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**LOCAL AUTHORITIES' COMMERCIAL  
ACTIVITIES AND THE ROLE OF CONSULTATION**

**ROGER KERR  
EXECUTIVE DIRECTOR  
NEW ZEALAND BUSINESS ROUNDTABLE**

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## **LOCAL AUTHORITIES' COMMERCIAL ACTIVITIES AND THE ROLE OF CONSULTATION**

### **Introduction**

The coalition agreement states that "any sale of over 24.9 percent [of power and gas utilities, airports and ports] would require prior approval of ratepayers or consumers".

The suggestion that local authorities or trusts be required to seek the approval of ratepayers before selling commercial assets raises two issues:

- the case for and against privatising local authorities' commercial activities, including utilities; and
- the best form of community input into the decisions of local authorities and trusts.

This paper considers each of these issues in turn.

### **The case for privatisation**

In my view, the case for private ownership of local authorities' commercial activities is overwhelming. Businesses exposed to competition, the disciplines of capital markets and monitoring by interested owners have much stronger incentives to perform than those merely subject to political oversight. Many of the important constraints on private sector managers cannot be replicated in the public sector. The absence or weakness of these mechanisms has adverse implications for their performance.

Providing state-owned enterprises (SOEs) and Local Authority Trading Enterprises (LATEs) with the objective of operating as successful businesses has generally resulted in substantial performance improvements. Despite much initial opposition to this step, corporatisation is no longer an issue. The debate has moved on and there is now widespread recognition that privatisation further improves the performance of businesses owned by local governments and trusts. It also ensures that capital intensive organisations can freely access capital markets – overcoming the problem of capital constraints on business expansion which local governments and trusts often face. With privatisation, ratepayers are not exposed to the risk inevitably associated with involuntary investments in commercial activities.

Privatisation facilitates the restructuring of industries where local government has a heavy involvement. For example, privatisation and corporatisation of electricity distribution companies has led to a number of them merging and restructuring. However, the weak incentives of local government and trust-owned organisations to seek out efficiency gains have meant rationalisation has proceeded at a painfully slow pace. The failure of local governments and trusts to privatise their electricity utilities is a major reason why the gains from electricity reform have been less than expected. The case for separating distribution companies into energy and line companies to solve perceived problems in the electricity market is not self-evident. A far higher priority is for local authorities and central government to withdraw from involvement in the electricity industry. Privately owned distribution companies would have strong incentives to embark on further restructuring. The sale of ECNZ and Contact Energy would create two major players with the potential to vertically integrate and increase competition in the local distribution markets. Competition would ensure that the benefits of rationalisation and greater efficiency were shared with consumers.

A number of arguments are still put forward against privatisation. None of them stands up to scrutiny.

One of the more easily rebutted claims is that the sale of a commercial activity would result in higher rates because the local authority would no longer receive a dividend stream. This is clearly not the case. If the local authority sells, it exchanges one asset – its shareholding in a company – for another, cash. While the council no longer gets dividends, it gains the capitalised value of the expected future earnings stream of the business – which is likely to be higher under more efficient private ownership. The proceeds can be applied to reductions in debt and/or rates. Only if councils regard the money as manna from heaven and spend it unwisely will rates rise.

If the shares are given to individuals, they will gain an income stream equivalent to that which previously accrued to the local authority or trust. Any increase in rates to match the income forgone by the local authority would be matched by an increase in the income received by individuals.

Another suggestion is that the assets cannot be sold because they are 'strategic'. But does this label have any content? What is meant by 'strategic'? If 'strategic' means the assets are important to New Zealand's economy or to the company's customers, this merely strengthens the case for privatisation. The more important the organisation, the more important it is that it operates with maximum efficiency. We would hardly choose to rely on public enterprises for the production of essentials of life such as food. The efficient production of private goods is most likely to be achieved by private owners.

The coalition agreement focuses on infrastructural or utility assets. Yet there is nothing special about these organisations that justifies special constraints. They do not produce public goods which might justify government involvement. The fact that the industries are often capital intensive merely strengthens the case for private ownership. Some have elements of monopoly power, but so do other organisations that are not subject to special controls.

The suggestion that government or trust ownership somehow constrains any monopoly power that an organisation might have is not borne out in practice. If a government-owned organisation operates without a profit motive, the result is likely to be cost padding, waste and poor service. New Zealand has had plenty of experience of this kind with organisations such as harbour boards and municipal electricity departments. Either prices to customers are raised to cover the inflated costs, or the organisation operates at a loss and ratepayers or taxpayers pay the bill.

Corporatisation improves the incentives of a government entity to minimise costs and operate efficiently. However, if an organisation has market power it may be tempted to abuse it. The prospect of monopoly pricing therefore needs to be faced when businesses are corporatised. Experience in New Zealand to date suggests that market deregulation and a light-handed regulatory regime will provide a reasonable restraint on any market power organisations might have, while not interfering unduly with commercial decision making. Once organisations are corporatised, no new monopoly issues arise with privatisation.

Many reviews of experience with privatisation have provided empirical evidence of the benefits of privatisation, including of utilities such as telecommunications businesses. This evidence supports the case for private ownership, whether or not the organisation has monopoly power. Of course some public enterprises have

performed well for some periods of time, and some private enterprises fail. The evidence, however, is that, on average and over time, privately owned businesses outperform publicly owned ones. As Nobel laureate in economics George Stigler has observed:

... we must base public policy not upon signal triumphs or scandalous failures but upon the regular, average performance of policy.

While ideologues attempt to represent privatisation as an 'extreme' policy, it is now the norm in many parts of the world. Most other countries have accepted the substantial gains that privatisation can achieve. In the ten years to 1995, worldwide sales of state-owned enterprises amounted to US\$535 billion. That is an unprecedented shift of resources from the public to the private sector. While New Zealand is sleepwalking, China – nominally still a communist country – is moving to privatise vast numbers of inefficient state enterprises. In the March edition of *Financial Market Trends*, the OECD estimated that privatisation in its member countries, already at an all time high last year, could reach a record US\$100 billion in 1997.

The coalition agreement proposes that ports, airports and gas and electricity utilities are 'strategic' assets that require special treatment. Yet in country after country such activities are being privatised. Australia has privatised most of its major airports. Victoria has sold two of its smaller ports and the sale of the Port of Melbourne may follow. Gas and electricity utilities are predominantly in private ownership around the world.

### **Restrictions on shareholding**

There is little merit in local authorities or trusts selling 24.9 percent or less of their shareholdings. Caps on the holdings of individual shareholders and constraints on foreign ownership are also undesirable.

A sale of a minority shareholding to a private party can have some benefits. Private owners may bring valuable commercial experience to a company. They are likely to focus on achieving commercial returns. Private owners have stronger incentives to monitor the firm since their wealth is directly at stake. If the shares of the company are listed, its performance will be subject to continuous monitoring by professional analysts and other market participants.

However, partial privatisation perpetuates many of the problems of government ownership and can create new risks, as experience with SOEs such as the Bank of New Zealand should remind us. It may create a shareholding group that will lobby the local government owner for special treatment. The private shareholders may favour an excessively risky investment strategy if they believe the majority government owner would bail out the organisation if it got into trouble.

Restricting private ownership to a minority holding weakens the controls on management performance imposed by capital markets. Investors have reduced incentives to monitor management if they cannot gain control of a company. At the same time, the threat of a takeover cannot constrain poor managers in organisations with majority government ownership. As long as councils are the majority shareholder, problems with designing an effective monitoring regime will remain. Political interference in the business is likely. The recent reaction by local politicians to Southpower's announced intention to increase its prices is a case in point.

Selling a minority stake may create a risk that future partial sell-downs or dilutions will allow control to be transferred to the initial minority owner without capturing the benefits for ratepayers of the premium for control. For example, if an initial owner has 20 percent and the government owner subsequently sells another 30 percent, the incumbent faces no other bidders who can achieve control.

Constraints on foreign ownership are undesirable. Such restrictions may prevent the most efficient owners – those with the most relevant expertise – from taking control of the assets. They reduce access to sources of capital, management expertise and technology. The benefits of a liberal foreign investment policy are well understood. There are no grounds for applying special restrictions to the industries listed in the coalition agreement.

The wider costs of imposing constraints on foreign investment can be seen in the response of some Asian countries to their current financial difficulties. The anti-foreign investment actions and rhetoric of some governments increased the turmoil in their currency markets and could provoke a deeper crisis affecting employment, investment and economic growth.

### **Techniques for privatisation**

Two main options for implementing privatisation at the local government level have merit. The first is simply to freely distribute the shares to ratepayers or consumers. This method has a great deal in its favour. It returns the assets to their true owners. In a sense a share giveaway is the ultimate form of democracy since it allows individuals to make their own choices as to how their assets are used. Individuals might choose to sell their shares to fund a medical operation, improve their home, or buy clothes for their children. They might prefer to retain the shares. Households are perfectly capable of making their own choices. Politicians cannot determine what trade-offs are in the best interests of any particular household.

Another advantage of a share giveaway is that local governments are not left with surplus cash. Owners of companies are increasingly demanding the return of surplus cash by way of special dividends or share buybacks, so that boards and managements do not redirect them to low return ventures. Councils may be tempted to regard the income from the sale of shares as a windfall gain, to be spent on projects which would otherwise not have high priority.

Community trusts have control of substantial assets yet are subject to minimal accountability requirements. Their objectives are unclear and may differ substantially from the individual members of the community who are the ultimate owners. The long-run performance of trusts in industries such as financial services and liquor retailing has generally been poor. The case for trusts giving away shares to ratepayers is therefore particularly strong. It reduces the likelihood that trusts will squander their wealth on low return activities, or provide benefits to some interest groups at the expense of others. The incentives of a community trust to adopt a share giveaway are likely to be very weak. Few 'public' organisations go out of business voluntarily.

The suggestion that assets should remain under so-called 'community control' is really just an argument for control by politicians. An article on the retreat from socialism in China makes the point nicely: "What most unsettles the party about relinquishing state ownership, however, is the loss of political control". This concern probably motivates much of the opposition to the idea that councils or trusts should return assets to their owners.

It is sometimes suggested that a 'community' is an entity that is different from its constituent members. This claim is usually followed by a demand that the 'community' assets be used to fund some special interest or another – for example infrastructure or 'cultural assets'. However, there is no sense in which a community has interests that are different from those who make it up. If individual members of a community are not prepared to fund infrastructure directly, this indicates that the benefits from the investment are unlikely to outweigh the costs. If resources are passed back to individuals they can each make this choice for themselves.

The other option for privatising utilities is a competitive sale of the shares – either a trade sale or a float of shares, with the sale proceeds returning to the council or trust. This option has merit if the council or trust makes good use of the proceeds – for example to reduce debt or rates.

A competitive sale ensures that the assets end up in the hands of those who can most efficiently operate them. If the sale process is well managed, it should enhance the wealth of the local authority. In a competitive sale process the local authority seller should capture some of the gains in efficiency that the new owner expects to make. Thus the seller gains more by selling than it could achieve through ownership. If the proceeds of a competitive sale are put towards the reduction of debt, for example, the sale of assets will improve the overall financial position of the council and ratepayers. A free and open sales process achieves the maximum benefit. This requires that there are no constraints on who may own the shares, whether they be local or foreign buyers. Since the maximum value is realised by capturing any premium for control, it makes little sense to sell less than 24.9 percent of the business.

## **Consultation**

Consultation about council activities is an important part of the democratic process but is no substitute for sound analysis and the responsibilities of representative government. The strength of representative government is that it delegates decision making power from principals (the electorate) to their agents (the elected representatives) who generally have the ability to research and debate policy options in much greater depth than their constituents. They have incentives to implement options that appeal to the majority. Citizens can vote out politicians who do not act in their interests.

Good representative government requires principled decision making and effective leadership by elected representatives to promote, explain and justify sound council actions. Decisions on the activities that a local authority is to be engaged in, and how they are undertaken and funded, need to be based on sound public policy analysis.

There are many reasons why the overall interests of the community cannot simply be determined by collecting expressions of view through meetings, polls and submissions. Many people do not take part in such processes. The information available to elected representatives cannot be provided to the public in the same detail. Sometimes there is a need for confidentiality. Constituents cannot be expected to devote the same amount of time to reviewing the relevant issues as councillors. The cost implications of options are often not fully considered and trade-offs can be difficult to assess. When differences are entrenched, consultation cannot produce a decision. Nor should the majority interest necessarily be allowed to prevail over the minority – democracy (properly conceived) is not a system in which 51 percent of an electorate can automatically coerce the rest. Finally, the political

process is vulnerable to the interests of organised and vocal groups that benefit from successful lobbying taking precedence over those of the unorganised and inactive majority.

Nevertheless, all successful politicians are sensitive to public opinion. Local authorities are likely to find consultation a useful adjunct to their decision making.

Consultation is an important part of the annual planning process undertaken by local authorities. The requirements for information disclosure and consultation as part of the annual plan have been strengthened with the amendment to the Local Government Act that will come into force from July next year. Ratepayers have available to them detailed information about local authorities' intentions and have the opportunity to comment on draft annual plans. Their views help to shape the final annual plan adopted.

The annual planning process is the logical way of informing ratepayers and seeking feedback from them on decisions likely to materially affect their well-being. A local authority intending to sell assets, whether utilities or other businesses, should signal its intentions in the annual plan and seek reactions.

The sale of a utility is just one of many council decisions that affect the well-being of constituents. The sale of other businesses, the purchase of assets and decisions on expenditure have similar effects. A decision to sell a utility is by no means the most important type of decision that councils make as it merely converts one asset into another. A well managed sale would generally enhance the financial position of a local authority and reduce the burden borne by ratepayers. In contrast, increases in local authority expenditure may have a greater impact on ratepayer well-being by increasing the rating burden.

This raises the question of why the sale of a utility should be required by legislation to follow special consultation procedures. It is hard to see any such case. In my view the sale of a local authority's shareholding should be subject to the normal annual plan requirements, including the existing consultation provisions.

Nevertheless, it is worth considering whether ratepayers or the community should be able to impose additional constraints on local authorities and trusts in making some of their decisions.

One possible option is to make greater use of ratepayer polls. I have an open mind on this possibility, and see both costs and benefits. If polls are to be used at all, they should be reserved for exceptional situations since they are in some respects contrary to the principles of representative government.

Ratepayer polls should generally be restricted to local constitutional or electoral matters or be used to constrain local authorities from exposing ratepayers to substantial increases in risks or higher rates. Thus polling might be justified for major expenditure proposals such as the Britomart development or the Wellington stadium that are outside the core responsibilities of local government. Polls should not be used to prevent local authorities from restructuring their assets.

Given the lack of accountability of trusts, and the limited incentives that the community has to monitor their performance, trusts are not good structures for managing large capital intensive assets such as ports, electricity utilities or water supply businesses. Their continuing role in administering assets for charitable or other purposes is also questionable.

Community trusts are likely to wish to continue operating whether or not they contribute to the community's well-being. I can see advantages in requiring them to consult with the community on whether they retain shareholdings in commercial activities or the proceeds of any sale, or whether they should return them to individuals in the community. There may be a case for exposing them to more stringent requirements.

For example, the case for distributing the assets of the Auckland Regional Services Trust (ARST) to the Auckland community is compelling. In the absence of political leadership, however, it is possible that special interest groups may derail a discussion of what should happen to the ARST's assets. A case could be made for allowing the electors of Auckland to decide the matter themselves by way of a poll. To ensure an objective presentation of the issues, an independent panel of disinterested persons with no connection to the ARST could be set up to administer the consultation process.

## **Conclusion**

My conclusion is that utilities owned by trusts and local authorities should all be fully privatised. There is only limited merit in a partial sale. Privatisation could be achieved either through a share giveaway or through an open, competitive sale process.

Consultation about council activities has an important role in a democratic system. Consultation is part of the annual planning process. This process provides the logical forum for informing ratepayers about local authority intentions in relation to their assets, and seeking feedback from the community.

Inevitably only a small number of individuals will present their views to councils. There is no guarantee that the views expressed through these processes are those of the majority.

Thus consultation is no substitute for sound representative government. Elected representatives should base their decisions on sound analysis, rather than merely collecting expressions of view through meetings, polls and submissions. There is no case for special consultative requirements covering the disposal of shareholdings in excess of 24.9 percent in utility companies.

Ratepayer polls should be reserved for exceptional circumstances such as the review of constitutional or electoral issues, or to constrain local authorities from exposing ratepayers to substantial increases in risk. They may also be useful in deciding the future of community trusts where the constraints of representative government are weak or absent.