New Zealand Business Roundtable

Submission on the Christchurch City Council's 1996/97 Draft Annual Plan

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24 June 1996

CHRISTCHURCH CITY COUNCIL'S DRAFT 1996/97 ANNUAL PLAN

Executive Summary

This submission starts by describing the principles that local authorities should observe when deciding on the functions they will undertake. It proceeds to examine a number of the Council's functions in the light of those principles, and shows that the Council should discontinue, or modify the form of, its involvement. The submission then draws attention to the risks to which ratepayers and residents generally are exposed by the Council's ownership, investment and financing strategies and makes proposals to change those strategies so as to bring those risks within prudent limits, as well as for efficiency reasons. Finally, the submission draws attention to weaknesses in the Council's revenue policies and proposes remedial action.

Three annexes are attached. Annex A explains the concept of cost of capital and shows why it must be taken into account in plans - such as the annual plan - and in investment, pricing or charging, and divestment decisions. Annex B discusses the Council's rating system and explains why the Council, when striking rates, is wrong to take into account the liability or otherwise of a ratepayer or class of ratepayers for income tax or GST, or their eligibility or otherwise to treat rates as an expense or input credit respectively in arriving at their tax liability. Annex C is a paper which contains a discussion of the relationship between divestment and a council's financial position.

1.0 Functions

General

1.1 The proper role of the Christchurch City Council - and all local authorities - is to ensure that local 'public goods' are efficiently provided in the right amounts, at the right times and places, and to the right standards, and that their costs are appropriately allocated and recovered. 'Public goods' are different from 'private goods'. 'Public goods' are goods and services which people cannot readily be prevented from enjoying even if they do not pay towards the cost, or which when used by some people are still available to others. Because of this, the private sector might not provide enough of a public good, and there might be a good case for a central or local authority to become involved in its provision. Street lighting is an oft-cited example. Private goods, on the other hand, can be provided so as to be available only to those who pay for them, and many private goods when enjoyed by the user are not available to other users to enjoy. Examples are food, clothing and housing. Private goods are normally bought and sold by willing buyers and sellers in the market. Some goods - like those provided by museums - are a mixture of public and private, and judgments as well as facts are involved in decisions about their provision and funding.

1.2 The law that sets limits to the activities that local authorities are permitted to undertake is fairly permissive. It allows local authorities to engage in almost any commercial or non-commercial activity they choose, subject in the case of commercial activities to requirements about organisational form. Some local authorities have chosen to provide all manner of private goods - such as rental housing and off-street parking - and Christchurch City Council is a notable example. That this is not unlawful is neither justification nor reason for providing them; on the contrary, it is an inappropriate use of the Council's powers which benefits the users while exposing others to costs and risks. Such redistributive activity, when justified, is the proper domain of central government, which alone has the information and mechanisms to do it properly. Local authorities should not arrogate the role of redistribution to themselves - the Local Government Association has clearly stated that it does not see local authorities as having an income distribution role - but instead should focus closely on doing those things that can be done only, or best, by them. They should leave everything else to individuals, voluntary and commercial enterprise and central government. Nor should local authorities expose their ratepayers - present and future - to commercial risk beyond the extent, if any, that it is necessary to perform core local public good functions. To do so beyond that extent is a disservice to their community and an abuse of the coercive powers, including the power to tax, with which they are entrusted.

1.3 The following paragraphs identify some major activities in which the Council is currently involved but in which its involvement should be reduced or discontinued, or modified in form.

Housing

1.4 The Council has as a Strategic Objective (A10) "The provision of access to quality, affordable housing appropriate to the needs of present and future households." Pursuant to that objective the Council provides about 2,200 units for housing elderly persons, plus 387 public rental housing units. The net cost in 1996/97, including a cost of capital at 7.2 percent[1], will be approximately $5.8 million. Assuming no recovery in rental income for the cost of capital, that equates to a subsidy from ratepayers to tenants of approximately $2,200 per unit per year, or over $43 per unit per week.

1.5 It is central government's responsibility, not the Council's, to provide income support to elderly people and others who would otherwise face hardship. In 1996/97 central government will spend more than $10 billion for this purpose. This will include $627 million by way of accommodation supplement to help meet the accommodation costs of some 292,000 people. The supplement pays 65 percent of the tenant's rent over and above 25 percent of the tenant's income. Again assuming no recovery in rental income for the cost of capital, the perverse result of the Council's housing policy is that the ratepayers of Christchurch are providing a subsidy of $5.8 million a year to tenants who might otherwise receive additional accommodation supplement of up to $3.8 million a year from central government. In such circumstances, the Council's housing policy would make its tenants about $2.0 million a year better off at a cost to its ratepayers of $5.8 million - the difference being effectively a subsidy from the ratepayers to central government.

1.6 For many years central government subsidised local authorities to provide pensioner housing at less than market rentals. Those days are long gone. Central government now relies on Housing New Zealand to provide publicly-owned rental housing, and pays accommodation supplement regardless of the provider (including to qualifying owner-occupiers). Housing is not a local public good. It is a waste of ratepayers' resources for the Council to persist with its policy. It should exit the rental housing market as quickly as this can be done in a way that takes due account of the legitimate expectations of its tenants - as Auckland City is doing.

Operation of water and sewerage services

1.7 Experience overseas and in New Zealand increasingly demonstrates that private sector providers of water and sewerage services are more efficient than local authorities. As a first step the Council should corporatise its own services to reap the immediate efficiency gains that commercialisation will provide. A variety of other water industry reforms were outlined in the report *Reform of the Water Industry*

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1 See the discussion of cost of capital in Annex A.

published by the New Zealand Business Roundtable in August 1995 and we commend these to the Council's attention. We believe the Council should also commission for public scrutiny and debate a study by competent and reputable advisers of the advantages and disadvantages of privatisation to citizens as users and owners. It will then be in a position to make a well-informed decision about the future of the services.

Library, art gallery and leisure services

1.8 These services together are planned to cost ratepayers upwards of $30 million in 1996/97. Since non-payers can readily be excluded from these activities, they do not meet the definition of a public good. Further, the large costs involved mean that efficiency is important to users and ratepayers. As in other areas of activity there is scope for major efficiency gains - represented by cost reductions or service improvements or both - from clarifying the objectives to be sought from these services and the prices to be paid for them. We suggest the Council should commission and publish during the year an independent study concerning the options for reform. For example, competitive contracting may be superior to a model such as the Canterbury Museum Trust Board because the Board simply levies local authorities for its net revenue shortfall instead of contracting transparently for agreed services at agreed standards and prices.

Economic development and employment

1.9 The Council has a major role to play in ensuring the vitality of business and employment in Christchurch, but only by means of focusing on its core roles, performing them well, and funding them by sound revenue policies. Schemes which try to assist particular businesses or individuals at the expense of ratepayers - who are also businesses or individuals - nearly always do more harm than good overall. There may be a local justification for the Council getting involved in them if central government meets at least the bulk of the costs. This is not the case for most of the activities planned under this heading, and the Council should therefore look to pass them on to private sector interests or, failing that, discontinue them. The Council should review its involvement in the Canterbury Development Corporation in the same light.

Off-street car parking

1.10 There is no case for the Council providing off-street parking and it should withdraw from this business.

City streets

1.11 The activities under this heading are budgeted to cost ratepayers $32.6 million in 1996/97, assuming a cost of capital of 7.2 percent. Over 600 staff are employed. The activities themselves include many of a purely commercial nature which should be transferred to a Local Authority Trading Enterprise (LATE) for subsequent privatisation, or simply discontinued.

1.12 There is no indication in the draft annual plan that the Council is considering, or intends to investigate, efficient and effective measures to deal with traffic congestion in its streets. Technology is now becoming available, and being introduced overseas, which enables the true cost of road usage to be recovered from road users themselves. This solves both the congestion problem - benefiting the road users - and the funding problem, to the benefit of ratepayers. There are also benefits to the urban environment. The Council should investigate road use as a matter of urgency and report the results in time for them to be carried into the next annual plan.

2.0 Investment and financing strategies

2.1 The Council owns 100 percent of a company called Christchurch City Holdings Ltd (CCHL).

2.2 The draft annual plan does not include a balance sheet for this company or its subsidiaries - Southpower Ltd, Christchurch International Airport Ltd, Lyttelton Port Company Ltd and Christchurch Transport Ltd. It would appear, however, from the Council's Annual Report for 1994/95 (page 26) that the Council's equity in CCHL was then worth some $250 million. In addition CCHL owed the Council $46.6 million. The Council also has an equity interest in the Selwyn Plantation Board, then worth about $34 million. Altogether these assets were therefore worth about $330 million as at 30 June 1995.[2] CCHL carries substantial debt - forecast to be $130 million in bills alone at 30 June 1997. Its ability to pay dividends to the Council is therefore vulnerable to interest rates on its debt and the profitability of its subsidiaries.

2.3 Yet the Council's strategy is to maintain its investment in CCHL. It plans to draw dividends from the company to offset its own interest payments and to contribute to other expenses, thereby relieving the call on rates. In 1996/97 it expects

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[2] As at the same date the Council owed term debt of $59 million and this is estimated to fall to $30 million at 30 June 1996 and then rise to $75 million by 30 June 1997. Over the same period its current liabilities will have fluctuated between $41 million and $47 million, and its current assets between $69 million and $41 million.

to receive \$8.3 million in dividends and \$3.1 million in interest and to pay \$6.7 million in interest - a net positive cashflow of \$4.7 million. This is a thin margin given the size and potential volatility of the financial flows that underlie it. The plan contains no sensitivity analysis showing how interest rates and profits that differ from those that have been assumed would impact on the result nor indeed any indication that sensitivity analyses have been carried out at all.

2.4 A simple calculation illustrates the serious risks to which this strategy exposes the Council and its ratepayers. Total non-current liabilities of the Council and CCHL at 30 June 1997 are forecast to be \$207 million. If that figure were constant through the year and interest rates turn out to be only one percentage point above those assumed, the combined interest bill would rise by \$2.07 million and in addition the profits of CCHL's subsidiaries would be reduced because of the debts they carry - perhaps by as much again.

2.5 There are other risks. Deregulation of the retail electricity market will be completed on 1 October next. Competition in the retail market can be expected to put increasing pressure on retail margins, affecting Southpower's profits and dividends. Growing competition in the port, airport and transport industries may also squeeze profit margins there. Both the dividend streams from CCHL and the value of its equity holdings could fall rather than, as the plan assumes, rise substantially in future years.

2.6 These are compelling reasons for the Council to reduce its indebtedness by privatising commercial assets. But there are others. The Council's projected debt position has deteriorated considerably from the 1995/96 plan to the 1996/97 plan. Last year the Council was projected to owe \$213.4 million in term debt in the year 2014/15 assuming an interest rate of 7 percent. This year the Council is projected to owe \$265.3 million in term debt in 2015/16. The latter figure assumes an average interest rate of 8.5 percent, which still looks low. The risk is high that the Council will, on its current strategy, find itself in an unsustainable position in the not too distant future and be forced to look to its ratepayers, or those who need its services, or both, to rescue the situation. If this happens during a cyclical downturn in the economy the impact will be all the more severe.

2.7 Even beyond these disturbing concerns, experience in this country and all around the world makes the case for privatisation. The World Bank, having examined a mountain of conclusive research on the subject, has found:

> ... it is clear that ownership matters; that ownership is a significant determinant of profitability and productivity in an enterprise.

The World Bank answered the question "Is privatisation necessary?" as follows:

> The answer is a decided 'yes'. Privatisation is necessary, and not simply to improve performance of public enterprises - though the evidence is striking that it can and does improve performance. Privatisation's essential contribution is to "lock in the gains" achieved earlier by reforming public ownership or in the process of privatisation; to distance the firm from the political process; and to inoculate the company against the recurrence of the common and deadly ailment of public enterprises: interference by owners who have more than profit on their minds.

2.8 It is assuredly not the case that maintaining ownership of assets and their associated dividend stream "holds down rates". The economic fallacy in this proposition is explained in the first three pages of a paper attached as Annex C, given by the executive director of the New Zealand Business Roundtable in November 1995. Divestment would *improve* the Council's financial position, and thus reduce, not increase, the call on rates. In addition, public goods functions would be financed in an appropriately transparent way.

Revenue policies

2.9 The Council's review of revenue policy, which was originally to have been completed early in 1994/95, has still not appeared. No reason for its non-completion is given. This situation is unacceptable and requires explanation. However, the principles that should guide the Council in setting its revenue policies are quite straightforward and are set out below.

2.10 The obvious and appropriate sources of revenue for core services are user charges and rates. Of the two, user charges are to be preferred whenever they are practicable because:

- user charges signal to users the true cost of provision and encourage economy in the use of resources;
- user charges generate revenue to fund services in proportion to the true demand for them; and

- user charges encourage the use of lesser-cost alternatives where available.

Rates do none of these things.

2.11 It would be inappropriate and impracticable to recover through user charges all or even a significant part of the costs of such things as public accountability and parks.

2.12 However, other activities can and should be funded entirely or substantially by user charges. A substantial reduction in rates would thereby be achieved.