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**IIR CONFERENCE ON OWNERSHIP, MANAGEMENT AND
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THE ARST FIASCO: FULL CIRCLE TO NOWHERE

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THE ARST FIASCO: FULL CIRCLE TO NOWHERE

Barely a week passes without the community being reminded of the costs of erratic policy directions as yet another reform initiative falters. This is plainly evident in the government's attempts at microeconomic reform, including efforts to get central and local government out of owning commercial businesses. The latest debacle has been the about-turn by the Wellington City Council, having committed itself to a sale process, on the small and geographically challenged Wellington airport, and the labyrinthine path followed by the government in deciding to dispose of its own shareholding.

Apparently a crucial factor in the Council's case was the decision of one councillor who drives a Wellington bus. On the fateful day he reported that he had listened to what the passengers were saying, decided the mood was against a sale, and thus opposed it. As one analyst remarked, "Pity he was on the Karori run and not Wadestown." Yet leading local government politicians still have the gall to claim they can run businesses as competently as private owners.

The previous similar example of policy meltdown was the creation of Infrastructure Auckland.

This saga is salutary for several reasons. Infrastructure Auckland replaces an entity that was intended to be temporary and was an anomaly in local government. Its creation followed a long and tortuous process that reflected a triumph of parochial politics over principled decision making. Despite its name, no one is sure of its mission and to whom it is accountable. In the ensuing vacuum there has been no shortage of suggestions about how to spend money on low yielding projects. With even less tightly focused objectives than its predecessor, the siren calls for high profile, politically popular but commercially wasteful projects will come thick and fast.

Furthermore, to the extent that Infrastructure Auckland does anything at all, it is likely to impede worthwhile reforms in other areas, either through subsidies that mask the true resource costs of goods and services, or as a shareholder that faces weak incentives to act commercially.

It is worth spending some time analysing these outcomes and looking for lessons for the future.

Infrastructure Auckland's predecessor, the Auckland Regional Services Trust (ARST) was created by statute in 1992. It arose from a reform of the Auckland Regional Council (ARC), which had at the time accumulated debt to the tune of \$224 million. The Auckland Regional Council retained its regulatory functions while the ARST was given the responsibility to manage and ultimately eliminate its debt through a programme of asset sales. In general, these moves made good sense.

The overall quality of the assets inherited by the ARST was low, reflecting the poor incentives of the Auckland Regional Council to make commercially sound investments. For example:

- Regional House was only 50 percent tenanted and had an associated debt of around \$100 million. It was eventually sold for \$36 million;
- the refuse transfer station at Constellation Drive cost \$20 million and was sold for \$4.5 million; and
- the City Bus Depot in Gaunt Street had an associated debt of \$10 million with a market value of \$2.5 million.

The ARST was seen as a transitional structure pending the rationalisation and sale of its assets. The assets that dominated its balance sheet were its 80 percent shareholding in Ports of Auckland Limited (POAL) and ownership of Watercare Services Limited (WSL), Transportation Auckland Corporation Limited (TACL), Northern Disposal Systems Limited and Regional Forests Limited.

The ARST had a relatively tight focus. It was required to apply its revenue to meet its costs, to reduce its debt (where appropriate and consistent with its functions) and, subject to other priorities and at its discretion, to pay any surplus revenue to a Community Trust. Because it did not think the Community Trust would spend money wisely, however, it paid over only minimal amounts.

With its relatively clear commercial focus, a favourable economic environment and the benefits of port reform, including substantial capital distributions by Ports of Auckland, it is unsurprising that the ARST managed to repay its debt ahead of schedule. Only those who did not understand the inefficiency of ARC and harbour board management

and the benefits of commercialisation regarded this achievement as a miracle. But having repaid its debts and being unwilling to commit funds to the Community Trust, the ARST started to have second thoughts about its future. The notion that it was intended to be a temporary structure also began to recede in the minds of other local body politicians.

Self-servingly, the ARST started to talk up problems about Auckland's infrastructure 'crisis' and the need for a funding agency to address and coordinate infrastructure needs. Cost estimates for funding necessary infrastructure of upwards of \$6 billion were bandied about. A study was funded by the ARST that proposed its replacement by an Infrastructure Bank. By the time the government published its discussion document *Pathways for Auckland* in mid-1997, infrastructure had become the central issue in considering the ARST's future.

Conveniently overlooked in the debate was the fact that Auckland is currently growing at a slower rate than in the 1960s. When pressed to be more specific, infrastructure needs of between roughly \$2 billion and \$4 billion were asserted by the ARC and Auckland local authorities, and these figures represented undiscounted costs over 20 years – hardly the stuff of an infrastructure funding 'crisis'.¹

But talking up an infrastructure crisis had served the purpose of obfuscating the debate about the future of the ARST. *Pathways for Auckland* set the scene for the ensuing struggle between competing local body interests that wanted to grab a slice of the pie. The document raised various options which broadly provided that the ARST be retained but be given the responsibility to fund infrastructure; that its assets be distributed to territorial local authorities to fund infrastructure; that a new holding company should be set up for this purpose; or that the assets be distributed to local authorities or to local electors.

Auckland politicians vigorously resisted the idea that shares in commercial investments (other than Watercare) might be distributed to electors. The catch-cry was that distributing shares to ultimate owners would remove community control and accountability. The practical (un)reality of current community control and accountability is illustrated by the fact that only 35 percent of electors in Auckland

¹ Information released under the Official Information Act.

voted at the last local body elections for the ARST, and fewer than 20 submissions on its 1997 Annual Plan were received. Voters are too busy and have too many competing priorities to invest time in selecting representatives on organisations like the ARST or monitoring their decisions.

Accordingly, community control and accountability is, in reality, the exercise of control and accountability by and to politicians. Further evidence of this is the fact that the legislation that set up Infrastructure Auckland is replete with provisions that reflect behind-the-scenes compromises and deals. Unsurprisingly, the hand of politicians has been strengthened. Accountability to the electorate will, in the future, be even weaker with members of Infrastructure Auckland appointed by, and only indirectly accountable to, an electoral college comprising local body appointees.

Political control does not necessarily promote community accountability, let alone efficient service delivery. As one observer in the United States noted in the context of the electricity industry:

When state regulatory agencies began urging electrical utilities to encourage conservation among their customers and to develop alternative energy sources, investor-owned utilities did more than municipally-owned utilities serving comparable markets. For many years the Environmental Protection Agency had more success in getting private power generators to reduce pollution than it had in getting the Tennessee Valley Authority to do so... . [Public] agencies enjoy political protection denied to most firms.²

Similar results that confirm the superior efficiency and compliance of investor-owned firms have been found in other studies. For example, since private investors have helped supply water to Paris from the mid-1980s, water provision has improved dramatically. The level of unaccounted-for water dropped from 22 percent in 1987 to 12 percent in 1991. Information about the quality and condition of water supply assets has also improved dramatically.³

² Wilson, James Q (1989), *Bureaucracy: What Government Agencies Do and Why They Do It*, Basic Books, New York, p 359.

³ On the successes of the French model in Paris, see World Bank, (n.d.), *Potential Private-Sector Participation in Lima's Water Services, Water and Sanitation Utilities Partnership*, Report No 2, p 7.

The problems with Infrastructure Auckland begin with its mandate. The principal function of Infrastructure Auckland is to provide grants to regional projects involving land transport, passenger services and operations of stormwater. The grants are restricted to projects or parts of projects that generate "benefits to the community generally in addition to any benefits that accrue to any identifiable persons or groups of persons". The idea here is to confine Infrastructure Auckland to public goods activities: services that cannot readily be provided and charged for by the private sector on a commercial basis. In addition, \$10 million is to be provided to fund the arts.

However, most of the activities envisaged for Infrastructure Auckland cannot be justified on the basis of public goods criteria. Thus there is little role for a regional funding body for land transport. State highways are currently owned by Transit New Zealand, with territorial local authorities providing local roads. Reform of existing institutional arrangements, including of road pricing, offers the best prospects for ensuring that the right mix and level of investment in roading occurs. Grants by Infrastructure Auckland risk creating distortions which would result in prices not reflecting the full costs of road provision and in inappropriate investments.

Likewise, there is no compelling case for a specialist agency to fund public transport options such as light rail. Given a proper road pricing system, including congestion pricing, efficient public transport decisions would be made on normal commercial criteria.

But the absence of a sound rationale has been no impediment to various parties suggesting ways of spending millions of Auckland ratepayers' dollars. Proposals have included a rail tunnel to Mount Eden (which briefly excited local interest), and hovercraft services on the Manukau Harbour. A hardy perennial that has been given new life by the advent of Infrastructure Auckland is the development of a light-rail network. This continues to be promoted in some quarters despite the absence of any respected international research that shows that a light-rail network would be economic for a city of Auckland's size and geography.

Auckland mayors have focused on the commercial assets of the ARST because of the potential to milk them as cash cows. Having access to a stream of income to fund

projects that are attractive to lobby groups but of little other merit is a far more attractive proposition than having to justify funding them from rates and user charges.

It follows that there was no need to set up Infrastructure Auckland to deal with perceived local problems. No such structures have been found necessary in other parts of the country. The chronic infrastructure problem in Auckland today is roading, which is best dealt with by the commercial approaches which the government is promoting. Similarly, other infrastructure services like electricity, gas, airports, ports and telecommunications are best provided by commercial utilities and there is no need for either central or local government to own or operate them. This has long become a widely held view. Only a dozen years ago the main infrastructure problem in Auckland was making telephone calls to the central business district. The opening of the telecommunications market to competition and the corporatisation and privatisation of Telecom solved that problem many years ago. The same lesson applies in the electricity industry: the confused governance structures of Mercury Energy did not help decision making in the company and continue to hold it back.

It became apparent to many participants in the ARST debate as it progressed that there is no such thing as an amorphous concept of infrastructure, merely a number of specific utility businesses, all of which – including increasingly roading and water and sewerage – can be run on conventional commercial lines. By contrast, it was found that the list of genuine public goods that required non-commercial sources of funding was exceedingly short, and that standard funding mechanisms for them were already in place. As noted, public transport is not a public good and the only possible candidate of any consequence is stormwater. Where user charges or proxies for them are inefficient, public goods should be financed from taxes or rates. In this way those making decisions about their provision are directly accountable to taxpayers and ratepayers. Stormwater services have been financed in Auckland and elsewhere in this way. Using the mechanisms of Infrastructure Auckland for this purpose merely blurs public accountability for decisions.

Even within the confines of the misconceived objectives of the promoters of Infrastructure Auckland, the legislation is deficient. There is an inadequate separation between the role of Infrastructure Auckland as a funding agency and its role as a manager of commercial investments to fund its activities. Locking in an undiversified portfolio for Infrastructure Auckland dominated by Ports of Auckland exposes its funding base to risks which few prudent fund managers with Infrastructure Auckland's

funding responsibilities would wish to accept. If the arguments for an infrastructure fund were sound – which they are not – logic would point to divesting disproportionately large assets in a specific geographical region and investing the proceeds in a balanced global portfolio to yield maximum returns.

What should have happened to the assets that made up the ARST? The reality is that the ARST is essentially just a holding company for a handful of businesses. The deficiencies of trusts as a governance form for capital intensive commercial operations are well known. The original plan should have been adhered to, namely that the restructured businesses should have been progressively moved to the private sector and the ARST wound up. The proceeds of the sales should have been returned to Auckland ratepayers or, alternatively, shares in some of the businesses could have been issued directly to ratepayers. All these options remain feasible and desirable.

Events were moving down that track. The ARST disposed of most of its property assets some time ago. It has now sold its bus operation to Stagecoach. Last week the chairman of the ARST was extolling the virtues of the sale in terms of improved services, new investment in buses and a good sale price. He did not mention that the ARST had stalled over the sale for years and had to be pushed into it by central government. Similarly, the forestry assets are on the market and the sale of the waste disposal business should be straightforward.

Essentially that leaves only the major businesses of Ports of Auckland and Watercare as well as the smaller investment in the America's Cup Village, a property investment that can be readily disposed of in due course.

Ports of Auckland was set up under the Port Companies Amendment Act in 1990. 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. The points he made about the mismanagement of ports under local government ownership are as pertinent today as they were then:

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.⁴

The ports legislation permitted local authorities to sell their shares in the port companies. The Waikato regional council sensibly proceeded to sell its 20 percent shareholding in POAL but the ARST declined to do so. The company has benefitted from partial listing. The disciplines of the sharemarket force directors and management to adopt a sharper commercial focus, and limit political interference. Nevertheless, POAL continues to be hampered by the constraints of public ownership in a number of ways. It has suffered from political infighting over the membership of its board. Public ownership and parochialism is an obstacle to rationalisation of the ports industry in New Zealand, which is necessary in response to international trends in shipping services. Capital raising constraints on new investment could be a problem at some stage, and the company is hampered in developing broader business strategies which could include, for example, involvement in the ports industry in Australia.

The sale of the government's shareholding in Auckland International Airport Limited has been accomplished successfully and with minimal controversy, and the company now has the benefit of majority private ownership. By contrast, Auckland local authorities remain inappropriate minority and majority shareholders in the airport and port companies respectively.

In the case of Watercare, the ARST deserves credit for setting up Auckland's bulk water operation as a quasi-commercial structure. It was the first major move in this direction in the New Zealand water industry, a major industry which has been lagging well

⁴ Hon WP Jeffries, speech to the North Island Waterfront Reform Seminar, July 5, 1990.

behind developments in other countries. Nevertheless, the limitations of Watercare's current structure have been apparent for some time. The legislation which set up Infrastructure Auckland and transferred the assets of Watercare to territorial local authorities almost completely failed to address them:

- it failed to remove uncertainty about whether or not Watercare can charge to recover its cost of capital, thereby retaining a significant obstacle to Watercare pricing water appropriately;
- it failed to allow Watercare to pay a dividend so that it is subject to normal commercial disciplines that promote wise investment;
- it failed to remove restrictions which impede Watercare's ability to sell major non-core assets. This will continue to prevent Watercare from rationalising its assets by freeing up cash for investment elsewhere or to repay debt or capital; and
- it entrenched ownership of Watercare by its customers which, together with the other restrictions noted, will lead to the under-pricing and wasteful use of water.

A truth that continues to elude many politicians is that Watercare, or any other entity for that matter, cannot supply services at lower cost to the community merely by not being required to achieve a profit and provide a dividend to its shareholders. Eliminating these expectations simply means that prices will not reflect the full opportunity costs of capital, incentives to control costs are weakened and principles of intergenerational equity are breached, since costs will not be recovered in the period they are incurred. Prices that permit an adequate return on capital are essential to ensure that WSL makes efficient investment decisions. The subsidy inherent in the lack of full recognition of capital costs will promote over-consumption of water and rationing by non-price means or pressure for the premature expansion of capacity. Either way, community welfare is reduced.

There is still work to be done at the national level to establish a sound, modern regulatory framework for the water and sewerage industry. But there is no reason why, within this framework, Watercare should not be placed on a standard commercial footing (like the Auckland City Council's Metrowater) and subsequently why various forms of private sector involvement ranging from franchising to the sale or giveaway of

shares should not be considered. As in the case of ports and power companies, private ownership would facilitate the mergers and rationalisations that are badly needed in the industry.

What all this means is that the outcome of the ARST debate this year was an opportunity lost. Politics triumphed and the result in the form of Infrastructure Auckland is even worse than the previous structure. The rhetoric of Auckland mayors was all about ratepayer control of community assets. The most direct way of reflecting ratepayer control would be through a share giveaway. When this idea was proposed, Auckland local body politicians ran a mile; they even opposed the idea of a referendum on the issue. It turned out that what they were really interested in was political control, not ratepayer control, of commercial assets.

The end result is a case of "California here we come, right back where we started from". The ARST's assets will be put back in the hands of local authorities in Auckland which mismanaged them in the first place. The regional and national economies will forgo the benefits of more efficient commercial operations and the further advantages of potential private ownership. The funds acquired by Infrastructure Auckland will be directed at a non-problem: a minimal set of public goods functions that are currently funded in more transparent and accountable ways. The complex structures of Infrastructure Auckland are unlikely to be an effective shield against special interest lobbying and spending on unjustified activities. In a relatively short period of time we are likely to have the same debate all over again.

In the end, the sorry saga of the ARST's conversion to Infrastructure Auckland demonstrates the failure of those in political leadership to explain the need to understand trade-offs in public policy. The community can have inefficient policies like public ownership or they can have higher incomes and more jobs, but they should not be led to believe they can have both. Those who say they are concerned about poverty and social problems should not complain when they get worse if they consciously support policies which reduce living standards, destroy job opportunities and create unnecessary social stress in their communities.

The handling of microeconomic reforms, including asset sales, are touchstones by which investors judge the quality of the investment environment. The rest of the world is marking New Zealand down fast as a good country in which to do business. The

erratic nature of policy decisions, irresponsible comments by politicians on important national issues, and cavalier attitudes towards contracts and property rights are all major negatives. The mishandling of various initiatives over recent months is an extension of a lack of commitment in recent years to serious ongoing reform. This has contributed to the deep economic problems the country is now facing. Those on the margins of our community and who seek to enter the workforce over the next few years face a bleak outlook without a revitalisation of the reform effort. This should include revisiting almost every aspect of the recently enacted legislation that created Infrastructure Auckland.