Financial and Corporate Sustainability Project

Kaikoura Port

Port Stocktake – Phase 1 (DRAFT)
Interim Summary April 2019

KAIKOURA
DISTRICT COUNCIL

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Contents

IMPORTANT: This document contains financial information that has been sourced from KDC staff and reports. We have been unable to convince ourselves that the information is sufficiently and consistently robust to rely on for the detailed analysis required to finalise our recommendations.

Therefore this report should be treated as indicative only until more robust information can be provided.

In addition the views expressed in this report are subject to formal legal confirmation

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The Brief

Morrison Solutions was engaged to undertake a stocktake of the Kaikoura Port and report on the following:

Stocktake of Current Position

- Operational compliance and H&S
- Council assets, deferred maintenance and future capital requirements to maintain current service levels for users and evaluate lease conditions
- Financial analysis – current and forecast

Growth Potential and Resilience

- Major operators views, plans and aspirations
- Growth potential and revenue capture mechanisms and level and basis of charges
- Resilience and adequacy as a future emergency site and potential upgrade costs
- Financial sustainability and funding policies including possible third party contributions
- Outline next steps to optimise sustainable operations and revenues

The work was to be undertaken in two phases with Phase 1 being a review of available information for quality and usefulness and in discussion to determine the objectives in more detail and if possible derive a preliminary position. This report summarises the Phase 1 findings and proposes a likely scenario to maximise KDC's position and returns

In undertaking this review Morrison Solutions has relied heavily on information provided by Council and Port Stakeholders.

1 – Stocktake Snapshot

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Stocktake Snapshot(1)

Very short Executive Summary

- Need ownership and financials clarified
- This is a more complex proposal than the Airport
- Whale Watch has a big issue with being involved with KDC
- Most likely recommendation is similar in nature to the airport but would be based on forming a Port company that would have significantly expanded facilities where KDC puts its assets into the company, then new shareholders (and possibly PGF) provide the capital for new facilities.
- The new company manages and operates the Port.
- The other port sites are rationalised by;
    - retaining the wharf at Wakatu, at least until the South Port plans are finalised
    - the land at Wakatu not required ~~directly~~ for potential port activities is sold, and
    - any other sites are sold if possible or leased on a long term basis unless there are operators who cannot be accommodated at South Port or who do not want to use the expanded facilities there.
- Some current operators would seem to support this approach in general for South Port but we advise all parties to ensure the process is completely transparent and that proposals are only considered in response to an EOI issued by KDC regarding options for the port's plan.

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Stocktake Snapshot(2)

Positives

- The Port assets and infrastructure include:
  - A new wharf and ancillary assets at South Port with a deepened channel following the earthquake
  - Other port facilities primarily on the northern side of the peninsula which are generally in poor condition. Although the Wakatu wharf is in operating condition, ~~but~~ the buildings are not
- The economic benefits from the port activities are significant to the community and these support whale and dolphin watching tourism, fishing, cruise ship visits and recreational uses
- There is clear interest in expanding the South Port facilities to allow for further growth and assist KDC in the mitigation of current management and operational issues
- The possible sale/lease of the land around the northern peninsula assets has some good possibilities for KDC to exchange non contributing assets for cash
- Wakatu wharf has potential to provide further docking activities if expansion at South Port is not forthcoming or not large enough to satisfy all users' expectations

Stocktake Snapshot(3)

Negatives

- Poor governance, management and operational controls leading to direct risk to Council (and perhaps it's senior employees):
    - Significant and long standing ownership disputes over South Port assets
    - Operator disharmony
    - Consent compliance issues at South Port
    - Unpaid leases
    - Under utilised assets (albeit generally in poor condition) with minimal return but possible cash benefits if they can be sold
    - Uncontrolled access etc leading to high health and safety risk
    - High distrust between some operators and KDC which does not help Council receive adequate return on its asset
    - Low confidence in accuracy of financials

Stocktake Snapshot (4)

Financial

- Information lacks robustness and no “single source of truth” meaning it is difficult to set fees and charges with any certainty
- There has been no extensive analysis of the financials as there is no certainty of ownership and unresolved commercial disputes could alter accounts significantly
- Accounts that have been provided show significant losses on a fully costed operating basis
- But these assume Council has ownership of all the facilities at South Port. If this is not the case the outcome is uncertain
- However there is likely to be some significant further benefits to KDC if expansion opportunities are undertaken
- The report summary therefore provides general information only on the recommended way forward once ownership disputes are resolved

2 – Current Situation

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Normalised Financial Reports

- Robust normalised/BAU financial information is required to give any third parties interested in involvement with the Port an indication of normal trading patterns
- Some work has been done on this but further and more detailed analysis of financial reports and forecasts is required before any final recommendations can be made
- We believe that KDC should appoint a temporary acting CFO to produce a 'single version of the truth' set of financials for the whole of Council and for trading units such as the Airport and Ports that has been developed from base data
- This would enable all parties to be able to have confidence in both the recommendations of this study and in determining their own conclusions relating to the Port
- Without robust financial data we are concerned that neither KDC nor Morrison Solutions will be able to confidently determine the level of return on its investment nor the lease fees and user charges with any certainty
- This makes future planning and forecasts highly speculative

KDC Management – Status Quo Pros, Cons and Risks

Pros

- Control of lease and usage fee revenues and currently KDC may have control of further economic development opportunities
- There appears to be opportunities to expand the South Port facilities to provide returns to KDC while limiting its current high exposure to governance, management and operating risks

Cons

- Probable losses will cause further financial constraints including the funding of future asset renewals and capital costs of expansion
- Port operations and commercial management responsibility including debtors and sorting disputes
- Exposure to subsidising from rates if shortfall
- Challenging for Council to add value to this business

Risks

- Management and operational risks that could arise in the event that KDC as the owner and operator does not effectively exercise its obligations to ensure that there is robust health and safety policies and management control to ensure these are complied with at all times
- Commercial risks with ratepayer's funds
- Not exercising sufficient hands-on competent management to mitigate the above risks

Conclusions

- There are significant issues around ownership of assets at South Port which may affect the future viability of the facility
- KDC currently carries high financial risk and has not had control of its outstanding debtors. This will currently be causing significant cash losses
- It is unclear whether the current revenues from leases and user fees fall short of that required to provide a viable commercial outcome
- KDC currently carries high operational risks as the Ports owner, manager and operator
- The management of the Ports has not been adequately resourced in recent times
- The South Port facilities are new but stretched for operational uses while there are redundant assets at other sites that could provide a one off cash surplus
- The Wakatu wharf has some potential to expand the availability of facilities and should not be disposed of or leased long term until the future plans for South Port are completed
- The Port facilities are predominantly used by commercial businesses which would suggest that KDC should be making adequate returns based on its assets and risks
- There is realistic potential to have expanded usage at South Port with commensurate returns for KDC
- We have not been able to satisfy ourselves that the provided financial accounts are sufficiently robust for an accurate picture to be drawn

3 – Growth Potential and Resilience

Operators Views and Aspirations

- Despite requests we have not been provided with the report completed by Danny Smith for the port users needs and wants
- We have made limited inquiries ourselves to allow us to have some understanding of the interest that other parties may have in the port and its activities

Financial Sustainability

- Financial sustainability of the current status must be addressed in the context of:
  - The real cost of capital should be recognised in assessing the viability of the business – such cost of capital being assessed as the Council's cost of borrowing plus a reasonable margin for the commercial risks of owning and managing an operational port
  - The port assets will need renewal over time and depreciation funding tagged to the port assets should be put aside for this in a port reserve fund
  - Council does exercise some management input which should also be recognised together with any insurance and compliance costs
- Unless all these requirements are met the ratepayer could be subsidising the private sector operators
- In our view there is a realistic and better option for improving the situation for KDC with expansion of the facilities as outlined later in this report

Revenue Opportunities

- Given the size and nature of South Port, the high commercial risk and uniqueness of its local service offering, revenues should be set at reasonable market rates and a WACC of between say 10 - 15%
- If this was achieved, then based on the costs of the South Port reconstruction and the underlying land etc then it could be expected that returns should be in the order of $600,000 - $900,000 per annum
- The current total revenues are well below the levels required to deliver anything like this sort of result
- The greatest opportunity however appears to be an expansion of the South Port facilities and possibly better utilisation of the Wakatu wharf
- Sale of non reserve land associated with Wakatu should be considered to provide a cash return (valuations apparently suggest this could be between $500k – $1 million)

Stakeholder investment possibilities

- We understand that amongst some current and future stakeholders there is interest in expanding the South Port activities.
- If this were to happen then KDC would have to make any arrangement it participated in subject to;
  - resolution of any ownership disputes, and
  - agreeing a governance structure that would ensure there was no impediment to other users' access to the facilities
- If this was achieved then it would seem that KDC could contribute its assets as a subscription for equity in a new Port Company which would have control of all the South Port assets as well as the expanded facilities.
- If the cost of expansion is significant (for want of a number say $36m) and funded by other parties (probably including one or more current stakeholders) then KDC, if it owns all the South Port facilities and land, would end up with around14% of a company worth $42m.
- KDC may also expect some return beyond this for giving up the control of the current assets which could either be returned to KDC as a cash payment or as a greater share in the expanded facility
- The new company would be a council organisation (CO) entity with KDC as a minority shareholder
- The new company would take over all management and operational responsibilities thus removing KDC from any direct exposure to these risks
- If any of the potential shareholders in the new company are currently in dispute with KDC the prospect of the large increases in their revenue may allow the parties to settle any disputes fully and finally subject to the new company being formed

4 – Maximising Council's Position

Legal Constraints and Opportunities (Summary)

- **Reserves Act 1977**
  - KDC cannot readily sell reserve land without going through the process prescribed in the Act
  - KDC could lease port related reserve land to an operating entity but note that any lease revenues could be tagged for reserves and not available as general revenues. This however may allow a reduction in rates expenditure on KDC's overall reserves that it administers under the Reserves Act.
  - Leasing revenues from improvements on the land (such as structures, ramps etc) are likely to be treated as general revenues
- **Local Government Act 2002**
  - KDC can continue to manage and operate the port
  - KDC can form a Port Company (CCTO or CO) and lease the land and improvements to it on terms it determines
  - If leasing, KDC can maintain an overriding level of control on how the land is used through the terms of the lease
- **Other**
  - Ownership issues will need to be more defined before entering into any changes
  - Seabed and foreshore claims (if any) would need to be understood to determine if there is any likely impediment to operations and/or ownership of assets

Disclaimer: Subject to legal confirmation

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Suggested Objectives for KDC

To optimise KDC's position we suggest possible options be tested against the following objectives:

- Objective 1: Enables **flexibility to contribute to economic development as required** (including being able to ensure there is good citizen control on current and future users and operators to avoid monopoly control)
- Objective 2: Delivers-**adequate and consistent returns on investment** and has the ability to benefit from future development that provides, returns and contributes to economic development without exposure to high risk and potential ratepayer subsidies
- Objective 3: **Minimise or extinguish KDC's exposure to Port management and operational risks including:**
  - Port operations and activities
  - Commercial management
  - Fees and charges setting and collections
  - Operator disputes

Opportunities – Economic Development

Objective 1 – Flexibility to contribute to economic development as required :

- KDC should optimise opportunities for any growth in economic returns to its community
- Some operators/stakeholders have some desire to increase facilities and this needs to be accommodated/facilitated
- There may be other operators/suppliers who would like to have a presence at the expanded Port
- KDC must have levers to ensure that future users are able to use the expanded Port facilities when warranted. This could be achieved by either KDC requiring an agreed governance structure or policy that ensures this happens, or that KDC leases rather than sells its South Port assets to the new company.
- The lease conditions for these assets could ensure that there is adequate access for new users
- KDC needs to retain the ability to influence tourism growth to align with its economic development strategy
- Where needed, KDC through its powers can remove constraints where possible or provide environments that allow further development through such things as zoning changes, open access to markets etc

Opportunities – Return on Investment

Objective 2 – Adequate and consistent returns on investment

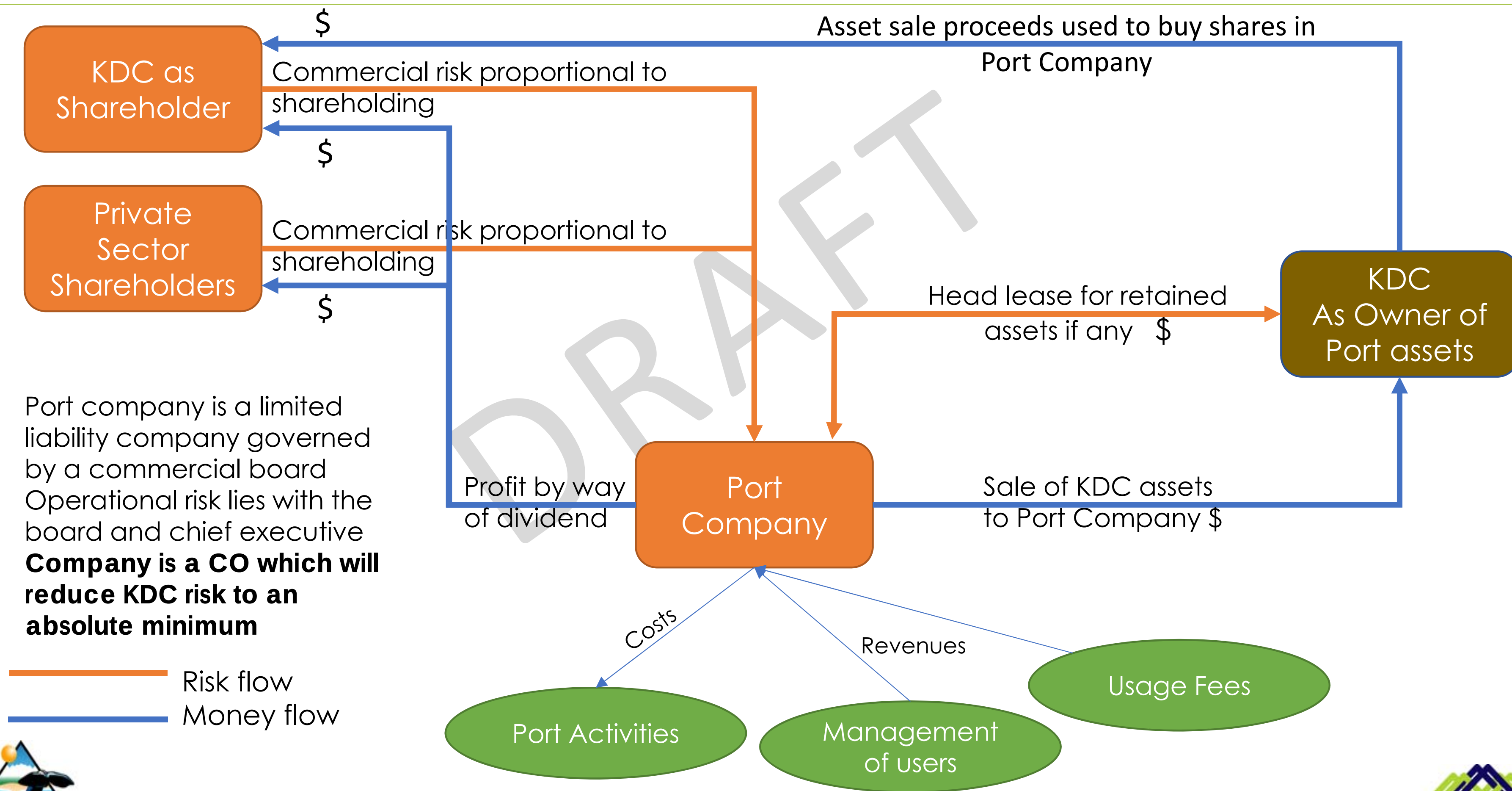
- With its relatively low risk and stable portfolio of land and facilities, KDC could receive adequate returns on existing investment and permit operators to grow where they see increased opportunities through expansion
- With the potentially large amount of finance involved it is expected that all owners will be driven by getting an adequate return on their investment (especially if any shareholders are not users or operators). Therefore KDC can benefit from the commercial arrangements and management put in place by the new company without having to being directly involved
- This would suggest that KDC will be getting a relatively risk free and more stable return on its investment than it is currently receiving

Opportunities – Minimise Risk

Objective – Minimise or extinguish KDC's exposure to port management and operational risks:

- KDC does not have expertise in port management and operations and there are others that could execute this role more effectively and make an adequate return
- KDC should consider options to transfer management and operational activities/functions to other parties that have greater ability to perform these activities to reduce its risk profile
- KDC can form a CO (<50% control) within the constraints of the LGAct
- If any progress is made to form a new company then, as long as current users are involved, KDC could use the process to resolve all existing and outstanding disputes with stakeholders
- **We advise all parties to ensure the processes are completely transparent and any proposals are in response to KDC seeking EOI's for options for the new port plan.**

Conceptual Model – The risk and the money



- Port company is a limited liability company governed by a commercial board
- Operational risk lies with the board and chief executive
- **Company is a CO which will reduce KDC risk to an absolute minimum**

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Summary comparison of options

	Department Status Quo	CO Lease
Control of reserve	Direct	Via lease terms
Land Ownership	KDC	KDC??
Asset Ownership	KDC	Port Company
Commercial drivers	Profit	Profit
Operational Risk to KDC	High	Minimal
Commercial risk to KDC	High	Lower exposure and commercial control Large company shareholding should provide greater certainty of returns
Attractiveness for potential partners	NA	Medium/high/subject to dispute resolutions
Achievability	Yes	Yes if private participant(s) found

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Comparison Against Objectives

	Department Status Quo	CO Port Company
Economic Development	√	√√√
Return on Investment	X	√√√ Primarily relying on other parties funding and expertise
Minimise Risk	X	√√√

5 – Preliminary Recommendations

Disclaimer: The following are interim recommendations pending receipt of robust normalised financial accounts and further analysis to confirm the optimum way forward for KDC.

We advise all parties to ensure all processes are completely transparent and any proposals are in response to KDC seeking EOI's for options for the new port plan

Preliminary Recommendations

1. KDC compiles robust financial and operational information and projections for the port's future sustainable business
2. KDC leads a detailed analysis of expansion plans selecting the plan that best meets the Objectives above and undertakes a Special Consultative Process for the transfer of assets if required
3. Subject to the SCP and Council's final decision prospective partners who have the expertise, financial capacity and an interest in the port's sustainability are sought through an EOI process and suitable candidates are selected to participate in the expansion
4. KDC facilitates forming a Port Company ("Company") with the selected participants. KDC pays for its shareholding in the new Company by contributing its relevant assets and transferring management and operational control ('the business").
5. The shareholders elect the Board etc
6. KDC transfers the business to the Company at a price to be determined and the other shareholders purchase their shares with cash
7. Care needs to be taken in how the relationship works regarding any involvement of external agencies providing grants or funding such as PGF. (Are the grants provided to Council, the new shareholders or the new Company? This can make a large difference to the KDC outcome.)
8. KDC sells or leases selected assets at other sites as noted above

Disclaimer: Subject to receipt of robust normalised financial accounts and further analysis

Preliminary Recommendations

Note: The size of the shareholding will not have a significant bearing on the returns received but the smaller the shareholding the less risk to KDC and the more attractive it will be to other potential shareholders

Plan B;

There are several options if sufficient interest is not shown by other parties which range from;

- Improving the status quo at South Port and rationalising the assets at other sites as noted previously, to
- Develop an expansion plan with interested users (not necessarily all the existing ones) entering long term leases for use of the new facilities and seeking external funding including grants from agencies such as PGF and top ups with debt. Rationalise other site assets as above

Outcome:

- **Our interim recommendation to form a Port Company that would be a CO (<50% control) removing KDC from the inherent significant risks and responsibilities contained in the management and operations of the port, and yet still provide essential controls through KDC's lease of reserve land while providing a low risk and stable return on investment**

Recommended Next Steps – Phase 2

1. KDC appoints a temporary CFO to develop whole of Council financials and port trading accounts from base data so there is a single source of truth that all Council activities can rely on
2. KDC re establishes the consultancy arrangements to enable the interim recommendations to be taken through to a final proposal for Council's approval
3. An independent party manages any EOI process (including marketing) to select preferred shareholders for the new Company