Attachment A – Budget update process and results

Purpose

1. To outline the process and budget updates for the 10-year Budget (LTP) 2021-2031 based on the updated forecasting assumptions.

Executive Summary

2. The Emergency Budget 2020/2021 was adopted by the Governing Body on 30 July 2020, including a projected reduction in cash operating revenue of around $450 million as a result of COVID-19 and a range of mitigating measures in response to this revenue shortfall as well as the unprecedented drought situation.
3. As the COVID-19 situation is still evolving, its financial impacts on the Auckland Council group remain highly uncertain. Therefore, an assumption driven, scenario modelling-based approach is still needed to develop financial projections for the council group's 10-year Budget 2021-2031.
4. Staff from Finance have worked with the Auckland Plan Strategy and Research department and the Chief Economist and prepared three scenarios in developing key forecasting assumptions for the LTP 2021-2031. These assumptions have been significantly impacted by the COVID-19 situation.
5. The assumptions were distributed to council departments and Council Controlled Organisations (CCOs) on 24 September 2020, seeking updated financial projections based on the balanced scenario as well as sensitivity analysis of better and worse outcomes against the balanced scenario under the other two alternative scenarios.
6. These key COVID-19 related forecasting assumptions and the methodology to develop them were subsequently reviewed by the Audit and Risk Committee (ARC) on 14 October 2020. The committee agreed that the methodology used is complete, reasonable and supportable given the uncertainty.
7. Updated budget submissions were received from across the group at the end of October 2020. The updated budgets reflect the application of the balanced scenario assumptions and include budgetary pressures identified from the bottom-up process. This process has involved work on draft asset management plans (AMPs) and based on the best available information. In some cases, this bottom-up approach has been cognisant of the budget constraints while others have taken an unconstrained view of investment demand.
8. Updated financial projections suggest that the revenue impact of COVID-19 will last longer than the one-year event previously anticipated. The projected cash operating revenue reductions compared to pre-COVID budget projections are as follows:

2021/2022	2022/2023	2023/2024
-$260m	-$170m	-$110m

9. Updated information on spending and investment challenges have also been submitted from the council departments and CCOs. In particular, the aggregated capital investment submission for the group adds up to $35 billion over 10 years, $8 billion up from the total of $27 billion relative to pre-COVID position.
10. Incorporating the budget updates from the October submissions, the updated financial scenario modelling indicates a debt to revenue ratio of over 300 per cent from year 2 to year 10 of the LTP, peaking at 330 per cent in year 8. Even at this level the scenario does not deal with all our growth challenges or include any package of climate change response actions. Not complying with the council's prudential policy limit for this long period would be a significant departure from the council's commitment to long-term financial prudence and is likely to result in a downgrade to our credit rating,

therefore leading to consequences such as higher borrowing costs, reduced access to debt markets and reputational damage.

Analysis and advice

Updated forecasting assumptions for the 10-year Budget 2021-2031

11. The extent of the impacts of the disruption from the COVID-19 situation remain highly uncertain and therefore an assumption driven, scenario modelling-based approach is still needed to develop the LTP 2021-2031.
12. The council's Financial Strategy and Planning department, in conjunction with the Auckland Plan Strategy and Research department and the Chief Economist, have prepared three COVID scenarios in developing key forecasting assumptions to be used to develop financial projections for the council group's LTP.
13. The three scenarios are:
    - Optimistic scenario
    - Pessimistic scenario
    - Balanced scenario
14. The optimistic scenario is similar to Treasury's main scenario released in the pre-election economic and financial update. Staff's concern with the Treasury scenario is that it makes no further allowance for more lockdowns or an extended time with borders closed.
15. The pessimistic scenario is based on the borders being closed for longer and six weeks of further lockdowns at level 3 or 4.
16. The balanced scenario is between the optimistic and pessimistic scenarios and reflects the uncertainty around the COVID-19 impacts and the council's low appetite for financial risk.
17. The assumptions cover areas such as the government health restrictions, growth (population and buildings), economic growth, inflation and behavioural trends for each of the three scenarios.
18. The balanced scenario is the main scenario that the draft financial projections will be based on. It assumes COVID-19 disruptions will last till December 2022, an overall three-year impact on council operations as opposed to a one-off impact as assumed in the Emergency Budget 2020/2021 and gradually return to business as usual from financial year 2023/2024.
19. The assumptions and guidance were distributed to council departments and CCOs on 24 September 2020. Apart from requesting updated financial projections based on the balanced scenario assumptions, the council departments and CCOs were also required to perform a sensitivity analysis on any significant impacts against the balanced scenario under the two alternative scenarios.
20. On 14 October 2020, the Audit and Risk Committee reviewed these key COVID-19 related forecasting assumptions and the methodology to develop them. They agreed that the methodology used is complete, reasonable and supportable given the uncertainty.

October starting point budget submissions

21. Updated budget submissions were received from across the group at the end of October 2020. The updated financial projections reflect the application of the balanced scenario assumptions, updates to project cost and/or timing projections and budgetary pressures identified during the bottom-up review of starting point budgets.

Impact on group revenue

22. The initial updated financial projections shared with the Finance and Performance Committee (F&P) at its workshop on 11 November 2020 indicated that disruptions, primarily from COVID-19, are more likely to result in a further three-year impact on council operations as opposed to a one-off impact as anticipated in the Emergency Budget 2020/2021. The impact on group cash operating revenue compared to the pre-COVID position is set out below (to the nearest $10 million):

2021/2022	2022/2023	2023/2024
-$260m	-$170m	-$110m

23. This extended impact on group revenue is mainly driven by the updated COVID-19 assumptions on government health restrictions (alert levels, border controls, etc.) and economic conditions.

24. Revenue reductions are forecast to persist for public transport services, Ports of Auckland, regional facilities and events as well as regulatory services. Reduced volumes due to the drought have also continued to adversely impact projected revenues from Watercare. In addition, lower commercial revenue including airport dividends is another key driver for the prolonged impact on group revenue.

25. The table below shows the key drivers of these revenue reductions:

$ million	Year 1 (FY22)	Year 2 (FY23)	Year 3 (FY24)	Key items for the movements
Auckland Transport	-43.3	-18.9	-6.5	Primarily reduced public transport patronage, alongside reduced parking and infringement revenue
Panuku	-1.0	-1.0	-0.9	Minor impacts on rental revenue
Auckland Unlimited	-19.3	-11.8	-3.2	Reduction in sports and cultural events (e.g. concerts) alongside reduced Art Gallery revenue.
Ports of Auckland	-79.1	-79.4	-81.1	Commercial impacts and reduced container volumes
Watercare	-23.9	-14.0	-1.5	Impacts of both the drought and COVID-19.
Auckland Council	-35.4	-19.5	-7.5	Primarily lower projections of regulatory activity and lower inflation assumptions.
Auckland International Airport dividend	-58.0	-30.0	-10.0	Reduction in profitability and dividend payments due to border closure
Total	**-$260.0m**	**-$174.5m**	**-$110.7m**	

26. These new revenue impacts, not anticipated for the Emergency Budget 2020/2021, will further reduce the investment capacity because of their impact on the debt to revenue ratio calculation.

27. Given the high degree of uncertainty, financial impacts have also been considered for the optimistic and pessimistic scenarios to test the sensitivity of better and worse outcomes against the balanced scenario.

28. Under the optimistic scenario, projected cash operating revenue would improve by $50 million, $40 million and $20 million respectively for the first three years of the LTP, reducing the revenue impact to (to the nearest $10 million):

2021/2022	2022/2023	2023/2024
-$210m	-$130m	-$90m

29. The improvement is primarily expected in Regulatory Services with a more positive economic outlook, Ports of Auckland with increasing volume levels and Auckland Unlimited (previously Regional Facilities Auckland (RFA)) with the favourable change to border restrictions, enabling more activity to take place.

30. Under the pessimistic scenario, projected cash operating revenue would reduce further by $60 million, $50 million and $30 million respectively for the first three years, with the below revenue reductions relative to the pre-COVID position (to the nearest $10 million):

2021/2022	2022/2023	2023/2024
-$320m	-$220m	-$140m

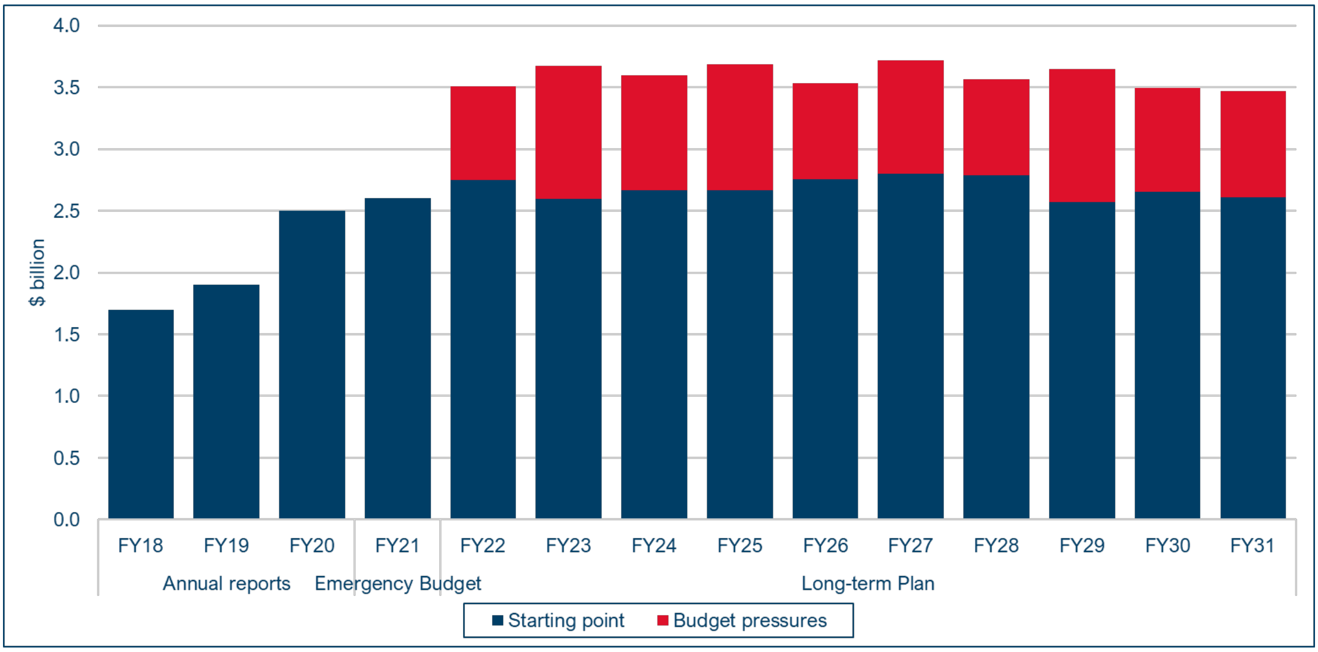
31. Areas that would be affected the most should the COVID-19 impacts be worse than the balanced scenario include Auckland Transport for its public transport services, Regulatory Services and Ports of Auckland due to a deteriorating economic outlook as well as Auckland Unlimited (RFA).

<u>Additional operating and investment pressures</u>

32. As part of the budget submissions, council departments and CCOs have also provided updates on spending and investment requirements from a bottom-up budgeting process.

Capital investment challenges

33. The consolidated group capital investment demand based on October budget submissions amount to $35 billion over 10 years, an increase of $8 billion or 30 per cent compared to the pre-COVID position. This has included the approved shovel ready projects that are funded by the Crown. The investment in shovel ready projects does not impact the group's funding capacity as the equivalent level of funding is received from the Crown.



34. The table below outlines a high-level summary of the capital investment submission by entity and key drivers:

$ billion	Pre-COVID	Submission	Notes
Auckland Transport	$11b	$11b	Starting position for ATAP prioritisation
Watercare	$5.4b	$10.8b	Bottom-up Asset Management Plan (AMP) review
Panuku	$0.8b	$0.9b	Onehunga Wharf, Waterfront renewals, extension of priority location programme
Auckland Unlimited	$0.3b	$0.8b	AMP review and transform Aotea precinct and Stage 1 stadiums investment
CRL	$1.3b	$1.3b	No change to existing forecast investment
Ports of Auckland	$0.7b	$0.7b	No change to existing capital programme
Auckland Council	$7b	$10b	Community Services full cost with current service model Additional city centre investment Healthy Waters high growth scenario
Total	**$27b**	**$35b**	

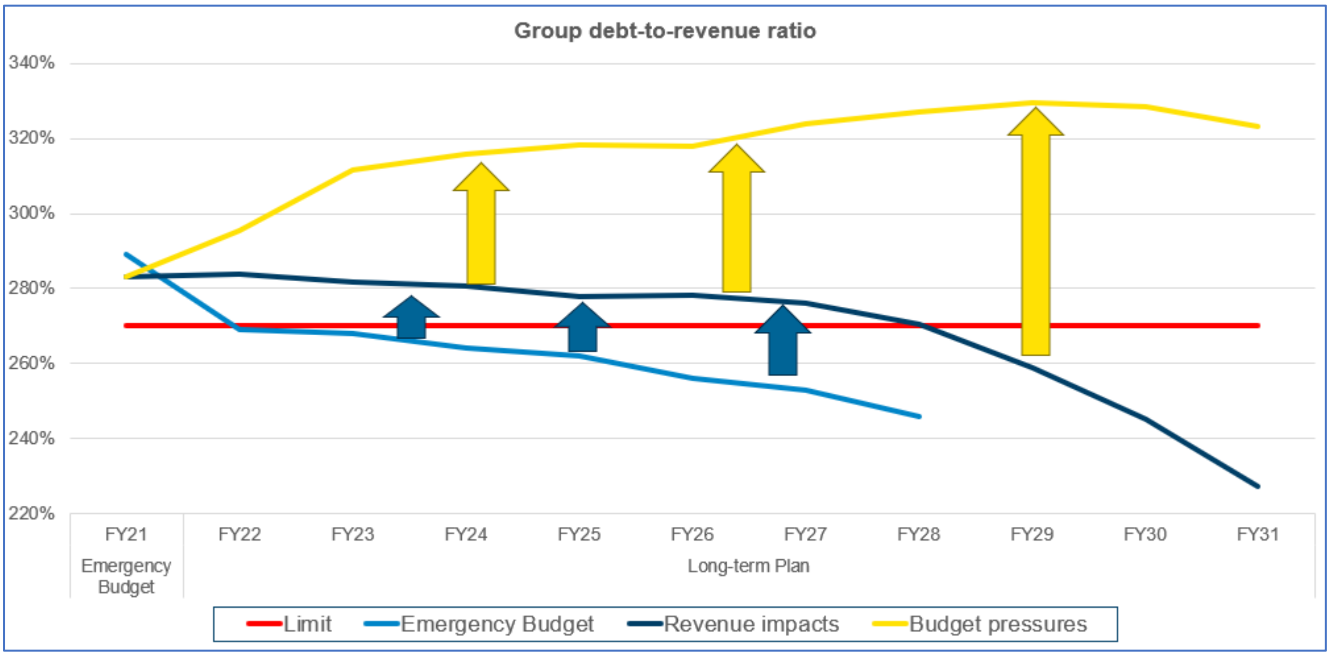
Operating cost challenges

35. The budget submissions have also included updated information on operating cost growth and additional spend requirement. Overall operating cost movements compared to the March pre-COVID position by entity are outlined in the following table:

$ million	Year 1 (FY22)	Year 2 (FY23)	Year 3 (FY24)	Key items for the movements
Auckland Transport	$73m	$90m	$110m	• Increased maintenance costs in line with AMP and consequential opex for new facilities • increased public transport services
Panuku	($2m)	($3m)		• Priority location spend
Auckland Unlimited	$1m	$9m	$7m	• Costs associated with FIFA Women's World Cup 2023 • Cost for other events, half of which are supported by external funding • Cost reductions from reduced activity at regional facilities
Ports of Auckland	($26m)	($26m)	($23m)	• Reduced activity due to lower volumes
Watercare	$26m	$16m	$17m	• Increased costs due to higher maintenance and consequential operating costs based on the updated AMP requirements and a larger capital expenditure programme
Auckland Council	$14m	$18m	$20m	• Unavoidable cost increases such as legal fees and insurance premiums partially offset by reductions due to reduced regulatory activity and lower inflation assumption • Also includes approximately $20m of cost pressures relating to ICT, digital strategy, legal and emergency management.
Total	**$86m**	**$104m**	**$131m**	

Updated debt to revenue ratio projection

36. Incorporating both the capital investment and operating cost challenges on top of the revenue impacts would result in a projected debt to revenue ratio exceeding the prudential limit of 270 per cent for all ten years of the LTP period and peaking at 330 per cent in year 8. This scenario would also still not deal with all our growth challenges or include any package of climate change response actions.



37. With this level of impact, the council would not be able to achieve a balanced budget in accordance with the Local Government Act 2002 or maintain its depreciation funding policy without further mitigating actions. The consequence of not complying with these financial policy requirements is an overreliance on debt funding to pay for operating costs and asset renewals, which over time would become unsustainable.