Heart of Wellington Association
Speaking notes on draft LTP

CentrePort is under performing

Table 1 is taken from the Productivity Commission's recent report (applying the Commerce Commission's Weighted Average Cost of Capital (WACC) model to CentrePort).

Table 1:
Commerce Commission WACC Model

	2007	2008	2009	2010	2011
Risk free rate (ex ante 5 years)	5.97%	7.13%	6.45%	4.80%	4.85%
Debt premium	2.50%	2.50%	2.50%	2.50%	2.50%
Leverage	**40%**	**40%**	**40%**	**40%**	**40%**
Asset Beta	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**
Tax Adjusted Market Risk Premium	7.0%	7.0%	7.0%	7.0%	7.0%
CentrePort's cost of equity	**11.00%**	**11.78%**	**11.32%**	**10.36%**	**10.40%**
WACC	8.87%	9.65%	9.19%	8.26%	8.30%

The 4 year average cost of equity is 10.96%.

Greater Wellington's January 2012 submission to the Productivity Commission states that:

> *"Greater Wellington remains committed to achieving the best use of capital and improving the productivity of the Port."*

It claims:

> *"In broad terms, taking into account dividends, subvention payments, guarantee fees and growth in shareholders funds, the return to Greater Wellington exceeds the cost of capital."*

That is false on any real measure of the cost of capital. It is true only if GWRC regards the risk it places on ratepayers as costless to them. CentrePort is significantly under performing.

Table 2: Comparison	2008	2009	2010	2011	Average	
Overall stated return	6.1%	4.5%	6.1%	6.0%	5.7%	
Cost of Equity for Centreport					10.9%	
Variance					**-5.2%**	pa
GWRC share of Centreport shareholders funds	146.3	149.0	154.9	159.2	**152.3**	$m
Return shortfall					**- 7.96**	**$m pa**

GWRC is not pricing its real risk

However CentrePort is a property company more than a utility. The 2011 balance sheet shows $217m out of aprox. $400m in investment properties.

But it is a property developer. The required return for a developer will be a multiple of the cost of capital for a property owner. For the risks GWRC is running as owner and lender to a property developer it should be getting more than three times what is getting on its property exposure.

But even that will not compensate for the risk it is running. Only the very best, and lucky, property developers survive the end of property booms. Wise investors then make money out of buying their developments at fire sale prices.

Developers risks include: building cost overruns; interest and currency changes; collapse of lessees; persistent vacancies.

As the Majestic example shows it is not uncommon for buildings never to regain their true cost price in real terms.

Accordingly GWRC is completely misleading itself about the adequacy of the returns for the risks it runs.

The LTP does not appear to have adjusted for the impact of the property development business on the overall riskiness of CentrePort. If things go wrong GWRC might still be able to squeeze a dividend out of CentrePort (though its directors cannot approve dividends that are not in the interests of the company) but GWRC will have to recognise in its accounts any loss in value of the company.

The Productivity Commission model assumed a debt risk premium of 2.5%. GWRC charges CentrePort only 2% for its guarantee. The 2.5% is a general rate that would already be pathetically low for lending into property development.

GRWC subsidising its own wally developer hurts Wellington

GWRC is putting money into a developer that appears to underestimate grossly the risks of its own business. Perhaps there are explanations that we've not been able to find. For example the law requires CentrePort to produce a Statement of Corporate Intent, but we've not been able to find one and we've had no response to our requests for a copy, but it seems:

a) As a developer it may be disguising its true costs and subsidising its tenants by providing the land at values below its real worth;

b) It is relying on a ratepayer guarantee that ignores the real risks of major losses; and

c) It is signing up "partners" on deals that leave the risk of property value changes with Centreport and thus GWRC.

This is not just a problem for GWRC and the Manawatu Regional Council as owners (though the Manawatu Councillors should be asking why their ratepayers are subsidising leases for government departments in Wellington, and taking the risk on inexperienced developers).

More importantly Wellington is hurt by having a major developer making decisions that are not financially 'rational' .

Underestimating its true cost of capital, or not properly recognising the value of its land, or offering take-outs to 'purchaser' of investment property that are really liabilities, can make life too risky for others who can only provide new buildings if the rentals carry the true costs. Subsidised developments crowd out projects that require returns that properly match the risks

Subsidising surplus capacity in the wrong place has another effect. It could be a major own goal for GWRC in financial terms. Office demand is not very price elastic. An oversupply will push rents down to below replacement cost. This is compounded when government departments have to show 'efficiency' by cramming their people into much smaller space, whether or not it could be cheaper to stay in less efficient older buildings.

Dropping rentals feeds through to falling property values throughout the city. That reduces Wellington's rating base. GWRC depends on that base too. The effect of subsidising its own developer could be to also depress its rating capacity.

That effect may be short-lived or not, depending on market expectations of how long any period of under estimation of the risks and costs might last.

And of course CentrePort's office buildings may distort the city, taking enough activity from the CBD to make it lose its buzz, without having enough critical mass itself to be a new vibrant centre. *Is this Manawatu's revenge – the Palmerstonisation of Wellington?*