schools 73ML;
- 3.2.1.2 Other educational institutions 82ML;
- 3.2.1.3 Commercial customers 45ML; and
- 3.2.1.4 Other Councils 100ML.
- 3.2.2 ERA Water has been in negotiations with private and public schools regarding the supply of water.
- 3.2.2.1 We understand that some of these negotiations include the provision of a connection at the cost of ERA Water, this is contrary to the assumption in the Financial Model and would require an additional unbudgeted capital commitment.
- 3.2.2.2 However, we understand that this decision is to be based on an individual business case to be prepared at the time which will consider the funding

constraint of the borrowing cap and a price for water, higher than forecast in the Financial Model.

3.2.2.3 We recommend that the ERA Water Board consider each business case for the connection of customers on its commercial merit.

3.2.3 We note that in the ERA Water LTFP overall Water Volumes Sold are based on 454ML whereas the Financial Model is based on 458ML.

3.2.3.1 In the ERA LTFP water volumes sold to the ERA Councils have been forecast at 217ML from Year 3 onwards which is slightly higher than the volumes forecast in the Financial Model 214.67ML.

3.2.3.2 In the ERA LTFP water volumes sold to non-ERA Councils and Educational Institutions have been forecast at slightly higher volumes over the 11 year period of the LTFP than in the Financial Model. This is shown in the Table below. However, we note that from Year 5 onwards the water volume sold is less than forecast in the Financial Model.

(ML)	1	2	3	4	5	6	7	8	9	10	11
ERA LTFP	0	0	107	237	237	237	237	237	237	237	237
Financial Model	0	0	55	217	243	243	243	243	243	243	243
Variance	0	0	52	20	-6	-6	-6	-6	-6	-6	-6

3.3 Revenue

3.3.1 Grant income has been received as per the Financial Model.

3.3.2 The SA Water price in 2016 is consistent with the actual price charged by SA Water for that year.

3.3.3 Water volumes sold to non-ERA Councils and Educational Institutions

3.3.3.1 Water sold to non-ERA Councils and Educational Institutions was forecast at 80% of the SA Water (for comparative modelling purposes). The price in Year 2 was forecast at \$2.59/KL.

3.3.3.2 We note the ERA LTFP has used a price of \$3.00/KL to reflect current discussions with these potential customers. If water volumes sold to these customers were consistent with those forecast in the Financial Model this would produce higher revenue in the ERA Water LTFP.

3.3.3.3 Revenues from water volumes sold to non-ERA Councils are forecast to be higher than in the Financial Model, as shown in the Table below. This would have the effect of reducing the price to ERA Water Constituent Councils.

(\$m's)	1	2	3	4	5	6	7	8	9	10	11
ERA LTFP	0.000	0.000	0.339	0.769	0.788	0.808	0.828	0.849	0.870	0.892	0.914
Financial Model	0.000	0.000	0.147	0.592	0.679	0.696	0.714	0.732	0.750	0.769	0.788

Variance	0.000	0.000	0.192	0.177	0.109	0.111	0.114	0.117	0.120	0.123	0.126
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3.3.4 Interest Earned

3.3.4.1 Interest earned is forecast to be higher in the ERA Water LTFP than in the Financial Model, this is shown below.

3.3.4.2 Higher interest earned would have the effect of reducing the price to ERA Water Constituent Councils.

(\$000's)	1	2	3	4	5	6	7	8	9	10	11
ERA LTFP	0.00	2.13	2.58	4.99	14.38	17.64	20.90	24.28	28.05	32.83	38.55
Financial Model	0.00	0.00	0.00	0.01	0.03	0.05	0.07	0.09	0.00	0.04	0.08
Variance	0.00	2.13	2.58	4.98	14.35	17.58	20.82	24.19	28.05	32.80	38.47

3.4 Operating Expenses

3.4.1 There was no provision in years one and two for Operating Costs (Maintenance; Electricity; Licencing; Interest Expense; Depreciation; and Amortisation), the provision in year three was \$0.242 million, increasing to \$0.333 million in year four then increasing by inflation.

3.4.1.1 These Operating Cost amounts were based on the capitalisation of assets to reflect the timing of the productive use of the asset.

3.4.1.2 If this accounting treatment is not applied then the subsidiary will trade at an Operating Deficit which is contrary to the basis on which the Financial Model was prepared.

3.4.2 Total Expenses forecast in the ERA LTFP and the Financial Model are shown below. Although Total Expenses are forecast to be higher for the period in the Financial Model this relates to the treatment of Sunk Costs. Excluding this, Total Expenses are slightly higher in the ERA LTFP than in the Financial Model.

(\$m's)	1	2	3	4	5	6	7	8	9	10	11
ERA LTFP	0.039	0.425	1.360	1.455	1.470	1.456	1.492	1.513	1.517	1.522	1.528
Financial Model	6.000	0.000	0.636	1.108	1.426	1.452	1.486	1.504	1.506	1.508	1.511
Variance	-5.961	0.425	0.724	0.347	0.044	0.004	0.006	0.009	0.011	0.014	0.017

3.4.3 Fixed Operating Costs have been higher than forecast.

3.4.3.1 The Prudential Report noted this risk and that actual cost of between \$0.250 million and \$0.300 million were more realistic.

3.4.3.2 We note the Fixed Operating Costs are higher in the ERA LTFP than in the Financial Model. This difference is shown below.

(\$m's)	1	2	3	4	5	6	7	8	9	10	11
ERA LTFP	0.000	0.170	0.221	0.232	0.238	0.227	0.266	0.289	0.297	0.304	0.312
Financial Model	0.000	0.000	0.126	0.141	0.145	0.175	0.212	0.234	0.240	0.246	0.252
Variance	0.000	0.170	0.095	0.091	0.093	0.052	0.054	0.055	0.056	0.058	0.059

3.4.4 We note interest expense in the ERA Water LTFP is forecast to be much lower than in the Financial Model.

3.5 Project Financing

3.5.1 ERA Water has been in discussion with the Local Government Finance Authority (LGFA) regarding the debt financing of subsidiary.

3.5.2 The LGFA has proposed a Credit Foncier loan, with interest only payments for the first two years of operation.

3.5.3 This type of loan has the benefit of a lower interest rate than the interest rate of the Cash Advance Debenture used in the Financial Model.

3.5.4 However, the requirement to make principal and interest payments in future years will result in a higher level of debt being required to finance the subsidiary.

3.5.5 We note that the borrowing cap imposed by the Constituent Councils is less than the peak debt forecast in the Financial Model of \$12.624 million (not adjusted for the additional contingency expected from the civil works tender saving).

3.5.6 Based on the Financial Model ERA Water could have insufficient funds to complete the Project works. The Constituent Councils will need to review and address this once the LTFP has been finalised.

3.6 Governance

3.6.1 The following Governance Risks were identified in the Prudential Report.

3.6.1.1 Long term membership of a regional subsidiary;

3.6.1.2 Lack of financial certainty over exit arrangements; and

3.6.1.3 Alignment between equitable interest and differential financial contribution (through commitment to water volumes).

3.6.2 These risks need to be actively managed by the ERA Water Board to ensure that there is strong Constituent Council support for the Project, we recommend regular briefings be brought to Council by the Independent Chairperson.

3.6.3 We understand that the ERA Water Board has discussed the pricing of water such that there is the potential for the subsidiary to generate an Operating Surplus. Under the terms of the Charter this would be distributed in proportion with the equitable interest in the subsidiary, rather than according to the underpinning financial contribution being made by each of the Constituent Councils.

- 3.6.4 We recommend this issue be addressed to ensure there is clarity in the expectation of each Council, either:
- 3.6.4.1 the subsidiary operates as outlined through the Prudential Report; or
 - 3.6.4.2 the Constituent Councils agree to vary the basis on which the subsidiary was intended to operate.
- 3.6.5 Until recently revision to the conflict of interest provisions in the Local Government Act were problematic for Elected Members and Council staff who were representatives on a subsidiary.
- 3.6.6 Burnside responded to this by appointing a representative other than the Chief Executive Officer to represent their interests on the ERA Water Board. This issue has been addressed by a change in legislation and no longer presents the same problem.
- 3.6.7 However, given the complexity and commercial nature of the ERA Water operations the ERA Water Board may benefit from additional business and specific water business expertise. In order to ensure the Constituent Councils remain strongly aligned with the Project it may be worthwhile considering expanding the number of Board members each Council can nominate to gain access to this expertise.

3.7 Risk Management

- 3.7.1 As suggested in the Prudential Report risk management is considered by the ERA Water Board as a standing agenda item.
- 3.7.2 Based on the ERA Water agenda and minutes, the risk register considered by the ERA Water Board does not appear to have been updated, to reflect the commencement of Project delivery, since the Prudential Report was prepared.
- 3.7.3 If the risk register has not been updated since the Project commenced the Board is not actively managing risk, we would view this as a serious governance weakness that must be addressed as a matter of high priority.
- 3.7.4 We note the quality of the information provided by W&G seems to be robust and sufficiently detailed to ensure the ERA Water Board is properly informed.
- 3.7.5 We believe it is the responsibility of the Acting General Manager to ensure the Board is properly informed to discharge its responsibilities. This does not appear to have been the case. We note the quality of the information provided to the Board appears to lack the rigour and detail that we would expect to see from a Council Subsidiary.
- 3.7.6 Key Financial Risks
- 3.7.6.1 Negotiations are under way with a range of potential customers however we have seen no evidence of “long term commitment to ‘take or pay’ contract”, this risk remains to be managed. The risks of “No contracts for sale of water” and “Securing customers or sale of volumes of water for the duration of the Project” also remain to be managed.

- 3.7.6.2 We have seen no evidence that the Constituent Councils have made binding arrangements to mitigate the “Demand risk i.e. no binding agreements within ERA Water Councils to commit to specified volumes of water”, this risk remains to be managed or addressed through contractual commitment.
- 3.7.6.3 The risk of “Lower SA Water prices” is not controllable by ERA Water.
- 3.7.6.4 There have been “Increases in Fixed Operating Costs” beyond those identified within the Prudential Report. Actions must be taken to mitigate this risk by reducing costs. We recommend that the Constituent Councils give consideration to utilising existing members of staff to provide the administrative and project management expertise to undertake the Project.
- 3.7.6.5 The risk of “Increases in capital costs” appears to have been effectively mitigated with a lower Project cost currently being forecast.
- 3.7.6.6 The risk of “Potential cost of supply in event of system failure” will only occur when the Project is in production and servicing customers, this risk will need appropriate mitigations at that time.
- 3.7.6.7 The risk associated with “Interest rates” is currently being managed in negotiations with the LGFA. Prevailing interest rates are lower than those in the Prudential Report.

4. CONCLUSION

- 4.1 The current forecasts are that the Project will be delivered for a lower capital cost than forecast, this should have a beneficial impact on the 'financial health' of ERA Water.
- 4.2 However, since the preparation of the Financial Model there appear to have been a number of decisions taken by the ERA Water Board which are inconsistent with the key foundations of the Financial Model, these include the treatment of Sunk Costs, higher Fixed Operating Costs and bringing forward the timeframe in which the assets will have productive capacity.
- 4.3 These decisions, which vary from the assumptions in the business model, may have an unintended negative impact on the ability of ERA Water to deliver the Project broadly within the parameters of the Financial Model.
- 4.4 The rationale for taking these decisions and the collective impact of the 'financial health' of ERA Water should be explained to the Constituent Councils by the Board.
- 4.5 Recommendations
- 4.5.1 We note the decision not to capitalise assets in year one is capable of being rectified and is under review, this should be given a high priority.
- 4.5.2 Higher Fixed Operating Costs are being incurred than forecast in the Financial Model. If these are not capitalised ERA Water will operate at loss. If they are capitalised there will be a marginally higher depreciation expense or higher Sunk Costs. Consideration should be given to reducing the amount of Fixed Operating Costs with these services being provided from within a Constituent Council on an agreed cost recovery basis.
- 4.5.3 The ERA Water LTFP should be finalised for adoption as far as practicable using the same assumptions as contained in the Financial Model, where these assumptions are to be varied a detailed explanation ought to be provided.
- 4.5.4 The capping of borrowing at \$12 million could possibly result in ERA Water having insufficient funds to deliver the Project as planned. This decision should be reviewed by the Constituent Council once the ERA Water LTFP is finalised.
- 4.5.5 Consideration should be given to supplementing the expertise on the ERA Water Board with those who have commercial experience and / or experience in operating a water infrastructure business.
- 4.5.6 The ERA Water Board should consider business cases for the connection of customers to the ERA Water network on their commercial merit.
- 4.5.7 To improve the quality of reporting information to the Board, Constituent Councils should give consideration to:

- 4.5.7.1 utilising existing members of staff to provide the administrative and project management expertise to undertake the Project; or
 - 4.5.7.2 engaging appropriate resource to provide the administrative and project management expertise to undertake the Project.
- 4.5.8 We recommend the issue of the equitable distribution of ERA Water operating surpluses / deficits be addressed to ensure there is clarity in the expectation of each Council, either:
- 4.5.8.1 the subsidiary operates as outlined through the Prudential Report; or
 - 4.5.8.2 the Constituent Councils agree to vary the basis on which the subsidiary was intended to operate.
- 4.5.9 Project risks need to be actively managed by the ERA Water Board to ensure that there is strong Constituent Council support for the Project, we recommend regular briefings be brought to Council by the Independent Chairperson.

ATTACHMENT ONE: OBJECTS AND PURPOSES OF ERA WATER

1.8 Objects and Purposes of the Subsidiary

The Subsidiary is established for the following objects and purposes:

- 1.8.1 to implement, oversee and manage the Project;
- 1.8.2 to develop, implement, oversee and manage practical solutions to provide water supply diversity within and outside the Region;
- 1.8.3 to supply water to the Constituent Councils and other persons for irrigation purposes within and outside the Region except that priority shall be given to the supply of water for irrigation within the Region;
- 1.8.4 to manage and oversee the distribution of water captured as part of the Project;
- 1.8.5 to provide strategic direction for the Project;
- 18.6 to fund, lease or own physical infrastructure required to undertake the Project;
- 1.8.7 to meet all legislative requirements for the Subsidiary;
- 18.8 to be responsible for the ongoing maintenance, replacement and other capital requirements of all physical infrastructure owned by the Subsidiary;
- 1.8.9 to utilise proven water management planning principles and technologies;
- 1.8.10 to manage, operate and control the necessary infrastructure for the Project;
- 18.11 to maximise economic, environmental and social benefits to the community by developing and implementing innovative water management principles and techniques;
- 1.8.12 to identify, develop and implement water recycling and supply opportunities for the Constituent Councils;
- 18.13 to provide technical and other expert services and advice to the Constituent Councils in the area of water management and recycling including identifying emerging issues and opportunities;
- 1.8.14 to represent the Constituent Councils and liaise with State government regarding the implementation or alteration of legislation in relation to water and licensing;
- 1.8.15 to be financially self-sufficient as far as possible.