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**PAYING FOR PAROCHIALISM:
THE COSTS OF STALLED PORT REFORM**

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1 Introduction

The New Zealand port reform programme that began in 1988 has seen enormous improvements in the efficiency of the ports industry. The Business Roundtable was a strong advocate of the corporatisation of harbour boards and of reforms to waterfront employment arrangements, despite much local government and union opposition at the time. Exporting and importing industries and the whole economy have benefited from the changes. However, much remains to be done. My purpose in this paper is to focus on why further reform is essential.

I've been asked to address two issues. First, is privatisation the next logical step? The short answer to this question is 'yes'. The second question is whether there any other viable options. The answer here is that there may be alternatives, but they are all inferior to privatisation.

The efficiency gains achieved since port reform began are evident at ports throughout New Zealand. The waterfront labour reforms and subsequently the Employment Contracts Act have led to large improvements in labour productivity. Port companies now focus on asset utilisation and capital management. These changes have resulted in increased profitability and returns compared to the days of harbour board operation, as well as better service. Ports now operate 24 hours a day and 7 days a week. The average turnaround time for a container vessel at Ports of Auckland has dropped from 38 hours in 1989 to 15.5 hours in 1998.¹ This is despite the fact that, on average, each ship is handling twice as many containers as in 1989. The cost of baggage handling for luxury cruise ships at Auckland is now a fifth of what it costs at Sydney.

¹ Geoff Vazey, "New Zealand Ports - We Can Do Better Yet", Speech to Shipping Conference, May 29, 1998.

However, the pace of change in New Zealand's port industry has slowed since the initial gains were made. The glaring omissions from the reforms of the last 10 years are industry privatisation and rationalisation, and the two are closely linked. Most local authority owners have been reluctant to divest their shareholdings or merge with other port companies. Since port ownership was transferred to them in 1988, most councils have treated the businesses as cash cows. Although councils have, on balance, interfered less in commercial decision making by port companies than they have with local authority trading enterprises, their resistance to private investment in port companies has prevented many potential efficiency gains from being realised.

This paper first discusses the opportunities and risks created by international trends in the shipping industry and their implications for the development of New Zealand port industry strategies. Secondly, I provide some examples of the benefits resulting from private sector investment in ports in the United Kingdom. These benefits illustrate the costs of continued local authority resistance to change. Finally, I will examine what privatisation might mean for New Zealand's ports.

2 International Trends

Two trends are affecting the port industry worldwide: the increasing use of larger ships and rationalisation of the shipping industry through shipping company mergers. Together, these factors are leading to the hub and spoke route structure for ships that has evolved in the airline industry since deregulation in the 1970s. Hubbing in the shipping industry is transforming sea transport just as it transformed air transport. Shipping lines use hubbing to save transport time and fuel costs by reducing the number of port calls they make. Hubbing improves their asset utilisation, which is a critical factor in shipping profitability. The trend towards hubbing will intensify as shipping lines build container vessels that can hold up to 8,000 twenty foot equivalent units (TEUs). Hubs within hubs are forming with the development of pure transshipment ports, for example in Malta and the Bahamas, at which cargo is transferred from one ship to another. Transshipment ports cannot rely on a large

population base to attract shipping lines, so they must make their cargo handling services extremely efficient.

Similar cost pressure is hitting mainland hubs, where cargo is transferred to local feeder services and other forms of transport. Like transshipment hubs, mainland hubs face the loss of business if handling costs are not minimised. In addition, they must optimise the links between sea, road and rail transport.

Hubbing is a technology intensive system. With extremely high cargo volumes, small improvements in unit handling costs can justify significant capital expenditure. For example, some very large operators such as Dubai Ports Authority are using differential global positioning systems (DGPS) which allow operators to locate containers to within 2.5 centimetres and to steer gantries automatically. With millions of TEUs handled a year, a small productivity improvement can mean big cost savings. Other forms of automation are becoming more common, using technology such as electronic data interchange and radio data terminals. The Port of Singapore Authority is investing in a remote-controlled bridge crane system for Pasir Panjang Terminal.² This is designed as an unstaffed terminal to handle 20 million containers per year. Ports of Auckland's recent investment in electronic data interchange is the first part of a major capital expenditure programme designed to reduce its costs and improve productivity.

The other factor placing pressure on port costs is the recent spate of mergers between shipping companies, some of which have themselves been driven by financial pressures. Merged companies are able to choose between existing ports of call. For example, when P&O and Nedlloyd merged, they had the choice of calling at either Hong Kong International Terminals or Modern Terminals Limited (MTL). Mergers have given shipping lines greater countervailing power which they have used to push for better service at lower prices.

² Port Development International, September 1997, "Sophistication gets sexier".

These trends are being felt in New Zealand. Auckland is widely acknowledged as New Zealand's hub port, with Lyttelton acting as a smaller hub for South Island traffic. Some ports will increasingly have to focus on specialised break bulk cargo handling to survive. Others may have to manage a continued decline in activity.

3 Gains from private investment in the United Kingdom

Ports in the United Kingdom were privatised in the 1980s. Since then, three major benefits of private ownership have become clear. First, industry rationalisation has occurred. Second, investment by specialist port investors has given UK ports access to a wide range of expertise which was previously unavailable. Third, the new investors have been willing to undertake extensive capital expenditure programmes in both containerised hub ports and in more specialised bulk cargo ports. However, capital expenditure has required commercial justification. Private port operators have been driven by profitability, not by local politics. Investment is not constrained by access to local authority funds.

A few examples of port developments indicate the scope of current investment programmes. One major port operator is Hutchison Port Holdings, which has investments in 17 ports around the world, including Hong Kong International Terminals, and handles over 10 percent of the world's container moves. At the port of Felixstowe, the UK's largest container port, Hutchison is spending more than £100 million during the next four years. This spending will be focused in three areas – new equipment (11 new cranes), information technology to allow for more efficient cargo handling, and additional rail infrastructure. Hutchison's investment at Felixstowe will increase annual capacity there by about 500,000 TEUs – more than the total container volume at Ports of Auckland in 1997. The company is continuing to invest in the United Kingdom and last year bought two more ports – Thamesport and Harwich International Port.³

Felixstowe has benefited not just from Hutchison's access to capital but also from the experience of other ports owned by Hutchison. One feature of the expansion programme at Felixstowe is the installation of a Radio Data Terminal (RDT) system which is already in operation at Hutchison's terminals in Hong Kong and the Bahamas.⁴

Another major port company is Associated British Ports (ABP). ABP now owns 23 ports in the United Kingdom, is listed on the London Stock Exchange and is subject to intensive monitoring by capital markets. It is the owner of the port of Southampton where it is spending £60 million on increasing its handling capacity to over 1 million TEUs per year and on increasing the channel depth so that access for large container vessels is improved. ABP has also spent more than £90 million at the ports of Grimsby and Immingham in the past five years. These ports specialise in bulk handling, including oil and sugar, and vehicle handling. The surrounding road network is uncongested, the ports have good deep water access, and a significant industrial base is nearby. ABP is forecasting substantial volume growth at these ports.

Smaller ports have also prospered when taken over by private owners. The UK port of Boston was sold to the Cleveland Trust in 1990, and has since increased its volume of trade and its revenue significantly. The Rutland Trust sold Thamesport to Hutchison last year for £112 million, more than twice its purchase price a few years earlier.

4 Further reform in New Zealand

There are 14 ports in New Zealand. Without private ownership, there is no sure way of knowing whether this number represents the most efficient port industry structure. It is likely that specialist port investment companies would be interested in owning more than one port in order to exploit operational synergies and reduce overhead costs. Substantial gains from rationalisation seem likely. A private owner of a number of ports could better rationalise facilities at different ports, enabling them to specialise in

³ Port Development International Magazine, September 1997, "Spending to Accumulate"; Port Development International, April 1998, "Global Port Investors".

different activities and to reduce port operations where this is desirable. Private ownership would give New Zealand port companies the opportunity to participate in port industry developments overseas, for example in Australia where the Victorian government has privatised the ports of Portland and Geelong.

Local government ownership is an inefficient ownership structure for port companies. There are four main reasons for this:

- local government ownership prevents rationalisation. This is the biggest problem for the New Zealand port industry. Local government ownership is slowing down investment where it is most needed and keeping resources in inefficient port operations;
- local government ownership would be a problem even if rationalisation were not necessary. The weaknesses inherent in government ownership of commercial enterprises, including the problems of mixed incentives and inadequate monitoring, have been widely discussed;⁵
- local government ownership involves commercial risks which ratepayers should not be forced to bear; and
- even if it made sense for councils to act as investors on behalf of ratepayers, which it does not, a typical local government portfolio of investments in a handful of utility businesses including ports in one geographical region in one country represents a poor investment strategy. Risks are undiversified and expected returns will be less than those available from a balanced global portfolio.

⁴ Port Development International Magazine, July 1997, "Radio ways".

⁵ See, for example, my paper to the New Zealand Water and Wastes Association 'Crossroads for the Future' Conference, 24 April 1998, or Douglas Myers, "Local Government Reform: Time for a New Blueprint", Speech to the ACT New

The problems with local government ownership were recognised by the Labour government at the time of the Port Companies Amendment Act in 1990. The Act permitted local authorities to sell their shares in the port companies. Few have done so. A handful of New Zealand's 14 port companies now have partial listings on the sharemarket, but all have local government majority ownership.

In his speech introducing the legislation into parliament, the minister of transport, Bill Jeffries, commented that the government had misgivings over continued full local government ownership of port companies. His comments are pertinent eight years later:

While the establishment of the companies has enabled commercial port operations to be isolated from the social and political baggage that harbour boards were saddled with, a strong element of the old system will remain as long as local government continues to be the main shareholder

Wider ownership of port companies will ensure a break with traditional local government perceptions that ports can be manipulated, at a cost to users, for the supposed value of regional or local development. History has shown that this attitude has led to bad investment decisions and inefficiency

It is time for local authorities to set aside the last vestiges of the tradition of local government control of our ports, and make their contribution to even greater port efficiency in the future by ensuring that outside investment in port companies can become a reality.⁶

There are a few signs that some local authorities are starting to recognise the benefits of privatisation. The Chairman of Westgate Transport and Deputy Chairman of the Taranaki Regional Council, Ralph Latta, has urged the Council to review its policy on

Zealand/Federated Farmers Local Government Reform Summit, 18 April 1998.

⁶ Hon WP Jeffries, speech to the North Island Waterfront Reform Seminar, July 5, 1990.

port ownership after the October local body elections.⁷ His comments illustrate the problems with the existing ownership structure:

We quite often get approaches from people with their hands out because they seem to think we are some form of local authority... . We have had approaches from people who suggest we should carry out significant developments because they will be of 'economic benefit' to our region. Quite frankly, this is not our job. ... Under Section 5 of the Port Companies Act 1988, Westgate has a responsibility to operate as a successful business. A successful business does not have such things as a community facilities fund, nor does it make multi-million dollar capital investments on the off-chance that they may be of benefit to someone, somewhere down the track.

Mr Latta went on to discuss the potential gains from private ownership:

A local body is risk-averse and that is its job. However, through a cornerstone shareholding, the port company would benefit from new expertise and capital. We would move from a risk-averse shareholder to one which is more entrepreneurial. That would be the major advantage of selling to the private sector.⁸

Southland Regional Council recently considered selling its 69 percent stake in South Port, but has decided not to proceed. It appears that vocal opposition from some Invercargill city councillors and a number of ratepayers affected its decision. The Regional Council justified it by saying the price was not high enough and the public was opposed to the sale.

Southland Regional Council should have sold. Its shares were worth \$1.65 last year at their peak. Last Thursday they traded at 96 cents. There is no guarantee that the value of the shares will increase while it waits. Until it sells, the Council continues to expose ratepayers to the risk of owning the port and prevents additional private sector investment. If the sales process is competitive, potential buyers will undertake due diligence and form their own views about the company's prospects. What makes council members think that their forecasts are more accurate than those of the bidders?

⁷ The New Zealand Shipping Gazette, July 18, 1998.

⁸ *ibid.*

If they put the company on the market, they would have incentives to present the company in the best light possible in order to maximise the sale proceeds. If, having done this, the bidders all believe that the port company's forecasts are optimistic and bid lower than expected, the local authority should sell for the best price it can get. Continuing to own a port company just because council members are not happy with the bids is like going to the races and betting that your horse will win when the odds are 100 to 1 against. The only difference is that councillors take such a risk with ratepayers' money, not their own.

Similar arguments about the timing of sales have been made elsewhere. The chairman of the Wellington Regional Council, Stuart Macaskill, commented in the Council's draft annual plan this year that the Council is "a seller at the right price rather than a holder at all costs." As in the case of Southland, the company has probably lost value in the last year or two. If the Wellington Regional Council ever decides that the price is right, nobody will be able to accuse it of selling prematurely. The possible sale of Port Wellington Limited has been mentioned for a number of years in the Council's Annual Plan, but it never seems to eventuate. The company's board has made it clear on many occasions that the port would be better off in private ownership, as has the board of Ports of Auckland Limited. For their own political reasons, the Wellington Regional Council and the Auckland Regional Services Trust have ignored the commercial advice of their own boards.

A few years ago the Mackenzie and Waimate District Councils sold their 28 percent shareholding in the Port of Timaru to South Eastern Utilities. South Eastern Utilities have since sold their interest to a group of local business people. The Timaru District Council owns the other 72 percent. The ratepayers of the Mackenzie and Waimate District Councils have had no reason to be concerned with the profitability of the Port of Timaru since their local councils sold their shares. However, Timaru residents have seen their already low returns reduced even further. In 1996 the port company paid a dividend which represented a 4.4 percent return on the book value of equity. In 1997, councillors and residents of Timaru had a nasty surprise when Port of Timaru paid no dividend and made a loss of \$2.8 million. It wrote off its investment in two failed

companies, Coastal Pacific, which operated the coastal shipper Searoad, and Turnbull Stevedoring Company.

Timaru's ratepayers would have made more money by putting their share of the stake in the port when it was established into the bank rather than by keeping it in the port. Unfortunately, the Council has not given them this option.

If a local authority really wants to give members of the local community the ability to own their ports and keep them in the community, there is nothing holding it back. It could float the company and ensure that a certain percentage of the shares were offered to local residents. Alternatively, it could give the shares away to ratepayers and let them choose whether they want to keep them or sell them. Too often arguments for 'community control' turn out to be a façade for the vested interests of politicians in maintaining 'political control'.

Under local authority ownership, port company managers' forecasts of volume growth and the need for new investment cannot be tested in the capital markets. Council-owned ports have made some costly investment mistakes. For example, the Sulphur Point development at Port of Tauranga cost approximately \$100 million in 1992 and is only now beginning to operate at profitable levels. Private ownership would force port managers to look harder for alternatives to expensive capital works programmes, such as making better use of existing space. When private port owners are convinced that the best solution to a problem is additional investment, they are likely to be less capital constrained than many local authorities.

Instead of making commercial decisions based solely on enhancing the efficiency and profitability of port operations, local authority owners consider factors such as regional development and keeping local jobs. This makes them reluctant to cut costs or let their port be bought by companies based outside the region. The pursuit of such objectives may be well-intentioned but it is misguided. It comes at the expense of New Zealand's importing and exporting industries, which pay through higher port costs. These costs feed through to all consumers. The inefficiencies cost jobs overall. Some councils such

as Nelson have determined that they will not require their port companies to achieve normal commercial returns. This means capital is not being allocated to its best uses and port users are being subsidised by other ratepayers. Community income is reduced through a misallocation of resources. Local authorities may keep voters happy by refusing to rationalise port operations, but they do nothing for overall economic performance.

0 Conclusions

Privatisation is the best option for New Zealand's ports. The basic alternative is the continuation of the status quo, in which all ports have local government majority ownership. Local authorities can continue to muddle along, priding themselves on past gains and arguing that now is not the time to divest their port companies, while other countries seize the chance to become more competitive relative to New Zealand. With majority public ownership, parochialism and local politics are bound to intrude into decision making, particularly when ports face tough commercial decisions, and the interests of exporters and importers in low cost and high quality services are bound to take second place.

Partial privatisation of port companies has been beneficial. Once listings occur, boards and managements are forced to adopt a clearer commercial focus and to concentrate on maximising shareholder wealth. However, minority shareholdings do not allow takeovers or facilitate industry rationalisation, and do little to ease constraints on capital investment.

These and other gains would come from full privatisation. Port companies would be freed to develop long-term business strategies which they could pursue with confidence. Ports are simply part of the transport chain. There is no longer any public ownership of the land-based connecting links of road and rail transport, or of shipping. There is no reason why the port link should remain in public ownership. Competition issues were addressed when port companies were set up. They have not been a significant problem and in any event are not best handled by public ownership. The

Commerce Act would apply in the case of any proposals for takeovers or mergers in the industry.

At the beginning of the port reform process, the Business Roundtable considered whether central government should require divestment of port company shareholdings over, say, 3-5 years, or whether such decisions should be left to their owners. We hoped that the arguments for privatisation which have been found compelling in so many other contexts in New Zealand and internationally would be accepted by councils. However, by and large parochialism has prevailed. Given the snail's pace of progress made by councils since the Labour government urged them to proceed with privatisation almost a decade ago, I believe there is now a strong case for central government, acting in the interests of the wider community, to require councils to exit from ports and other commercial activities and focus on their proper public goods functions.

The method and timing of divestment should be open to discussion in individual cases. Competitive trade sales, public floats as in the case of Auckland International Airport Limited, and share giveaways to ratepayers are all feasible options. There are advantages in having a substantial cornerstone shareholder, particularly as a catalyst for industry rationalisation. Consultations about sales should be the same as for other major council decisions, namely the normal annual plan process.

Port industry reform has been one of New Zealand's success stories over the past decade, but the country is now paying a price for the lack of a strong forward momentum in the industry, as it is in other areas. New Zealand's international competitiveness rankings have been falling as other countries have moved ahead. International trends in the port industry make continuing rationalisation and adaptability particularly important. New Zealand is a small, open economy. For it to prosper in the international environment, the port reform process should be revitalised.

