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**ROLES FOR PUBLIC AND PRIVATE CAPITAL IN
INFRASTRUCTURE DEVELOPMENT:
NEW ZEALAND EXPERIENCE**

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ROLES FOR PUBLIC AND PRIVATE CAPITAL IN INFRASTRUCTURE DEVELOPMENT: NEW ZEALAND EXPERIENCE

Introduction

The brief for this session notes that reliable and advanced infrastructure is fundamental to economic development. It observes that government ownership of infrastructure has decreased in many countries through privatisation. It reports that privatisation in Australia as well advanced in the electricity and telecommunications sectors, but that major problems exist in the water industry. Nevertheless, privatisation of water resources and private sector participation in government-owned water utilities is now underway. Finally, the brief notes that in many countries the public role in funding and maintaining health services is stretched to the limit, which points to the need for well-regulated private capital investment in health.

I agree with these general perspectives. There is strong evidence from international experience in a wide range of developing and developed countries that increased private sector involvement in infrastructure provision generates substantial benefits for consumers, taxpayers and the shareholders of privatised businesses.

These findings have encouraged a wide range of countries and governments to embark on privatisation programmes, with privatisation effectively halving worldwide state ownership of assets over the past two decades.¹

New Zealand has been part of this worldwide trend. Its government moved rapidly to involve the private sector in providing and managing infrastructure in the late 1980s through to the mid-1990s. Progress then slowed and came to a standstill at the end of 1999, with the election of a government opposed to further privatisation.

Despite the documented evidence of benefits from corporatisation and increased private sector involvement in infrastructure (and other) industries, a large number of New Zealanders remain deeply sceptical about the reforms. Until the issues are openly debated, and central and local government politicians are once again prepared to lead public opinion, improvements in critical infrastructure industries in New Zealand will lag the rest of the developed world.

¹ Megginson, W L and Netter, J M, *From State to Market: A Survey of Empirical Studies on Privatisation*, working paper, University of Oklahoma, March 2000.

Case for private sector involvement

A large body of empirical research demonstrates that, on average and over time, privately owned businesses perform more efficiently than state-owned enterprises. This is true whether the businesses operate in competitive or less competitive markets. Substantial efficiency gains have also been documented for franchising and contracting arrangements.

The authors of a recent article published in the *Journal of Finance* concluded on the basis of their own research and a review of 14 studies of several thousand companies in 50 countries involving "every imaginable industry" that these "papers ... speak with a consistent voice documenting privatization-induced output, efficiency, and profitability increases". They conclude, "privatization 'works' and it works in almost every institutional setting".²

Academic research conducted in New Zealand supports these findings. One study found that the corporatisation and subsequent privatisation of Telecom New Zealand had resulted in substantial improvements in total factor productivity and had achieved annual real cost reductions of 5.6 percent per annum in the period 1987-1993. The gain in overall welfare (producer plus consumer surplus) from the improved efficiency of the company over this period was estimated at around \$0.5 billion. The bulk of the gains accrued to consumers.³

Another study examined the gains from of the privatisation of New Zealand Rail. It concluded that they were in the order of \$1 billion to \$10 billion depending on the assumed counterfactual. It noted that most of the benefits accrued to taxpayers (through not having to subsidise rail) and the firm's private owners.⁴

Anecdotal and less formal empirical evidence supports the academic research. Corporatisation and privatisation have turned many businesses from a loss-making position into sustainable profitability. Costs have been cut and performance improved. Consumers have enjoyed substantial improvements in services, and often lower prices.

² D'Souza, J and Megginson, W L , "The Financial and Operating Performance of Privatized Firms During the 1990s", *Journal of Finance*, vol LIV, no 4, August 1999.

³ Boles de Boer, D and Evans, L, *Government Department to Public Corporation in a Deregulated Economy: The Economic Efficiency of New Zealand Telecommunications*, July 1994. The authors note that it is not possible to separate the benefits from corporatisation and deregulation from those of privatisation. They state that they believe that at least half the benefits are attributable to privatisation.

⁴ Evans, L and Boles de Boer, D (principal authors), *The Privatisation of New Zealand Rail*, report prepared for the New Zealand Treasury, July 1999.

The empirical results are not surprising. Businesses exposed to the disciplines of capital markets and monitored by interested owners are likely to have stronger incentives to perform than those subject to political oversight. While corporatisation and exposure to competition can improve the incentives for publicly owned businesses to perform, the sustainability of any gains is questionable given political imperatives. Politicians find it difficult to resist pursuing political as well as commercial objectives through their ownership of businesses. Public ownership inevitably risks politicisation of decision making, rent seeking and political grandstanding over prices.

Private sector involvement can clarify the commercial objectives of businesses, provide managers with better incentives for performance, improve monitoring and reduce the politicisation of business decisions. The involvement of the private sector brings skills and know-how that are not available to governments. The private sector can mobilise finance for new investments when governments are hard pressed to raise funds for the large outlays required for infrastructure investments and ill-placed to handle the associated business risk.

New Zealand reform process

New Zealand was a latecomer to privatisation of state-owned assets, including infrastructure assets, but significant moves began in the late 1980s. Petrocorp, which owned a major gas utility operation, was sold in 1988. Telecom was privatised with a light-handed regulatory regime in 1990. New Zealand Rail was sold in 1993. Most electricity distribution companies were corporatised and privatised or their ownership transferred to community trusts in the early 1990s. The government divested its shareholdings in Auckland and Wellington airports in 1998, and sold Contact Energy, a major generating company, in 1999.

Local government has largely resisted privatisation of its infrastructure assets although a few councils have sold their shares in ports and airports. The cessation of the privatisation programme by central government has left it owning and operating a number of important infrastructure assets including most electricity generation capacity, as well as the high voltage transmission system. The government also owns New Zealand Post, which is responsible for most of the postal system. The state highway roading network is owned by the government, and other roads are largely in local government control. Water utilities are primarily council-owned. The government is the dominant owner of health care facilities (outside the primary health sector which is largely private and for-profit), and is effectively a monopoly provider.

Infrastructure industries

Corporatisation improved the performance of the government's electricity and postal businesses. However, the sustainability of these gains is uncertain (New

Zealand Post seems likely to be required to enter into banking, in which it has no expertise), and opportunities for further gains in operating efficiency, diversification, synergies with other businesses (including multi-utility operations) and overseas expansion are curtailed.

In relation to roading, the previous government proposed, after an extensive review, to adopt a more commercial approach. It suggested combining existing roading operations owned by central and local government into a small number of commercial companies. Pricing of road use was proposed to help manage congestion and fund expansion of the network. Privatisation was ruled out, although private sector involvement in roading (for example through toll roads) was envisaged.

The proposed changes were strongly resisted by local authorities – roading constitutes the major activity for many of the smaller councils. The present Labour/Alliance government rejected the commercial approach, and no reforms have been made.

Road users continue to be frustrated by congestion and delays, particularly in Auckland, and no solutions are in sight. Councils routinely promote public transport options which can at best make only a marginal contribution to solving the problem. While the government has signalled that it might contemplate private sector investment in roading, so far there has been no action.

Local government – both regional and territorial councils – is a major owner of infrastructure including landfills, ports and local airports as well as roading and water and sewerage. Auckland and Wellington city councils have shareholdings in the Auckland and Wellington international airports. A few councils continue to own electricity businesses.

Local government has largely been hostile to commercialisation and privatisation of its infrastructure assets, although there have been a few exceptions.

Councils were required by the government to corporatise their port and airport businesses. There is a pressing need for mergers and other forms of rationalisation in the port industry, but in practice this is largely precluded by majority public ownership. Councils have corporatised and sometimes privatised the small council units that provide infrastructure-related services, particularly 'works' operations such as roading maintenance.

Only a few of the water and wastewater businesses operate in a corporatised framework. Auckland City Council's water distribution business (Metrowater) was corporatised in 1997. Watercare, the bulk water supplier in Auckland, operates as a constrained commercial entity.

Private sector involvement in owning and operating infrastructure assets is limited. Papakura, one of the smaller Auckland councils, franchised its water and wastewater operations to United Water in 1997, achieving net cost savings of around 10 percent. Wellington City Council franchised Anglian Water to build, own and operate its sewage treatment plant.

Many of the longstanding problems in the sector, including poor maintenance of pipelines, system failures resulting in the discharge of untreated sewage, high levels of losses from pipeline systems, water restrictions in many areas during summer months and poor quality drinking water in some areas, have not been addressed. Few councils have introduced usage-based pricing despite its environmental and efficiency benefits and its widespread adoption in Australia.

Dismayed at the state of the water and wastewater sector, the government initiated a review in 1988. However, in the face of strong opposition from councils, responsibility for the review was passed to local authorities in the following year. Nothing tangible has subsequently happened. Little reform appears likely unless it is directed by central government – but central government seems at present unlikely to take the lead.

The greatest area of private sector involvement at the local government level has been achieved through the contracting out of council services. Contracting out has been a consistent success story for local government – cost savings of 10 to 30 percent from contracting out are commonly cited.

Most infrastructure design and construction and a good deal of infrastructure maintenance is contracted to the private sector or, if undertaken in-house, is awarded through a competitive contracting process. Some councils have contracted out core functions such as administration, planning and regulatory services.

Health

The reforms to the health system implemented by the National government in the early 1990s envisaged greater private sector involvement in the funding and delivery of health services. Private sector competitors were expected to improve the delivery of services while providing incentives for public providers to improve their performance. Regional and then national health funding authorities – the government's purchasing arm – achieved some limited successes in contracting with the private sector.

However, the government did not implement the full package of health reforms – failing, for example, to allow individuals to buy their own health insurance from private providers as initially intended. It prevented public hospitals subcontracting space to private providers and bailed out loss-making hospitals,

undermining the incentives to cut costs. Ultimately, the semi-commercialised publicly owned model for hospitals achieved only limited gains and has proved politically unstable.

The government-dominated health sector remains characterised by poor performance – for example, long waiting periods for hospital treatment and a lack of choice (with consumers having to pay a substantial premium to purchase alternative private services). Consumer dissatisfaction is high.

The health sector is now undergoing a further set of changes initiated by the Labour/Alliance government. These unwind most of the changes implemented by the previous government. The changes will reduce private sector involvement and weaken the commercial disciplines and accountability of the monopoly government providers. Ongoing problems can be expected.

The government recently renationalised the accident insurance market which was partially opened up to private sector competition in 1999. This action was taken despite the large benefits achieved during the brief period of liberalisation – benefits conservatively estimated to be around \$300 million a year.

Summary

Despite clear evidence of the benefits of privatisation, there are unfavourable attitudes in New Zealand to the sale or franchising of publicly owned assets to the private sector. The lack of support for privatisation is reflected in the government's anti-privatisation position and the resistance of many local authorities to privatisation.

The halting of reform stands in stark contrast to the progress in other countries, including Australia, where commercialisation and private sector involvement in infrastructure is proceeding apace.

The failure to reform government-owned infrastructure industries and the state monopolies in health and accident insurance carries a heavy penalty. The poor performance of these sectors will continue to operate as a drag on the living standards of New Zealanders and the international competitiveness of the business sector.