31 May 1996

The City Secretary
Auckland City Council
Private Bag 92516
AUCKLAND

Dear Sir

The New Zealand Business Roundtable (NZBR) is pleased to respond to the Council's invitation to make submissions on its 1996 draft annual plan and the review of its strategic plan. We would like the opportunity to elaborate on this submission at hearings that are to be held by the Council.

The submission is presented in five sections as follows:

1 does the draft plan meet the requirements of the Act?
2 expenditure and revenue;
3 other issues;
4 the strategic plan; and
5 concluding comment.

Although section 4 is devoted to the review of the strategic plan, comments on it are also contained in other sections of this submission.

1 Does the Draft Plan Meet the Requirements of the Act?

Publication of an annual plan is required by section 223D of the Local Government Act. The plan (referred to in the section as a report) must outline in particular terms for 1996/97 and in general terms for 1997/98 and 1998/99 the following:

- the intended significant policies and objectives of the local authority;
- the nature and scope of significant activities to be undertaken;
- the performance targets and other measures by which performance may be judged in relation to the objectives;

- the indicative costs, including both an allowance for depreciation and the cost of capital employed;

- the source of funds; and

- the rating policy of the local authority.

The NZBR submits that the Council's 1996 draft plan does not comply fully with these requirements. In particular the plan does not present:

- intended significant policies and objectives of the local authority. The plan contains a mission statement, makes passing reference in the chief executive's overview to significant changes in relation to water supply, to the upgrade of sewerage and water systems and to certain leadership projects, and contains brief comment on certain aspects of future policies relating to rates, user-charges and airport shares. Significant policies and objectives of the Council are not otherwise discussed. The plan, for example, is silent on the proposed 5.25 percent increase in the amount of rates payable on each dollar of ratable property. The financial profiles presented in the review of the strategic plan are summarised in the annual plan but the note which discloses that they incorporate a rate increase in 1996/97 is not reproduced. The first mention of the rate increase that could be found is on the third to last page of the review of the strategic plan. The rate increase was noted in *City Scene* but that publication and the review of the strategic plan do not form part of the annual plan.

  The plan states that commercial projects, such as the Britomart transport centre, are approved on a case-by-case basis and are omitted from the list of major projects. The approval in principle of the Britomart project, its size and the recent signing of a heads of agreement with a developer, mean that the Britomart project is a significant policy. The chief executive notes that construction is scheduled to start during 1996/97. Apart from the two or three sentences referred to, the annual plan does not discuss the project. The fact that the Council intends to finance the centre by the sale of other assets (namely the rights to undertake commercial developments above the centre) does not justify its exclusion from financial projections. Expenditure has been incurred on the Britomart project by acquiring properties, undertaking investigations, holding public hearings and engaging in negotiations. The NZBR has been unable to find any statutory authority for the Council's treatment of the Britomart project and other commercial projects in its plan;

- in general terms the nature and scope of the significant activities to be undertaken in 1997/98 and 1998/99. A three year forecast of revenue and expenditure which was included in last year's plan has been omitted from the present plan;

- in general terms the performance targets and other measures by which performance may be judged in respect of 1997/98 and 1998/99;

- the indicative costs, including an allowance for depreciation and the cost of capital employed, of activities for the relevant years. The Council does not include a cost of capital in respect of "non-discretionary assets". The NZBR is not aware of any statutory authority for this treatment. We drew this point to the Council's attention in our submission on the 1995 annual plan. As noted above, indicative costs for 1997/98 and 1998/99 are not presented at all; and

- the source of funds for 1997/98 and 1998/99.

These shortcomings are not trivial. They go to the heart of the legislation that is aimed at greater transparency and accountability. Councils have had ample time to comply with section 223D which came into effect on 1 October 1991. The Council may be exposed to the risk of court action on procedural grounds.

If the NZBR's understanding of the requirements of the Act is valid, the Council should bring its plan into conformity with the Act and reissue it according to the special consultative procedure.

2 Expenditure and Revenue

The plan discloses a 27 percent increase in the gross cost of activities between that budgeted for 1995/96 and the forecast outcome for 1995/96. The overall cost of Council activities is forecast to fall by almost 8 percent in 1996/97 but will still be almost 17 percent above the budgeted level for 1995/96. There is no satisfactory explanation of these trends. They may indicate substantial growth in Council spending, net of user-charges, and in the rate burden. Auckland City already has the second highest per capita rates of the major centres.

The Council has taken insufficient steps over recent years to determine those activities which it should undertake and to withdraw from those for which there are no valid grounds for Council involvement. As a consequence, Council spending and rates are excessive. There is no serious examination of this issue in the 1996/97 plan. Furthermore, a feature of the review of the strategic plan is its confusion between the proper role of the Council and that of individuals and firms. A decision to sell the Council's rental housing and all its airport shares would be desirable first steps.

The Council continues to be poorly advised on this matter. In response to our submission on the 1995/96 plan, the Finance and Administration Committee was advised that:

> Council is working within the framework and discretions set by the Government. Should the NZBRT [sic] wish to debate the core functions and financing of local territorial authorities this should be undertaken with central government.

The Council's adviser apparently has no idea of the meaning of the word "discretion" and he or she does not seem to understand that the Council - not central government - is accountable for Council decisions. The legislation provides councils with wide scope to engage in activities. The NZBR has supported that approach in submissions to central government. This does not mean, however, that ratepayers' interests are advanced by councils undertaking all activities other than those that are prohibited. Councils are required to exercise judgment in determining which activities they should properly undertake and which should be a matter for individuals and firms. The Auckland City Council could, for example, legally establish a steel mill but would anyone think that steelmaking is a sensible activity for it to engage in?

The chief executive stated in the draft 1995/96 plan that a major review of rating policy would be undertaken in conjunction with the review of the strategic plan. There is no evidence in either the annual plan or the review of the strategic plan that the intended re-examination has been undertaken.

Revenue from rates is forecast to increase in 1996/97 by almost 8 percent relative to the forecast outcome for 1995/96. This comprises an increase in rates of 5.25 percent, growth in the value of rateable property and insignificant changes in some minor aspects of rating policies. The strategic plan adopted by the Council in December 1993 proposed a once only 5 percent increase in rates to pay for "the long term benefits of the strategic plan". This increase was implemented in 1994/95. Rates were increased in line with the rate of inflation in 1995/96 and are now to be increased by a further 5.25 percent, indicating the short shelf life of the strategic plan for the period to 2020.

As the value of rateable property could be expected to keep pace with the rate of inflation, at least over the longer term, the proposed rise in rates amounts to a large real (i.e. inflation adjusted) increase which should be justified by the Council. There is substantial scope to reduce rates by confining expenditure to core activities and increasing user-charges where feasible. Financial profile 1 in the strategic plan, while modest, is consistent with this view.

The NZBR's submissions on previous plans provided detailed argumentation for such a strategy and examples of spending that should be reduced and areas where user-charges should be introduced or increased. The divestment of assets such as commercial property and car parking buildings, higher user-charges for libraries, the art gallery and city promotions, and a reduction in losses in respect of the Aotea centre were advocated.

The proposed rate increase should be abandoned. Spending should be cut instead. An increase in rates would adversely affect internationally competing firms that are unable to reflect rate increases in higher prices and would discourage employment. It would also add to pressures on prices and mortgage and other interest rates. Moreover, it is unduly disruptive to business and individuals to increase rates in 1996/97 if it is also the Council's intention to reduce them in 1997/98 as user-charges for stormwater are introduced.

The Council's rating policy provides for a regular review of differentials to ensure that rates collected from each sector are appropriate, taking into account relevant factors. The main differentials to apply in 1996/97 are unchanged. The effective differential for non-residential CBD ratepayers is to remain at 217.55 percent compared with 100 percent for residential ratepayers. This differential is likely to significantly distort land-use patterns, such as discouraging businesses from locating in the city. The only justification for differential rating is where ratepayers in certain localities impose identifiable additional costs which cannot be cost-effectively recovered through user-charges. It is implausible that the present differential could be justified on this basis.

It is sometimes suggested that businesses should bear a disproportionate share of rates because they are able to deduct rates for income tax purposes. Income earned by firms is generally subject to income tax. Because firms are taxed on a net rather than a gross basis, a deduction for expenditure on rates is permitted. This does not place firms in a favourable position relative to residents. Residents receive a deduction for rates if their gross income is taxed, for example where property is rented. However, where gross income is not taxed, for example implicit rents that accrue in respect of owner occupied housing, a deduction for related costs including rates is disallowed. Owner-occupiers are, if anything, advantaged because they do not pay tax on the net income that arises from their investment in housing. It is incorrect to conclude, as some observers do, that firms gain an advantage over residents because they can deduct rates for income tax purposes.

The claim is sometimes made that the ability of some businesses to claim an input tax credit for GST paid in respect of rates confers an advantage on businesses and justifies a differential rate. This view is also incorrect. The GST system was designed to impose tax on final consumption spending. For this reason, firms, but not consumers, generally receive a deduction for GST paid on inputs but pay GST on their sales. The deduction in respect of GST is intended to avoid a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt services, effectively pay GST on the net value which they add.

The NZBR submits that a planned programme to reduce the differential to justifiable levels should be adopted and implemented, starting in 1996/97.

The Council lags behind councils such as Wellington City and Rodney District in focusing on its core activities and in moving to more efficient rating and user-charges policies.

3 Other Issues

The Council could improve its efficiency and effectiveness by:

- exiting commercial activities. Government agencies have been shown to be poor managers of businesses. Council participation in commercial activities involuntarily exposes ratepayers to unnecessary commercial risks. The Britomart project is an example of a policy that will greatly increase such risks; the many assertions to the contrary are simply not credible.

  A decision to quit the Council's total investment in the airport and residential housing would be steps in the right direction but there is substantial scope to go further. There are no grounds for Council ownership of a transport business. A partial sell down of the Council's airport shares could sacrifice value attaching to its 25.8 percent interest which is the second largest holding;

- recognising that a subsidy for one business or ratepayer involves the imposition of a tax on other ratepayers or businesses. The Council can best contribute to the local economy by reducing its expenditure and rates, and by carrying out its core functions efficiently.

In particular, the activities of City Promotions should be severely curtailed, if not disbanded altogether. This unit is promoting major events that are claimed to provide implausibly large benefits for the national and regional economy. It is using an inappropriate economic model and apparently applying insufficient rigour to analyses of whether subsidies to some activities, and hence taxes on all other activities, are justified;

- applying a proper cost of capital. The cost of debt does not reflect the Council's true cost of capital. Its activities are mostly funded by ratepayers' equity. Council borrowing is backed by its ability to impose rates. The cost of ratepayers' funds, including the administration and compliance costs, should be reflected in the cost of capital. The economic losses or deadweight costs associated with the raising of rates, which amount to a reduction in the volume of goods and services produced and hence lower community incomes, should also be taken into account in making spending decisions. These deadweight costs alone could be expected to be larger than borrowing costs;

- improving the quality of its advice. The Council appears to be poorly advised on major public issues. Five examples are noted:

  - the plan does not appear to comply with the Act;

  - responsibility for core activities. The Council's advisers are apparently unaware that the Council is responsible for deciding which activities it should undertake;

  - the Britomart project. A secret heads of agreement has been signed without proper scrutiny of the long-term financial consequences and risks for ratepayers, including the level of operating subsidies required, and its contribution to solving transport problems. The project is a very partial approach to Auckland's transport needs and is best seen as a very large commercial property development. There is no valid role for the Council to be the project promoter and residual risk holder.

    Provision has been made in Britomart for light rail. The NZBR is not aware of any studies that have been undertaken suggesting that light rail could be justified on economic grounds in the foreseeable future. It is understood that international research suggests that light rail is uneconomic in a city of Auckland's size and geography. The Auckland Regional Council's recent report is understood to advocate the regulation of bus services because they might be more economic than rail options (although the case for regulation to support such services seems highly dubious).

    A lack of transparency in respect of the Britomart project is a major concern. The Council is required to balance democratic and commercial interests. The balance in this case is excessively slanted against the openness which is proposed as a value to be endorsed by the Council. Claims of commercial confidentiality may be a smoke screen aimed at protecting an inadequate analysis by the Council's advisers from independent scrutiny;

  - City Promotions. As noted, City Promotions is apparently unaware of the inadequacy of its analysis and advice; and

  - an inadequate review of the strategic plan (see below);

- reducing expenditure on "regional assets" to the level which the Council believes is appropriate for ratepayers to fund. The Council's mandate is to advance the interests of its ratepayers. Other councils could contribute on a voluntary basis if they wish. Higher user-charges would also help to address the perceived problem; and

- examining the possibility of reducing the size of the Council and Community Boards as suggested by the mayor. There appears to be scope to improve the level of advice available to the Council and for the Council to focus on its policy and representation roles. The Council is comparable in size to the Cabinet but has lesser responsibilities.

4 Strategic Plan

The review of the strategic plan is one of the least commendable reports on local government that the NZBR has examined. Some of its deficiencies are noted below:

- under the heading "challenges" the report states that "With the centralisation and privatisation of many public services, city and district councils are now the primary democratic organisations representing and balancing the interests of people and businesses". This is an astonishingly inaccurate statement.

  There has been no significant centralisation of public services and recent approaches to public sector management have led to greater decentralisation. Privatisation does not lessen democracy. Businesses are all owned by people. If interests have to be balanced, then it is the interests of one group of people, such as ratepayers, that are balanced against those of another group of people, such as those benefiting from council activities or council staff;

- there is no attempt to link the review to the existing plan. What has been achieved? What remains to be done? What policies are being changed and why?

- the report provides little perspective on what is important and therefore fails to identify and discuss, at an appropriate level, strategic issues through to 2020. The report states, for example, that:

  - the Council's leadership contribution involves (as the first item) "improved access to information and services through a one-call telephone number ..." The same idea is repeated under the very next goal and at other places in the report. It is noted as a major target for the year 2000; and

  - the role of other people in a city that is "alive and exciting" includes "property owners developing people generating businesses around the

Viaduct basin". The Council's contribution includes "encouragement of outdoor eating in [sic] cafes";

- the report provides a confused view of the proper role of local government. It suggests that the Council's regulatory powers should be used in quite inappropriate ways. The Council's contribution in relation to transport is said to be to "use [its] planning and regulatory functions to create a liveable city where people will choose to use public transport". Such a strong pro-public transport stance is inappropriate. The Council should be concerned to establish the conditions within which people will take decisions that advance their interests and community interests simultaneously;

- instead of analysing options for the future delivery of important services, such as water, the plan asks without any discussion: "How can we best ensure that the water industry stays in public ownership but has efficient ownership structures?" Although there are many aspects to improved provision of water services,[1] there is clear evidence that private ownership can be more efficient than public ownership (see, for example, the attached summary of a recent report by the Reason Foundation) and this option should be the subject of objective analysis by the Council;

- the costings presented in relation to each goal are not defined. Are they lists of operating costs? Do they include capital expenditure? Do they include capital charges? Secondly, the categories are different from those used in the annual plan. It is therefore difficult to form any judgment about relative shifts in spending that may be implied by the review;

- the financial profiles provide for a significant increase in input prices for services that are being contracted out. Competition typically reduces costs rather than increases them. The OECD reported that contracting out of a range of government services in four countries produced efficiency savings of between 6 and 50 percent, with most savings falling between 15 and 25 percent.[2] The assumption of escalating input prices, like much of the document, seems to be unduly aimed at maintaining existing policies; and

- the financial profiles should include the Britomart project, including operating costs.

The following comments are submitted on policy issues incorporated in the financial profiles:

- ARST should not fund any Council services. Surplus funds held by ARST should be returned to ratepayers, perhaps by a reduction in rates payable to the Auckland Regional Council;

- all non-core assets should be sold including residential housing and all shares in the airport;

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1 See CS First Boston New Zealand Limited (1995), *Reform of the Water Industry*, New Zealand Business Roundtable, Wellington.

2 Organisation for Economic Co-operation and Development (1993), *OECD Economic Outlook*, No. 54 (December), Organisation for Economic Co-operation and Development, Paris.

- additional expenditure in core areas should be funded by reductions in other spending, not by increased expenditure;

- we are sceptical that a valid case could be made for large expenditure on the waterfront development and the redevelopment of the Civic Theatre, and as a contribution to a new indoor venue/cultural centre. Public consultation on these projects should be informed by a thorough analysis of the costs and benefits;

- a proper evaluation of options for the delivery of water and stormwater services should be undertaken. The introduction of user-charges and the establishment of a separate business unit are only two of the options that should be thoroughly examined; and

- the "undergrounding Quay Street" at a cost of $40 million should be subject to a cost/benefit study.

The review of the plan should be subject to a rigorous examination and should be resubmitted for public comment.

5 Concluding Comment

Copies of this submission are being referred to the Secretary for Local Government and to the Controller and Auditor-General to seek their advice on whether the Council's plan meets the requirements of the Act.

Yours faithfully

R L Kerr
EXECUTIVE DIRECTOR

New Zealand Business Roundtable

The 1996/97 Draft Annual Plan of the Auckland Regional Services Trust

30 August 1996

THE 1996-97 DRAFT ANNUAL PLAN OF THE AUCKLAND REGIONAL SERVICES TRUST

1.0 Summary

1.1 The Auckland Regional Services Trust ('the Trust') was established as a temporary structure and is something of an anomaly in local government. The net assets of the Trust as at 30 June 1997 are projected to be $540 million, or $525 for each resident (over $1,500 for each household) in the Auckland region. The Trust is New Zealand's fifth largest business.

1.2 Contrary to the view expressed in the strategic plan, the Trust should not be regarded as either a holding company managing investments in publicly-owned assets or as an entity that functions as a commercial organisation. There are significant differences between the Trust as an investment vehicle and an investor-owned firm. These differences give rise to the following incentive problems which, *on average* and *over time,* are likely to mean that the Trust will underperform compared to investor-owned companies:

- capital market constraints on the performance of the Trust are relatively weak;

- there is an ongoing risk that political pressures will influence commercial decisions. The objectives of the Trust may therefore differ from those of its subsidiaries;

- incentives which ratepayers have as ultimate owners of Trust-owned assets to monitor the Trust's performance are relatively weak; and

- the objectives of ratepayers, as involuntary investors in the Trust, may differ from the objectives of the Trust.

1.3 These incentive problems mean that the Trust is poorly suited as a vehicle for ratepayers to hold commercial investments which they would typically hold directly. The Trust is also an inappropriate vehicle to make investments in infrastructure and other assets, which the strategic plan indicates is a strong desire of the Trust. Not all of these investments will exhibit a high degree of public good characteristics. To the extent they do, financing such investments through rates (and user charges to the extent it is feasible to identify private benefits that accrue) is more transparent and better promotes accountability between a local authority and ratepayers.

1.4 A central feature of the annual plan is the Trust's intention to finance, develop, own and manage facilities for the America's Cup regatta. This project seems to have been justified by the mis-use of an economic impact analysis by Ernst and Young. Valid public policy grounds for the Trust to undertake the investment are not presented in the plan.

1.5 The apparent desire of the Trust to assume major responsibility for financing regional infrastructure, the risks of using business assets to fund such investments, and early warning signs from the America's Cup initiative all lend weight to our view that the assets of the Trust should be disposed of and the proceeds returned directly to ratepayers, sooner rather than later. Statutory impediments to achieving this goal should be removed as soon as possible. The strategic plan should include an appraisal of the most appropriate approach for distributing the assets of the Trust.

1.6 In the interim, the Trust should refrain from trying to find further infrastructure projects in which to invest. It should also seriously consider ways in which a better separation can be achieved between the management of the Trust, with its non-commercial objectives and constraints, and the management of its commercial subsidiaries.

2.0 Introduction

2.1 This submission is made on behalf of the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

2.2 As noted in the introduction to the 1996/97 strategic plan ('the strategic plan'), the Trust was created by statute in 1992. The Trust arose from a reform of the Auckland Regional Council which had, at the time, accumulated debt with a market value of $224 million. The Auckland Regional Council retained its regulatory functions while the Trust was given the responsibility to manage and ultimately eliminate its debt through a programme of asset sales.

2.3 The Trust was established as a temporary structure and is something of an anomaly in local government. The key elements of the structure of local government in New Zealand are regional councils and territorial local authorities. Regional councils assume regulatory functions, including resource planning, and some funding activities, for example of public transport subsidies. Territorial local authorities (city and district councils) have primary responsibility for the delivery of services.

2.4 The only assets the Trust is obliged to retain are shares in Watercare Services Limited. Among other things, section 707ZJ of the Local Government Act 1974 obliges the Trust to sell the shares in Transportation Auckland Corporation Limited (TACL), Northern Disposal Systems Limited and Regional Forests Limited as soon as is practicable and prudent. Under the same provision, the Trust may hold shares in the Ports of Auckland and must adopt special consultative procedures in relation to any proposal by the Trust to sell the shares.

2.5 The Trust must apply its revenue to meeting its costs, to the reduction of its debt (where that is considered appropriate and consistent with the Trust's functions) and, subject to the other priorities, to pay the surplus revenue, at the Trust's discretion, to a Community Trust to be established by the Trust.

2.6 The Statement of Financial Position of the Trust as at 30 June 1997 shows projected net assets of $540 million. This represents a value of about $525 for each resident in the Auckland region, or more than $1,500 for the average household.[1] The Trust is New Zealand's fifth largest business. The efficiency of its operation in the medium to long term is therefore likely to have a significant impact on the regional and national economy.

2.7 The strategic plan reflects the statutory context within which the Trust was created. This submission therefore comments, in turn, on:

- whether the Trust is a suitable vehicle to hold commercial assets, or to fund investment in infrastructure and other activities;[2] and

- the broader statutory context. In particular, inadequacies in the statutory framework relating to the Trust and to Watercare Services Limited are discussed. These are weaknesses that the Trust should be actively seeking to remedy.

3.0 Is the Trust an Appropriate Vehicle to Hold Commercial Investments?

3.1 The introduction to the strategic plan states that "the Trust can be regarded as a holding company managing the investment in publicly-owned assets" and that, in the main, the Trust functions as a commercial organisation.

3.2 The Trust has achieved its key goal of eliminating the debt it inherited. This reflects the gains in performance that have been achieved by corporatisation, clarifying management's objectives and increasing accountability for performance. The Trust has adopted many tools of good management practice, including comprehensive use of economic value added as a performance measure, the formal assessment of directors of subsidiaries and not having Trust members serve as company directors.

3.3 While practical experience with corporatisation in New Zealand has shown that the gains from this process can be substantial, it has also focused attention on inevitable deficiencies in the corporatisation model. These stem from incentive problems associated with continuing government ownership. This is the case with Trust ownership, which is the main alternative if public ownership continues. Incentive problems arise from the following sources:

- capital market constraints on the performance of the Trust are relatively weak. For example, management is not exposed to the threat or reality of takeovers and information generated by the sharemarket reflecting management performance is absent. While this applies particularly to the Trust as a holding entity, incentive problems also arise for subsidiaries owned or controlled by the Trust which the Trust is reluctant to sell;

- there is an ongoing risk that political pressures will influence commercial decisions. Trust ownership makes it easier for special interest groups to lobby the Trust to invest its surplus funds in low-yielding projects, like inappropriate public transport facilities. Accountability to the ultimate owners, ratepayers, is intermediated through politicians, a more indirect mechanism than in the private sector; and

- the relatively weak incentives which ratepayers have as ultimate owners of Trust-owned assets to monitor the performance of the Trust and its management. This is because ratepayers are not able to act directly on information they receive about its performance, for example by buying and selling shares.

3.4 The above incentive problems are heightened because the objectives of the Trust may differ from those of its subsidiaries. Subsidiaries may be charged with the obligation to provide a minimum threshold rate of return on Trust investments by vigorously pursuing commercial goals. In most businesses, shareholders share the same goals. However, the Trust may wish to pursue broader goals through its investments, such as investment in infrastructure or the promotion of certain events, like the America's Cup. These goals may conflict with commercial objectives. Conflicting objectives of the Trust and its subsidiaries may impede necessary restructuring of an industry. For example, decisions about mergers and acquisitions involving subsidiaries may be dominated by parochial rather than commercial considerations.

3.5 In addition, the objectives of ratepayers may conflict with those of the Trust. Ratepayer interests may be better served by the Trust distributing its earnings or liquidating assets and returning the proceeds directly to ratepayers. The interests of management or of the Trust may be achieved by retaining earnings and investing in politically popular ventures that, due to poor returns or risk, would not be undertaken by an entity subject to normal commercial disciplines.

3.6 Similar issues arise for listed companies. Managers of listed companies, for example, may prefer to retain company earnings, and therefore to keep a greater degree of control over their use, than to distribute them to shareholders. The returns the company can derive on assets may be lower that what shareholders could achieve by investing in other entities. The payment of dividends from listed companies is seen as a market response to this problem, even though this may incur a tax penalty compared to retaining income. In effect, shareholders may expect a minimum level of distributions in order to align the interests of management with those of shareholders.

3.7 In the private sector, shareholders are increasingly demanding that firms with surplus funds release them through share buybacks or special dividends. They want to ensure that managers remain subject to tight financial disciplines rather than invest in unrelated non-core activities. Indeed, this has been the case for a major listed entity in which the Trust has a predominant interest. Ports of Auckland Limited has made a number of distributions of subscribed capital, implicitly on the basis that shareholders of the company may have higher yielding uses for the resources than the company. As noted above, however, the Trust is not subject to a similar constraint.

3.8 An aspect of the conflicting objectives of ratepayers and the Trust is that building up investment funds and retaining commercial assets may conflict with ratepayers' preferences for personal spending and saving, and for risk taking. The preferences of ratepayers are unlikely to be uniform because they face vastly different circumstances. Some ratepayers may be hard pressed to pay for necessities such as food, housing and clothing. They could be expected to put a low priority on the accumulation of investment funds or the retention of non-core assets by the Trust compared to receiving cash distributions or the proceeds of selling the assets, either of which would increase their disposable incomes. Ratepayers who wish to invest in commercial assets can do so independently of local government or the Trust. The Trust cannot reflect the preferences of each ratepayer since its decisions affect all ratepayers.

3.9 A similar point arises in respect of risk-taking. The willingness of ratepayers to take financial risks differs. The sale of the Trust's business assets and the return of the proceeds to ratepayers would reduce the risk they face, or would enable them to manage their own risk according to their preferences. Many ratepayers have limited opportunity to influence the decisions of local bodies like the Trust and have few options to offset the effect on them of poor decisions. It is very costly, for example, to move to another local government jurisdiction with a more satisfactory financial policy.

3.10 As an entity in which investors are captive, performance measures adopted by the Trust, while certainly superior to none at all, are a pale reflection of the disciplines that apply in the private sector. It is simply impossible to establish the counter-factual - what return could ratepayers achieve if they had the ability to make alternative investments?

3.11 These differences between the Trust and an investment vehicle in which stakeholders directly hold ownership interests mean that, contrary to the view expressed in the introduction to the strategic plan, the Trust should not be regarded as a holding company managing investments in publicly-owned assets. The incentive problems noted also mean that, *on average* and *over time*, private enterprises outperform public enterprises - that is to say, they produce better quality and lower cost goods and services and therefore do more to raise living standards. This conclusion is supported by overwhelming evidence and has been the motivation for the massive programme of privatisations around the world in the past 15 years - probably now amounting to a trillion dollars worth of assets.

3.12 This conclusion does not detract from the competence or commitment of the existing management of the Trust. Quite clearly, some public enterprises like the Trust perform well for a period and some private firms fail spectacularly. All firms make wrong decisions, but private firms face disciplines which mean they make fewer and correct them faster than firms owned by governments, which tend to cover them up. Governmental authorities should not play against such odds and gamble with taxpayers' and ratepayers' funds.

3.13 The incentive effects noted above suggest that the case for accelerating the privatisation of most of the business assets held by the Trust is overwhelming. The Trust is prevented from selling its shares in Watercare Services Limited. Legislation provides ample scope for privatising the other assets of the Trust, however.

3.14 The approach to privatisation in the strategic plan appears ad hoc and half-hearted. The strategic plan indicates that the sale of forestry cutting rights is expected in this financial year but that TACL should not be sold "until we have maximised the returns to the shareholder" and that Northern Disposal Systems will not be sold "until [the Trust] feels that it is practicable and prudent to sell this investment". The sale of TACL is unlikely until 1998. No timetable is indicated for the sale of Northern Disposal Systems.

3.15 With little supporting comment, the strategic plan notes that the Trust does not intend to sell its shares in Ports of Auckland Limited in the short term. The port is simply a transport facility and the grounds for maintaining its business assets in public ownership are no stronger than they are for connecting services, such as road, rail or ocean-going transport. Many ports around the world have been privatised and subsequently achieved major efficiency gains. Despite earlier opposition, corporatisation of the Ports of Auckland has been a remarkable success and the listing of the company provides some commercial disciplines. However, there are likely to be further benefits to port users from a greater proportion of the company being privatised.

3.16 Reasons given in the strategic plan for deferring the sale of assets are unconvincing. The reasons for deferring sale of TACL due to uncertainty in the regulatory environment expose ratepayers to risk. Presumably these risks are similar to those faced by private sector competitors to TACL and do not represent a valid reason for deferring sale. Regulatory and business risks would be priced into any bid for the company. Such risks did not detract from the benefits of the privatisation of the Wellington City Council bus fleet. In 1995, the privatised company Stagecoach had held fares in dollar terms since 1990 and reduced them by 10 percent in real terms, increased passenger numbers significantly and reduced subsidy requirements from $14 million to $5 million, a saving of $8 million.

3.17 Deferral of the sale of TACL and Northern Disposal Systems until shareholder value is 'maximised' is also questionable. The price paid for an asset reflects its expected future income stream. Competing bidders for the asset face the strongest incentives to base their bids on the expected 'best use' of the asset, using information that may be unknown to the seller. By this means, the seller reaps benefits of the expertise of the purchaser in the price paid for the asset. Money spent by a seller in trying to 'enhance' the value of the asset prior to sale may, in fact, be wasted.

3.18 The strategic plan fails to present any objective analysis of the pros and cons of the Trust retaining ownership of its full range of commercial assets, taking account of the above considerations. The Trust's attitude to privatisation seems to be reflected in the Chairman's statement, given prominence in the plan that:

> Fortunately, there is strong support for the argument that the Trust should keep its current structure and be allowed to contribute with skills and resources to solving some of Auckland's most pressing problems. Problems that are not being solved by anyone else.

This comment misses the point. Claims about political support at a given point of time are no substitute for an informed debate about the merits of policies. Public choices change in response to logic and evidence. Sound local democracy requires decisions to be made on the basis of good information, careful analysis and open debate. Politicians should lead and encourage that debate, not try to stifle it by resorting to shibboleths.

4.0 Is the Trust an Appropriate Vehicle to Make Investments in Infrastructure and Other Assets?

4.1 The Trust believes that it must utilise the economic value of its assets as a mechanism to "support the development of and investment in much needed regional infrastructure". The view stated in the strategic plan is that Auckland needs a body with a regional focus that is capable of undertaking regional infrastructural asset development and investment. The Trust is seen as being particularly useful for this purpose, since territorial local authorities are, in the Trust's view, required to act in the interests of 'their ratepayers' and this may preclude them from adopting a regional view.

4.2 The key areas for infrastuctural investment noted in the strategic plan are urban transportation, water and waste water infrastructure, and tourism infrastructure. Recent studies commissioned by the Trust have identified infrastructure investment requirements of $6 billion. It is unclear from the strategic plan how investment in these areas is consistent with the Trust's view that it is primarily a commercial organisation, or by what criteria investment projects will be chosen.

4.3 The Trust is certainly 'thinking big'. The nature of the strategic plan raises the critical question of whether the surplus funds of the Trust should be applied to finance activities like public transport, or ones that are usually among the core activities of territorial local authorities such as the financing of foreshore improvements and public spaces.

4.4 It may well be the case that significant investment in infrastructure in Auckland is necessary. But not all of this development will represent investments with high public good characteristics.[3] Water and sewerage services are commercial operations that could be undertaken by corporate entities not necessarily owned by the Trust, or even by local authorities. Moreover, services with high public good characteristics are properly the core business of territorial local authorities.

4.5 Financing these activities, and other unspecified infrastructure investments, through surpluses generated from the Trust's assets is inappropriate. These investments should be financed from rates and user charges (with user charges set, where feasible, to reflect the private benefit content). These methods of financing are much more transparent. Primary reliance on annual rates revenue and user charges to finance such investments is likely to increase the accountability of councils to ratepayers for the quality of their decisions.

4.6 Few today would argue that a regional Trust should be set up to engage in risky new business activities such as port, transport and waste disposal companies in order to finance public transport or marina developments. The symmetrical argument is that holding on to such assets for the same purpose makes little sense.

4.7 A central feature of the strategic plan is the Trust's intention to finance, develop, own and manage an infrastructural facility for the America's Cup regatta. The draft annual plan provides approximately $25 million for the funding of the facility. The plan states that the investment is expected to provide a "sound" commercial return for the region. No detail is provided in the plan about the costs and benefits of this proposed investment.

4.8 It is noted on page 9 of the plan that the extent of the Trust's financial investment in the America's Cup facilities has not been finally decided. The contribution approved by the Trust is expected to be in the order of $20-$30 million. However, an article in the *New Zealand Herald* of August 28 states that the Trust's contribution is now expected to be $37.6 million, significantly greater than the amount provided for in the current plan.

4.9 The proposal for the Trust to make a substantial contribution to the costs of facilities for the America's Cup is a good example of the concerns raised earlier in this submission about the role of the Trust as an investment vehicle. If the America's Cup investment is expected to provide a commercial return, the question arises as to why it would not be undertaken by the private sector. If the private sector is reluctant to undertake the venture, it may well be because the project is unlikely to provide acceptable returns. If that is the case investment by the Trust would involve a waste of resources, unless there were significant public good elements in the investment. However, in that case, the investment should more appropriately be undertaken by a territorial local authority for the reasons noted above.

4.10 The Trust commissioned an assessment of the economic impact of the America's Cup by estimating the direct and indirect spending generated by the event. The study was undertaken by Ernst and Young and estimated that additional sales of around $127.7 million would be generated by the event. However, the authors of the study were careful to note its limitations. Near the beginning of the report they stated that:

> There is currently extensive debate as to the extent to which Auckland and New Zealand should finance the development of the Auckland waterfront for use in the America's Cup. This report is not intended to be an analysis of the advantages and disadvantages of the proposed waterfront development. Neither does the report comment on the form or structure of the waterfront development. In addition, this report is not a cost-benefit analysis.

4.11 These qualifications (in particular, that the analysis is not a cost-benefit study) are critical, but have been ignored when the study is used by the Trust. The chairman of the Trust is quoted in the *New Zealand Herald* of 3 July 1996 as saying in relation to the study's findings that "this overwhelming benefit fully justifies ratepayer and taxpayer spending on a $50 million Cup base at the Viaduct Basin...". In a recent letter to the *National Business Review*, the Chairman wrote that "the trust is taking a sound commercial approach to its investigation of the provision of facilities for the America's Cup. Our studies so far have shown that the event will benefit both the regional and national economies".

4.12 Economic impact analyses of this nature are not a basis for commercial decisions by investor-owned companies. More importantly in the current context, they do not represent a valid basis for investment by the Trust, for two main reasons.

4.13 First, the approach does not take adequate account of the costs incurred in generating the benefits of the additional spending. That is, it does not evaluate the opportunity costs of using public funds in alternative ways. Resources committed by the Trust to the venture do not have an opportunity cost of zero. In the hands of ratepayers, the resources would also generate a return that may be superior to that which can be achieved by the Trust. In addition, multiplier effects are not confined to spending by the Trust; they apply also to spending by ratepayers. A similar study to that undertaken on the America's Cup was undertaken by Ernst and Young on the Queensland IndyCar Grand Prix. The study was used by the government of Queensland to justify the significant losses it incurred to fund the event. The limitations of using the Ernst and Young analysis in this way were discussed in a recent public policy journal. The article is attached as an Annex.

4.14 In contrast to the use made by the Trust of the Ernst and Young study, a cost-benefit analysis would potentially be a more appropriate basis for assessing the America's Cup venture. We are not aware of such a study. However, even if a study indicated that investment by the Trust might produce net benefits, that would not represent a sufficient ground for intervention. It would still need to be established that the benefits would not arise if the Trust did not undertake the investment (i.e. that 'spillover' benefits arose) and that these benefits exceeded the cost of funding the venture (including the opportunity cost of the funds in terms of yields forgone by ratepayers, transaction costs, and deadweight costs associated with using the Trust to raise the finance).

4.15 The apparent desire of the Trust to assume major responsibility for financing regional infrastructure, the risks of using business assets to fund such investments, and the early warning signs from the America's Cup initiative all lend weight to our view that the assets of the Trust should be disposed of and the proceeds returned directly to ratepayers sooner rather than later. Statutory impediments to achieving this goal are discussed in the next section.

5.0 Statutory Considerations

Trust Distributions

5.1 As noted in the introduction, the surplus funds of the Trust that remain after meeting its costs and debt reduction targets are required to be distributed to a Community Trust ('the Community Trust'). The Community Trust is unlikely to be a suitable vehicle to return assets of the Trust to the community. Similar accountability and incentive problems with the Trust would apply to the Community Trust.

5.2 This may influence the policies of the Trust, which may be reluctant to make substantial distributions to the Community Trust.[4] The strategic plan notes that $5 million is to be distributed to the Community Trust for the year ended 30 June 1997 but that "it is unlikely that any funds will be surplus for the years ending 30 June 1998 and 1999". This is despite expected net cash flows from operating activities of $32.4 million and $34.2 million respectively for each of those years. Net cash flows in those years are fully devoted to planned investments in the America's Cup facilities and provision for the (unspecified) capital requirements of subsidiary companies.

5.3 A more appropriate approach to distributing the assets of the Trust would be to use one of the following mechanisms (or a combination of both):

- returning the proceeds of the sale of commercial operations directly to ratepayers by reducing rate burdens;[5] or

- providing a mechanism by which the shares held by the Trust are given directly to ratepayers.

5.4 Under the latter proposal, ratepayers rather than politicians would be able to decide whether to hold the shares or quit them. The strategic plan should initiate debate about the most appropriate methods of distributing the benefits to ratepayers.

Watercare Services Limited

5.5 The Local Government Act specifically provides that Watercare is not to pay a dividend or distribute any surplus to its owner or any other shareholder. Each year Watercare is to decide whether or not to return any surplus to its customers, and to determine the method of return. Watercare must first seek funding for investment from the territorial authorities and only if the territorial authorities decline to subscribe is Watercare able to fund capital requirements from outside providers.

5.6 The legislative restrictions applying to Watercare Services Limited result in a confused ownership and accountability structure for the organisation. Because institutional arrangements matter for the performance of an organisation, it is likely that the unusual arrangements applying to Watercare weaken its performance.

5.7 These arrangements mean that the owners (the Trust) who bear the risks of investment, and who have responsibility for management of the company, are unable to retain income from surpluses generated. The company's operations and investment programme are subject to territorial authority agreement. Customers enjoy the rights to residual earnings but are unable to directly influence performance. They can, however, restrict Watercare's ability to invest or increase prices.

5.8 There are currently no long-term contracts between Watercare and the territorial authorities. This provides the scope for substantial opportunistic behaviour by Watercare's customers seeking to expropriate some of the value of Watercare's assets. This could be achieved through under-pricing of services provided by Watercare. Because there are opportunities for major wealth transfers between the Trust which legally owns Watercare and its customers, the difficulties and risks of financing any major new investments are significantly increased. The Trust cannot retain or distribute any surplus that Watercare generates, so it cannot obtain a return for any risky investment it undertakes. This must affect its incentives to undertake such investment.

5.9 The special legislative provisions relating to Watercare serve no useful purpose. Their perverse effects are evident from the strategic plan which forecasts negative value added of $67 million for the Trust's investment in Watercare. The special legislative provisions relating to Watercare should be repealed. Serious consideration should be given to either:

- establishing Watercare Services as a local authority trading enterprise ('LATE') under the general provisions of the Local Government Act 1974 with the remaining providers of water and wastewater services also being corporatised as LATEs. There may be a case for central government deciding the best initial structure of the water industry in Auckland in the absence of privatisation. Ownership of an integrated entity by the territorial local authorities is an option; or

- moving towards the private ownership of Watercare Services.

5.10 In either case monopoly concerns should be addressed through an appropriate light-handed regulatory regime. A light-handed regulatory regime offers advantages over alternative regulatory approaches.[6]

5.11 A recent study by the Reason Foundation of private (investor-owned) and government water systems in California found among other things that:

- investor-owned water companies provide comparable water services to consumers at the same price as government-owned water companies even though they pay taxes;

- investor-owned companies are substantially more efficient in their operation of water services than government-owned water companies;

- it is likely that government-owned water companies spend more on facilities than investor-owned water companies; and

- governments can better regulate an investor-owned water company than a government-owned water company.[7]

5.12 As directed by its governing legislation, the Trust has investigated the feasibility and desirability of integration in the Auckland region of bulk water supply and drainage with local reticulation of water and local sanitary drainage. In the light of the evidence relating to the benefits of privatisation, the Trust should use the strategic plan as a forum to pursue the review of appropriate ownership arrangements. This should include an objective analysis of the merits of provision of water and sewerage systems through investor-owned companies.

6.0 Transition

6.1 Until more appropriate mechanisms are available in legislation to distribute the business assets of the Trust to ratepayers, the Trust should refrain from using its surpluses to undertake new and risky investments in infrastructure projects. Moreover, the current structure of the Trust, under which each of its business subsidiaries is owned directly by the Trust, should be reviewed. The Trust is not subject to normal commercial disciplines, as noted earlier. Its strategic plan suggests that its objectives are not the same as an investor-owned entity. It is therefore important that there be an appropriate separation between management in pursuit of the Trust's objectives and management of the business assets of the Trust.

6.2 Accountability in the interim would also be enhanced by ensuring that the Trust's subsidiaries did not enjoy or suffer any advantages and disadvantages as a consequence of the Trust being a principal shareholder.

6.3 The Trust intends to finance, develop, own and manage the facility for the America's Cup. If the Trust insists on funding ventures like these, any investment should be through a properly structured LATE. Alternatives to direct investment should also be considered, and it is not too late to consider these alternatives in relation to the America's Cup venture. The most obvious alternative would be for the Trust to specify the nature of the services it seeks to acquire. The Trust would then invite tenders from competing bidders for the provision of such services. For example, tenders to finance, develop, own and manage facilities for the America's Cup could be called where each tenderer would bid for the amount of subsidy required to undertake the project. The advantages of this approach are that:

- the costs of subsidising the provision of the services are made explicit, unlike the case for direct commercial investments. The Trust's risk exposure is also capped;

- the benefits of contestable provision are captured by the Trust, unlike the situation if the Trust undertakes the investment itself; and

- the Trust would not become the owner of assets which it would later need to quit. This would reduce the longer-term risks faced by ratepayers.

7.0 Conclusion

7.1 The strategic plan represents a lost opportunity for the Trust to take leadership in promoting an informed debate about the advantages and disadvantages of the suitability of the Trust as a vehicle for ordinary ratepayers to hold commercial investments that they would typically hold directly. Instead, the Trust seems to be the leading advocate for its continued existence, contrary to the intent of its governing legislation at the time it was enacted.

7.2 The apparent desire of the Trust to assume major responsibility for financing regional infrastructure, the risks of using business assets to fund such investments, and early warning signs from the America's Cup initiative all lend weight to our view that the assets of the Trust should be disposed of and the proceeds returned directly to ratepayers, sooner rather than later. Statutory impediments to achieving this goal should be removed as soon as possible.

7.3 In the interim, the Trust should refrain from trying to find further infrastructure projects in which to invest. It should also seriously consider ways in which a better separation can be achieved between the management of the Trust, with its non-commercial objectives and constraints, and the management of its commercial subsidiaries.

1 The 1996 New Zealand Official Yearbook estimates the population of the Auckland Regional Council area as 1,027,700. The national average number of people per household in the 1991 Census was 2.9.

2 In the remainder of this submission, ratepayers and citizens as stakeholders in the Trust are referred under the generic title of 'ratepayers'.

3 Public goods are those which are non-excludable (i.e. where it is not possible to exclude a person from using the service) and non-rival (i.e. where the use of the service by one person does not reduce its value to another person).

4 The chairman of the Trust was quoted in the *New Zealand Herald* of 3 July 1996 as saying that it would be "crazy" for all of the Trust's surpluses to go into the community trust.

5 A reduction in the rate burden would be through a combination of lower debt, lower debt servicing costs and the return of the proceeds of sales to ratepayers.

6 For further discussion on this issue, refer to CS First Boston (1995) 'Reform of the Water Industry', New Zealand Business Roundtable, Wellington.

7 Neal, Kathy and P J Maloney, J A Marson and T M Francis (1996), 'Restructuring America's Water Industry: Comparing Investor-Owned and Government-Owned Water Systems', Reason Foundation, Los Angeles.