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CONFERENCE INFRASTRUCTURE CONFERENCE

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REDUCING BARRIERS TO INVESTMENT IN  
INFRASTRUCTURE

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## **REDUCING BARRIERS TO INVESTMENT IN INFRASTRUCTURE**

### **What is infrastructure?**

This year there has been a lot of talk about infrastructure. Among other things we have had the government's infrastructure stocktake, the formation of an infrastructure lobby group, and a very good winter lecture series hosted by the Natural Gas Corporation. Infrastructure is certainly a fashionable topic. Yet despite the attention it has attracted, some key points have not been brought out with sufficient clarity.

People often fall into the trap of talking about 'infrastructure' as though it is a clearly defined block or class of assets. Infrastructure, however, is not a homogeneous asset class or even a meaningful industrial classification. It is a collection of separate industries, each with its own characteristics and each of which needs to be analysed in its own right.

Typically, infrastructure industries are taken to include roads, railways, electricity, water, gas, telecommunications, ports and airports. The definition of infrastructure favoured by the government, however, seems to be 'everything that the state takes responsibility for'. Listing infrastructure spending recently, finance minister Michael Cullen included prisons, defence force equipment, replacement of hospitals, building new schools, recapitalising a national airline, installing new electricity generating capacity, upgrading the electricity transmission grid, road building and even "saving rail."

Defence and prisons are genuine 'public good' activities for which the state must be responsible (although, as I shall discuss later, there is no reason why the private sector can't manage prisons under contract). By contrast, many infrastructure industries, like ports and airports, can be run as normal businesses. We need to tease out the differences between various types of infrastructure and think carefully about how each should be handled.

In most privately owned industries, we don't have to worry about capacity constraints, at least in normal circumstances. The same should be true of infrastructure. Too often it is not, however, for reasons that are specific to the sector. In this paper I focus on two key artificial barriers to infrastructure investment that can and should be eliminated:

- the barriers created by government ownership of commercial businesses; and
- the regulatory barriers created by misguided government interventions.

I will also discuss how governments can reduce the uncertainty investors face, by providing secure and tradable property rights and a stable regulatory regime for investment.

### **Uncertainty**

Uncertainty is a fact of life – no one can precisely predict the future. Governments can, nevertheless, help to reduce uncertainty by establishing secure property rights and a stable regulatory regime. Unfortunately, governments often make matters worse by behaving in ways that increase rather than reduce uncertainty. The electricity sector is a case in point. As Bill Gallagher, CEO of Gallagher Group, noted recently, “the real problem with electricity is that business does not know what the government will do next.”

Since the corporatisation of the old Electricity Department, which yielded major benefits, we have had interminable meddling in the sector – Max Bradford’s forced separation of lines and energy trading, more regulation and an Electricity Commission with a flawed governance structure and multiple and often conflicting functions. Most recently, we have seen the government step in to help a state-owned enterprise (SOE) get a new power project off the ground. Even the Electricity Commissioner, Roy Hemmingway, felt it necessary to criticise that intervention. As he stated:

The country needs more electricity generation but this is the wrong way to get it ... If the Government is in a role of backing SOEs, we may have problems in the future getting investment from places other than government.<sup>1</sup>

### **Ownership**

In May this year, the Ministry of Economic Development released a nationwide infrastructure stocktake prepared by PricewaterhouseCoopers.<sup>2</sup> The main areas of concern identified by that study were security of

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<sup>1</sup> ‘Electricity Commission head attacks Government deal’, *New Zealand Herald*, 14 August, 2004.

<sup>2</sup> PricewaterhouseCoopers, ‘Infrastructure Stocktake: Infrastructure Audit’, a report prepared for the Ministry of Economic Development, January 2004.

electricity supply, investment in electricity transmission, road congestion, water allocation problems, and water quality problems.

What do these sectors – electricity, roading and water – have in common? One thing stands out: they are all government-dominated.

- Three of the four main electricity generators are state-owned. On the lines side of the business, Transpower is 100 percent state-owned, while consumer trusts – a legacy of the half-baked electricity reforms of the 1990s – continue to dominate the distribution business.
- State highways and local roading are 100 percent owned by central and local government. Despite the advances in technology and widespread use of tolling overseas, progress in New Zealand with toll roads is extremely slow.
- In the case of water, the government claims ownership while usage rights are unclear, water allocation is becoming an increasingly contentious issue in many parts of the country, and water and sewerage operation are under local government control.

Notably absent from the list of problem areas identified in the PwC report are the five infrastructure industries dominated by the private sector: telecommunications, gas, railways, airports and ports.

Contrast the situation today with that in the early 1980s. The major problem areas then included telecommunications, ports and railways, all of which were publicly owned. In 1987 there were 15,000 people waiting on average 6 weeks or more to have a phone connected. Our ports and railways were a disgrace. Governments of the time undertook an extensive programme of deregulation, corporatisation and privatisation and the problems of capacity shortages and poor performance have, by and large, gone away.


Few, if any, people complain about under-capacity in telecommunications today. In ports, the only problem is that the job has not been completed: local government ownership has impeded industry rationalisation. The largely privately owned airports like Auckland and Wellington international airports have been stellar performers for shareholders and travellers alike.

Likewise, the gas industry is largely privately owned and performing well, although the government seems bent on fixing a problem that doesn't exist.

Rail has been controversial again in recent years. However, proponents of renewed state intervention miss two points. First, for all its faults, Tranz Rail (now Toll) has done a better job than when the business was under government control and the company has at least achieved a better, if inadequate, return on capital. Second, deregulation of road and rail transport has delivered huge benefits to users and to New Zealand's international competitiveness. The arguments used to justify the government getting involved are weak.

A chart produced recently by Dr Brent Layton, Director of the New Zealand Institute of Economic Research, captured succinctly the relationship between capacity constraints and ownership of New Zealand's infrastructure.

**Perceived capacity issues early 2000s  
v ownership structure**

<b>Very high</b>					<ul style="list-style-type: none"> <li>State highways</li> </ul>
<b>High</b>	<ul style="list-style-type: none"> <li>Gas production</li> </ul>			<ul style="list-style-type: none"> <li>Electricity generators</li> </ul>	<ul style="list-style-type: none"> <li>Electricity transmission</li> </ul>
<b>Moderate</b>					<ul style="list-style-type: none"> <li>Water &amp; sewage</li> <li>Local roads</li> </ul>
<b>Low</b>			<ul style="list-style-type: none"> <li>Electricity distribution</li> </ul>		
<b>None</b>	<ul style="list-style-type: none"> <li>Gas distribution</li> <li>Gas transmission</li> <li>Telcos</li> </ul>	<ul style="list-style-type: none"> <li>Railways</li> <li>Airports</li> </ul>	<ul style="list-style-type: none"> <li>Ports</li> </ul>		
	<b>100% commercial</b>	<b>Mainly commercial/ some public</b>	<b>Some commercial/ some public</b>	<b>Some commercial/ mainly public</b>	<b>100% public</b>

The chart highlights my point that those sectors most in need of new capacity (like roads, electricity transmission and electricity generation) are largely publicly owned while those with few, if any, capacity constraints are dominated by private ownership.

Dr Layton might have added that other areas of community dissatisfaction are health and education, where the government is involved in a major way (other than in the primary health sector and the early childhood education sector, which are largely private and work well).

We should question, from first principles, whether the public sector needs to own infrastructure assets at all. Generation of electricity is a contestable business and countries all around the world are privatising electricity supply. Amongst Organisation for the Economic Cooperation and Development (OECD) countries, Australia, the Czech Republic, Germany, Hungary, Poland, Portugal, Spain and the United Kingdom have all undertaken privatisation in their electricity sectors, while in the United States and Japan the electricity industry has been predominantly privately owned throughout its history. In contrast to New Zealand, the electricity industry around the world is now overwhelmingly in private hands.

It is true that in the case of the electricity lines businesses (both high and low voltages), monopoly power is an issue. In such circumstances, policy makers are faced with three basic choices: public ownership; regulating a privately owned utility; or leaving the business largely unregulated. Given what we have learned over the years about the weaknesses of public ownership of commercial businesses, it is hard to see public ownership being the superior choice.<sup>3</sup>

Similarly in the case of water, there is much to be done. We already have numerous private forms of water collection and distribution in New Zealand – from water tanks on the roofs of private houses on Waiheke Island to irrigation in the McKenzie basin to private water supply in the towns of Oamaru and Waiouru. However, as with most of our infrastructure, the public sector dominates. Many countries are now far ahead of New Zealand in charging for water on a more economically efficient basis, establishing tradable water rights and facilitating private operations.

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<sup>3</sup> For a survey of the evidence, see M Shirley and P Walsh (2000), 'Public versus Private Ownership: The current state of the debate', World Bank Research Working Paper #2420. The authors conclude that, while there is argument in the theoretical literature as to whether government ownership of monopolies is preferable to appropriate regulation of a private monopoly, "the empirical literature is less ambiguous, finding that private regulated firms perform the same as or better than SOEs in most studies."

Much has been said and written about public-private partnerships (PPPs). PPPs have been adopted in over 140 countries, New Zealand amongst them. They can be very successful. Contracting out, for example, has been a consistent success story for local government in New Zealand, with cost savings of 10 to 30 percent commonly cited. Papakura 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 and while it was unnecessarily gold-plated, the plant has operated successfully for many years.

Much has been learned in the United Kingdom and elsewhere about how to structure PPPs and where they work best. A critical issue is whether the provider's performance can be adequately defined and measured. Where it can be – as, for example, in the case of prisons – private providers can offer considerable advantages by bringing lower costs and/or more innovative services. The experience has been so positive in the United Kingdom that all new prisons must be designed, built, financed and operated by private firms (with no in-house bid by the Prison Service allowed).

However, PPPs can also become dodgy and corrupt where proper processes are not followed or where performance cannot be adequately measured. The debacle involving former TVNZ and NZ Post chairman Ross Armstrong, who was forced to resign after allegedly offering the inside running on government contracts to business people, highlights the potential problems.

My conclusion in relation to PPPs is that they can have a role to play, but outright privatisation is often a better policy. Why, for example, go for a convoluted second-best solution like a public-private joint venture or partial privatisation when full privatisation is feasible and known to deliver the goods? Isn't it better that governments focus on what they can do best – setting the rules, ensuring the provision of public goods, and providing a welfare safety net – and allow the private sector to focus on running commercial businesses?

That is not to deny a role for public ownership in certain circumstances. In respect of roads, public ownership of road operators run on a commercial basis is likely to be necessary, at least for a while yet, given technological constraints and the political environment. Ideology, however, should not prevent examination of private sector options. Already companies owning billions of dollars of toll roads are listed on the Australian Stock Exchange, and there are many examples of public and private sector partnerships in roading around the world.

The basic problem with roading management in New Zealand is that it operates on a Soviet-style model – just like so many other things in this country 20 years ago. Roading is determined by central and local government planning – it is not driven by consumer demand. Resources are allocated to a large extent by political and bureaucratic processes rather than commercial criteria. Rationing in the form of congestion, rather than pricing, is the norm in key parts of the system. Capital funds are rationed according to an arbitrary benefit:cost ratio of 4:1, which tells us that something is seriously wrong with either the level of funding or the calculation of benefits and costs, or both.

Auckland's congestion problem is a national disgrace. Cities with a population of a million or so around the world don't typically snarl up the way Auckland does. As far back as 1993 the Business Roundtable released a major study on options for roading reform in New Zealand. The solutions advocated then were not radical or complex. They are simple and are now well tried around the world. Firstly, build more road capacity where it is economically justified; secondly, face users with the true costs of services by introducing economically efficient pricing; and thirdly, put the management and operation of roads (not the planning function) on a similar basis to other utilities like telecommunications, and extricate it from political control.

Finally, when discussing infrastructure ownership in New Zealand, the role of local government deserves particular attention. Local government – both regional and district councils – is a major owner of infrastructure, including landfills, ports, local airports, roading and water and sewerage. A few councils continue to own electricity businesses. One central

government consultation document put the assets of the local government sector at \$46 billion.<sup>4</sup> With the Local Government Act of 2002, local government was given wider purposes and a power of general competence, which enables the sector to pursue any agenda that takes its fancy. This is not a recipe for good government. There is no need for local government to own and/or operate many infrastructure businesses. Its involvement should be cut back. To their credit, Auckland and New Plymouth councils have recently done so with airport and power company investments respectively, but wider moves will require action by central government.

Dr Cullen said recently that he had “asked government officials to think about imaginative ways of financing specific elements of the infrastructure.” The only reason imagination is required is because the simple and the obvious has been ruled out. Other countries are getting on with privatisation. Australia has been a notable case, at both state and federal levels and under both Liberal and Labor governments. New Zealand is going in the opposite direction, with over \$5 billion of assets renationalised in the last few years. We are the only country in the OECD with a blanket ban on privatising SOEs. This is despite the overwhelming evidence that the private sector is better, on average and over time, at running commercial businesses than the public sector. Not all private sector firms are successful and not all publicly owned firms are failures, but the general pattern is clear and governments should not bet against the odds. With the evidence available today, opposition to privatisation can only be ideological.

### **Regulatory barriers**

The government has unleashed a veritable avalanche of new regulations on the business sector. This includes the re-regulation of the labour market, more regulation of the electricity and telecommunication industries, the removal of competition in accident compensation, and making the Commerce Act more and takeover regulation more restrictive. A host of other measures could also be mentioned including energy efficiency legislation, the application of whistleblower legislation to the private sector,

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<sup>4</sup> Review of the Local Government Act 1974: Have Your Say (2001), Consultation Document, Department of Internal Affairs, Wellington.

gas information disclosure regulations and new regulations in the building code, to name a few.

There is little, if any, evidence that the benefits of these new regulations are likely to outweigh their costs. The evidence points in the other direction: a recent report by the US National Bureau of Economic Research, for example, finds a significant positive impact of deregulation on investment in the transport, communications, and utility industries.<sup>5</sup> The study finds that barriers to entry are the most harmful type of regulation. A reduction in entry barriers leads to a reduction in the mark-up of prices over cost, and facilitates capital investment.

The main regulatory barrier to investment in infrastructure in New Zealand is the Resource Management Act. The RMA is fundamentally flawed – it doesn't work in theory and it doesn't work in practice. Its problems were summarised well by ACT New Zealand MP Ken Shirley in a recent speech. He noted that “the basic premises that (the RMA) is built on are invalid.” Its stated purpose – to promote the sustainable management of natural and physical resources – generally defies meaningful definition. Other key concepts in the RMA such as the need to have regard to the principles of the Treaty of Waitangi, the definition of the environment, kaitiakitanga and intrinsic values are also fuzzy and problematic.

Experience with the RMA has been dismal. Newspapers have documented many cases over the years of absurd decisions and anti-competitive, opportunistic or near-extortionate behaviour under it. Perhaps most tellingly, there have been few if any major investments (over \$1 billion) in infrastructure in New Zealand since the RMA became law. It is without doubt a deterrent to investment in New Zealand and thereby detrimental to our development and prosperity, as well as being a poor vehicle for achieving environmental goals.

The government's recent review of the RMA has come up with only minimalist improvements and some backward steps. The package does not even include many of the very modest reforms advocated by numerous

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<sup>5</sup> Alberto Alesina, Silvia Adragna, Giuseppe Nicoletti and Fabio Schiantarelli, 'Regulation and Investment', National Bureau of Economic Research, Working Paper, No 9560, March 2003.

parties, such as reintroducing security for costs and limiting standing to parties directly affected by a project. Overall, on a scale of zero (equals no improvement) to 10 (equals a high quality reform), I think the government's proposed changes rate a mark of about one-and-a-half. Some would regard that as generous.

### **Conclusions**

Most of the changes required to promote better infrastructure in New Zealand can be summarised simply: more private enterprise and less government. This conclusion is based on years of experience and hard evidence from around the globe. The government talks about evidence-based policy but often turns a blind eye to clear research findings. The OECD has reached the same conclusion in its recent reports on New Zealand. In relation to infrastructure, the OECD has recommended that the government drop its ideological opposition to further privatisation, focus on reform of roading management rather than on rail or public transport, and address the problems of (government-induced) uncertainty, creeping regulation and the impact of the RMA.

Removing the artificial barriers to investment in infrastructure is essential if we are to continue to grow as an economy and a society. The greatest concern that I and many others in the business community have is that New Zealand is moving too late and too slowly. Surely we should ask why central government and councils are taking so long to address these issues. With an economy that is currently achieving faster average growth rates than in the past, and which could do much better yet given continuing reforms, the economic costs of poor infrastructure policies are high and unnecessary.