

30 April 2007

Rates Inquiry
PO Box 10-916
The Terrace
Wellington 6143

Independent Inquiry into Local Government Rates Funding

Introduction

The New Zealand Council for Infrastructure Development notes that one of the primary drivers of the need for increases in local authority rates funding is the need to redress past infrastructural underinvestment and growth in demand for infrastructural services. Ensuring adequate funding for infrastructure development is an issue of direct concern to NZCID.

NZCID is a non profit organisation. Members comprise a diverse range of leading private and public organisations including infrastructure equity owners, financiers, constructors, service providers, public sector agencies, and major infrastructure users. NZCID was formed in 2004 to promote world class infrastructure development for the benefit of all New Zealanders, a goal we are committed to achieving by:

- Raising awareness of the fact that infrastructure underpins our community's quality of life and that inadequate infrastructure holds back New Zealand's economic, social and environmental development
- Generating valuable debate on the quality and level of infrastructure provision to meet New Zealanders' needs
- Encouraging the implementation of best practice infrastructure provision and management
- Identifying the condition of New Zealand's infrastructure and the challenges facing our infrastructure providers.¹

NZCID wishes to raise two key issues in respect of the rate review:

1. The need to adopt alternative means for funding infrastructure including public debt and options for private sector funding of public infrastructure

¹ Information on the Council, its members, policy and work can be found at www.nzcid.org.nz

2. Recommendation that a separate inquiry be undertaken to evaluate potential for efficiencies to be gained from local body structural reform

This submission represents the views of NZCID as a collective whole, and may not necessarily represent the views of individual member organisations, some of whom will be making their own individual submissions.

Alternative funding for infrastructure including options for private sector funding of public infrastructure

The analysis undertaken by the Rates Inquiry panel shows that many Councils are struggling to fund the levels of investment required. They face significant infrastructural renewal particularly in roading, public transport and water while at the same time are under constant pressure to reduce increases in the rates and levies they charge. While Government subsidy schemes exist, these are greatly oversubscribed and insufficient.

Lack of funding means there is a significant risk that much of the planned or future projected infrastructure development contained in Long Term Council Community Plans will not proceed to plan. Lack of certainty has a direct effect on industry capacity, construction costs, and ultimately project bankability.

The market is extremely fragmented with limited resources spread thinly across the ground. All local authorities operate differently, some being very progressive while many struggle to keep pace. Consolidation of development across Council boundaries has the potential to achieve significant economies of scale and improved levels of service.

International best practise has shown there are opportunities for marked improvement in infrastructure development and renewal through the application of modern technologies and advanced contract management and financing techniques. But these opportunities are not well developed in New Zealand and much can be done to proactively advance infrastructure development and renewal across the country.

NZCID considers that the full range of alternative funding options available to local authorities must be considered including the combination of debt funding and greater use of private sector investment and financing as a means to bridge the infrastructure gap.

As the inquiry panel research has already noted, local councils (in many cases) could make much more use of public and private sector debt. Clear funding principles based on intergenerational equity is required in order to ensure that funding reflects the real costs and benefits derived from assets which have a long-life and high sunk costs.

In addition to public sector debt, using public private sector partnerships (PPPs) to finance, build, operate and provide services can often provide better value for money and provide the opportunity to inject additional third party revenues through direct user pay options.

PPPs are used extensively by central and local governments overseas for a wide range of infrastructural services - drinking water, wastewater, storm water, roads, libraries, leisure centres, and public housing, for example. PPPs have been used to facilitate higher quality and more cost-effective public services sooner than would otherwise have been possible. Competition between bidders for a whole of life asset and related services provides scope for innovation and effective asset management to achieve efficiency savings above those achieved under equivalent public sector delivery and financing.

PPPs can and do provide improved value for money

NZCID does not consider that PPPs are the total answer to reducing rates increases. However, overseas experience has shown that they can and do provide better value for money than traditional public sector procurement methods when applied correctly in the right circumstances. NZ should always be open to learn from international best practise.

Research undertaken by the National Audit Office and HM Treasury in Britain has shown that PPPs offer value for money for certain investments through a long term focus on whole life costs, risk management expertise, and greater certainty for the public sector that services will be delivered to the specified standard.

It is a commonly perceived myth that value for money outcomes achieved by PPP projects are compromised by higher private sector borrowing costs. Public sector ability to borrow more cheaply is purely a function of its capacity to levy taxes to repay borrowings. Credit markets perceive this power as reducing the risk of their investment and therefore will lend to government and may lend to local authorities at lower rates. However, when it comes to raising finance for a project, it is the risk of the individual project that determines the real cost of finance. The difference between the private and the public sectors is that private sector capital markets explicitly price in the risks of a project into its sources of finance. This is not the case in the public sector. Instead, taxpayers / ratepayers implicitly subsidise the cost of the project by bearing the risk of cost overruns, time delays or performance failures, which are not priced into the public sector borrowing rate. ²

² The risk associated with viability of traffic volumes has been clearly demonstrated in New Zealand with the Tauranga Route K project which has failed to attract anywhere near the number of vehicles projected when the council sought special tolling legislation to build it. The road lost nearly \$5.2 million in its first year of operation to June 2004 – a cost now being borne by Tauranga City rate payers. It is difficult to see how the Tauranga Route would have proceeded as a private toll project had the proposition been tested in the market, or, if it had, the risk would have been much more clearly exposed at the time.

The Cross City Tunnel PPP project in Sydney has been subject to substantial controversy and has led to some adverse concern about the introduction of PPPs in the NZ context. Despite traffic volumes being substantially lower than projected, and which have caused the company to go into receivership, the project was opened eight months early, and, unlike the Route K situation in Tauranga, the cost of the reduced revenues has fallen on the private sector equity owners, a cost that might well have otherwise fallen fully on the State Government. This clearly shows the value of risk transfer. While the State government may have been able to borrow at a lower rate than the private sector to fund the project, it would have taken a heavy financial burden by assuming the project risk.

The importance of the finance element of privately provided infrastructure lies in the incentive it can provide for the performance of that infrastructure, and the disciplines external financiers can provide on the delivery of projects to time and budget. While a key objective of the public sector is to achieve a more comprehensive upfront consideration of risks in conventionally financed projects, it is difficult to replicate the strength of private financing incentives within a conventional financing process where all risks of delivery reside with the public sector.

PPPs record of delivery means that the British Government remains committed to using PPPs as a procurement option where it is value for money to do so.

A 2003 HM Treasury report found: ³

- 89% of PPP projects were delivered on time or early
- All PPP projects in the HM Treasury sample were delivered within public sector budgets.
- No PPP project was found where the unitary charge had changed following contract signature – other than where user requirements changed
- 77% of public sector managers stated that their project was meeting their initial expectations
- There is scope to reduce procurement times

Previous National Audit Office research has shown 70% of non PPP projects were late and 73% ran over budget.⁴

Similarly, Australian PPP experience has demonstrated improved value for money on major and complex projects, where there is opportunity for innovation and risk sharing. This is done by stimulating innovation through competitive bidding, use of output (ie. services) rather than input specifications, appropriate transfer of risk and facilitating whole of life cost considerations. Importantly projects will only proceed as a PPP if this provides better value compared with what the same project could achieve under a more traditional procurement method. A Public Sector Comparator (PSC) is used in this value for money comparison assessment. Policy ensures:

- the risk related to infrastructure finance, construction and operation is transferred to the party best able to manage it
- the project is allocated a whole of life cost, with an incentives regime for the private sector to complete the job on time and on budget as well as service it over its lifetime

³ p4, HM Treasury (2003) *PFI Meeting the Investment Challenge* See http://www.hm-treasury.gov.uk/media/648B2/PFI_604.pdf

⁴ p3, National Audit Office (2003) *PFI Construction Performance* See http://www.nao.org.uk/publications/nao_reports/02-03/0203371.pdf

- infrastructure and services developed by the private sector can be used in an innovative and commercial manner, thus offsetting costs by generating extra revenue that government would not normally be able to achieve

Key benefits of this funding method include:

- The ability to spread the cost over an extended period of time, meaning improved intergenerational equity
- The local authority knows in advance exactly how much it will pay for the service,
- It has the right to withhold payment if the service is not up to standard.
- Services can be provided on a user pays basis, reducing the burden on those ratepayers who don't use the services but would otherwise have to pay for them in their rates bill.
- Costs are managed down through a competitive tendering process.
- The private sector carries the risk of all costs over the entire life of the contract and only makes its profit through innovation, good asset management and by applying its resources and specialist skills.

Rates inquiry panel should recommend enhanced Government support for PPPs

In New Zealand the government is sending inconsistent messages regarding PPP projects and more needs to be done to support development of a domestic market for PPPs. Currently, the government has no formal position and no proactive support or encouragement has been given.

In contrast, international experience has been that government support and clear political commitment is vital. Certainty about PPP expenditure enables the private sector to plan and more economically bid for projects.

In the United Kingdom the Blair Government has been very supportive of PPP Projects and has provided the private sector with the confidence it needs to take on major projects. It established a PPP Operational Taskforce – a small unit acting on behalf of Treasury to work with government, local authority and advisory bodies to provide proactive support on projects and operational issues.

In Ireland PFI Projects have the support of the Prime Minister and the Minister of Finance. It is government policy in Ireland to encourage the use of PPPs in the provision of public infrastructure services. The National Economic and Social Council have concluded that they have the potential to play a pivotal role in supporting the accelerated delivery of strategic national infrastructure, yield long term value for money for the government and ensure quality public services.

Not only is there the need for government support, but also the need for a government sponsored organisation or centre of excellence. For example in New South Wales there is a Private Projects Branch of New South Wales Treasury to advise the government and government agencies, provide economic and financial expertise in assessing PPP and to promote best practice.

In Queensland, the Brisbane City Council (the largest Council in Australia) has put together a specialist major projects team to deal with PFI Projects. Partnerships UK and Partnerships Victoria are examples of specific agencies set up by respective governments to support their PPP programs and provide an interface to the private sector.

Education is also vital. The lesson from the United Kingdom, Ireland and Australia is that you need people with the skills to deliver projects, a predictable pipeline of projects and an ongoing commitment to infrastructure development. In Ireland there has been the establishment of the National Development Finance Agency's Centre of Excellence for PPPs. Melbourne University has a centre for infrastructure. Treasuries in both Victoria and NSW have a central area of expertise. They are heavily involved in projects, but individual agencies run them. They are involved in preparing business cases and in helping with negotiations.

If PPP projects are to be used as a useful alternative source of additional funding and improved procurement practice in New Zealand they need the support of and central administration by government.

Inquiry Panel should recommend removal of legal impediments to PPPs

The Land Transport Management Act 2003 allows for the development of tolling schemes and concession agreements for the delivery and operation of new roading infrastructure under certain circumstances. A road tolling scheme can be established on Ministerial recommendation by Order in Council. However, the ability to seek a tolling order relates only to a public sector roading agency for the purposes of a public road. There is no ability for a private sector party to seek its own tolling order.

There are also a series of conditions and requirements that must be met before a tolling order will be granted. In particular, the consenting and approval process by which a concession agreement for a toll scheme can be granted is onerous, expensive and uncertain. There is a significant amount of discretion in the Minister who can impose whatever conditions he or she sees fit and these conditions must be satisfied before a concession agreement can be signed. In the absence of a clear understanding of what conditions could be imposed there is excessive risk for the private sector to invest significant time and funds.

In the water and wastewater area the Local Government Act 2002 imposes restrictions. Section 136 deals with contracts relating to the provision of water services. It prevents a local government organisation from entering into contracts for the operation of a water service for a term of longer than 15 years. It further provides that if a contract is entered into the local government organisation must retain control over matters relating to the pricing of water services, the management of those services and development of policy relating to those services.

NZCID considers current legal impediments to PPPs require reform to enable a more flexible and permissive environment for the development of PPP solutions to infrastructural needs.

Inquiry Panel should recommend a separate inquiry be undertaken to evaluate potential for efficiencies to be gained from local body structural reform.

NZCID is concerned that the Inquiry's Terms of Reference preclude consideration of structural reform in local body governance. The Terms of Reference clearly state:

“The Inquiry is not a review of the system of local government per se, and in particular of: the purpose, autonomy or structure of local government; or the principles of democracy, transparency, equity and accountability that local government operates under”

NZCID concurs with the view expressed by Business New Zealand in its submission that the core business of local authorities should be the funding and – in justifiable circumstances – the provision of local public goods and services that cannot be better provided by firms, households and non-profit organisations, and the administration of appropriate regulations.

Effectively removing from the Inquiry's Terms of Reference, such important issues as the role and structure of local government, substantially weakens the potential impact of this inquiry.

Although structural reform lies outside of its terms of reference, it is recommended that the inquiry panel should take this opportunity to highlight the current costs and inefficiencies of the existing structures and recommend a separate inquiry into the potential benefits of structural reform of local body governance.

The balance of this submission sets out the reasons why NZCID considers this an issue that warrants further independent investigation.

Need for reform of local and regional governance structures

A significant proportion of national infrastructure (including water, storm water, roads, public transport, footpaths, and street lighting) and most of the planning approvals for both national and local projects currently come under the responsibility of the 73 City and District Councils and 12 Regional Councils

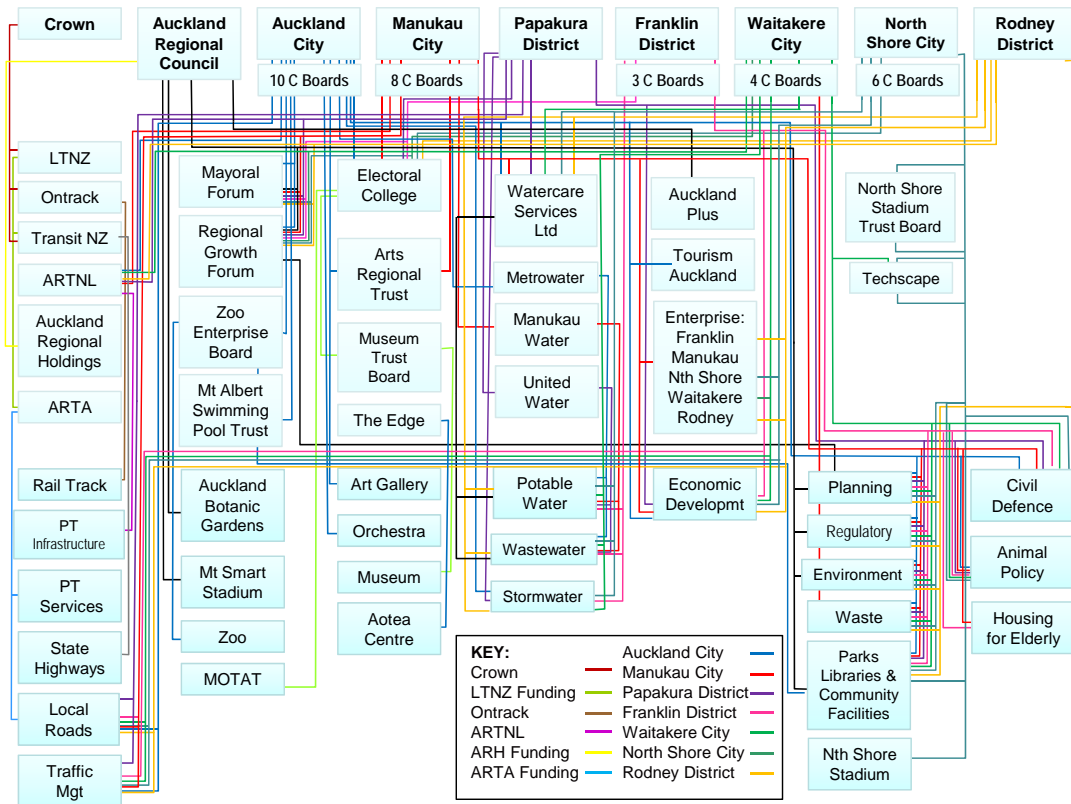
Local government structures in New Zealand are extremely complex especially given the relative small population base being served. Within each of the regions there is significant duplication of function across City and District Council jurisdictions. These include:

- Democracy and associated support costs
- Governance activities in addition to the democratic role
- Strategic planning, policy, research, and economic development

- Policy and planning in service provision
- Contract management of devolved activities and projects, and corporate contract systems administration
- Corporate support functions such as HR, IT, finance, insurance, risk and audit

The existing complexity of local government structures is particularly evident in the Auckland region illustrated below:

Auckland Public Sector Governance



Auckland local government comprises 8 administrative structures, 31 Community Boards, 264 elected representatives, 5,500 staff, 8 separate rating bodies, 8 plans and bylaws, 7 building control authorities, 12 water network operators, 18 transport agencies, 14 finance IT & HR systems.

Various agencies fund and or control components of the Auckland regional infrastructure system but no one agency has full responsibility and accountability for regional services. Instead, control of regional assets is diverse and their operation dependent upon complex cross organisational relationships. This adds considerably to cost.

International benchmarks on savings from rationalization of complex organizational structures typically start at some 10%. With current local government revenues from all sources in the Auckland region of \$2.5Bn, savings of \$250 M should be achievable to invest in better services

Over and above the physical direct cost of staff and systems, substantial costs are incurred with inter-agency collaboration, coordination and meetings. The complexity of the structure and disaggregated decision making and funding processes make it extremely difficult for the private sector to engage effectively with the multitude of public agencies. Equally it is extremely difficult for the public to understand who is responsible and accountable for the delivery of the services they receive or pay for.

In recent times it has been difficult to hire skilled professional staff in a tight labour market resulting in interagency recruitment of existing staff among the Councils. Similarly, a lack of internal staffing results in external contract hire and consulting support, often resulting in duplication across the region as each agency needs to develop its own strategic and policy position on every significant issue.

Complexity also inhibits effective and timely decision making. Regional priorities are often subject to parochial interests. Experience has been that it is commonly impossible to gain regional unanimity without substantial compromise on outcomes. The net result is that productivity and growth are both severely compromised.

A recent analysis undertaken by Auckland councils on the need to strengthen regional governance identified the following problems:

- "There is generally adequate strategy but this is not fully integrated or aligned into an overall direction that indicates the region's priorities
- The region fails to deliver on strategy because of fragmented powers and accountabilities for funding and service delivery and commitment to fund
- Some decisions appear to be "mis-located" (undertaken at the national or local sphere of government when the impacts are mostly regional)
- There is heavy reliance on voluntary and statutory joint decision-making forums but these are not able to 'bind' or influence expenditure and other decisions of sovereign organisations. Non-funders also have significant influence on decision making particularly in the area of transport
- The result is a lack of certainty (especially in funding), clarity, understanding, mandate, leadership and single voice for Auckland with central government
- There is insufficient revenue at the regional level
- There are inefficiencies and inconsistent standards and financial impacts due to duplication and transaction costs." ⁵

Not Just an Auckland Problem

These problems are not constrained to the Auckland region. Similar issues confront all local authority areas to some degree. While current structures provide for strong local representation there are

⁵ Strengthening Auckland's Regional Governance Proposal for consideration by Auckland Councils December 2006 p8

fundamental weaknesses in the local authority governance structures that must be resolved. These generally include:

Inadequate Funding:

Many local authorities are very small scale entities. Local funding mechanisms lack economies of scale.

Within the transport sector Central government funding is skewed by subsidy rates that favour state highway solutions (funded at 100%) over local roads (which require 50% local funding). Failure to meet local share funding requirements reduces funding for local roads in favour of state highways. The net result is insufficient funding to do the job. New, more effective funding mechanisms are required.

National and Regional needs subordinated to local interests:

Regional Councils responsibilities include environmental management, flood protection, land management, provision of **regional** parks, planning and funding of public transport. However, Regional Councils have limited funding mechanisms available to them. At the regional level the real power lies at the local City and District Council level who collectively possess the bulk of the funding and control the key infrastructural assets.

Key decisions are made by locally elected lay people whose political accountability is local rather than regional or national. This creates an environment where political leaders compete at the local level rather than contribute to regional or national good.

While most elected representatives are well qualified to represent local interests they lack professional training in the wider issues before them. Some fail to understand implications of decisions in a complex environment and are unable to think and plan strategically, or be discerning of good advice. There can be consequential lack of scrutiny of activities of officials.

Dilution of Expertise

High quality political and staff resources are wasted in duplicated functions across the 84 regional and local authorities. Similarly, a considerable amount of highly skilled management time is taken in transactions and consultation among and between parallel organizations.

Complex decision making processes and poor accountability:

Within that context planning, decision making, funding and implementation processes are unnecessarily complex with consequential lack of responsibility and accountability. Vague national level policy frameworks means local body politicians may not be held to account for decisions that affect regional or national outcomes. Elected members can and do divert funding away from needed infrastructure into favourite pet projects or postpone hard decisions.

For the reasons set out above, NZCID considers that the opportunity to provide better value for money through improved economies of scale, streamlined decision making processes, strengthened regional delivery agencies, improved procurement, removal of functional duplication, rationalisation of IT, HR and administrative system warrant substantive investigation. Accordingly, it is recommended that the Inquiry highlight these potential areas to reduce the pressure on rates and recommend a separate inquiry into structural reform and rationalisation of local body governance structures.

Conclusion

NZCID is concerned to see that adequate funding is available to ensure New Zealand's future infrastructure development needs are met. The existing funding base which is substantially reliant on rates as the primary source of funding is both too narrow and is proving to be inadequate to meet community infrastructure needs. The full range of alternative funding options available to local authorities must be considered including the combination of debt funding and greater use of private sector investment and financing as a means to bridge the infrastructure gap. Clear funding principles based on intergenerational equity is required in order to ensure that funding reflects the real costs and benefits derived from assets which have a long-life and high sunk costs. While PPPs are not the total answer to reducing rates increases, overseas experience has shown that they can and do provide better value for money than traditional public sector procurement methods when applied correctly in the right circumstances. Current legal impediments to PPPs contained in the Land Transport Management Act 2003 and the Local Government Act 2002 need to be removed or at least reformed. International experience has shown that government support and clear political commitment to development of the market for PPPs is vital. Certainty from the government about PPP expenditure enables the private sector to plan and more economically bid for projects.

NZCID is disappointed that the Inquiry's Terms of Reference preclude consideration of structural reform in local body governance. Although structural reform lies outside of its terms of reference, it is recommended that the inquiry panel should take this opportunity to highlight the current costs and inefficiencies of the current structures and recommend a separate inquiry into the potential benefits of structural reform of local body governance.

Yours faithfully,

Stephen Selwood
Chief Executive