

10 CURRENTLY AVAILABLE NON-RATES FUNDING MECHANISMS

This chapter covers that part of the terms of reference requiring the Local Government Rates Inquiry to examine the use of other sources of revenue currently available to local authorities. It considers how appropriately these other sources of revenue are being used, and their capacity to provide more funding.

SUMMARY OF KEY POINTS

10.1 Local government has available to it a range of sources of funding other than rates. The major sources are central government transfers, development contributions, debt funding, income from commercial investments, and user charges and fees. Other funding is possible through fines, grants, and donations, as well as the sale of assets.

Central government transfers

10.2 Transfers from central government are an increasing source of funding for local government, especially in transport, and accounted for 13% of total operational revenue in 2005/06. Existing transfers from central to local government are targeted at many different areas of activity, but are heavily skewed towards roads and public transport (64% and 25% respectively) in 2005/06.

10.3 The financial assistance rate (FAR) system uses dedicated roading user charges paid into the National Land Transport Fund and is perhaps better regarded as a funding partnership than as a system of transfers from central government. It has been in operation for many years. The Panel concludes that overall the system is a fair and reasonable method of funding local roads.

10.4 However, analysis of the pattern of road grants across local authorities suggests that they are skewed in favour of lightly used rural roads. Holding other factors constant, road grants are

- lower for urban than rural roads
- lower in locations with more traffic (vehicle kilometres travelled)
- lower in densely populated areas (population/total road length).

10.5 A number of submissions to the Rates Inquiry sought to have all fuel excise duties allocated to the funding of transport. This has recently been accepted by the Government. It can be noted that the total land transport expenditure by central government has exceeded fuel excise duty since the 2006 Budget and this is forecast to continue.

10.6 The largest area of forecast new local government capital investment in transport is in major arterial roads, particularly in Auckland. The Panel considers that there is some inequity in the lower level funding of major urban arterial roads, many of which carry more traffic than State highways. This is an issue that the Government should examine in future reviews of the National Land Transport Fund and the FAR.

10.7 Where locally provided services have spill-over benefits for the country as a whole or are required to meet standards determined nationally that are higher than those that would be determined locally, central government should contribute to their costs. Consistent with this principle there is scope for some expansion in the current range of transfers from central government for local government infrastructure expenditures in the three waters – water supply, waste water, and stormwater.

10.8 The existing pattern of transfers from central government does not appear to be based on consistent principles. A range of transfers has emerged, managed by different ministries. There is a need for a more consistent approach that better reflects the equalisation principles behind transport transfers – namely recognition of different costs and different revenue bases between councils, as well as national benefits. The Panel considers that a review of the scope and valuation of current transfers is desirable, as part of the development of the new Infrastructure Equalisation Fund recommended in Chapter 11.

Development contributions

10.9 Development contributions are being used by many councils as a way of recovering infrastructure costs associated with accommodating growth. In principle, they have a sound rationale based on efficiency and equity criteria. In practice, it has been difficult for councils to formulate and implement development contributions policies that are consistent with those criteria. Councils should consult closely with each other and with developers in reviewing their development contribution policies.

10.10 Development contributions are expected to be a significant and growing funding source for some parts of the sector. According to the long-term council community plans, development contributions will fund an estimated 17% of total capital expenditure by 2016 compared with 7% in 2006. This estimate may be on the high side given recent litigation on development contributions. The Panel considers that regional councils should be given the same powers to levy development contributions as territorial authorities. It does not support these powers being given to Transit New Zealand.

Debt funding

10.11 The Panel considers that, provided prudential benchmarks are observed, there are good reasons for local government to make more use of debt to finance long-life assets. Overall, local authorities currently make only limited use of debt, reflected in low debt-to-asset ratios averaging well under 4%. Although the long-term council community plans project significant increases in debt, these levels still result in low debt-to-asset ratios. Greater use of debt is one major strategy for holding the level of rates, as discussed earlier in Chapter 8.

10.12 The Government has recently announced that it intends to remove the Securities Act 1978 requirement for local authorities to issue a prospectus before borrowing in capital markets. This will facilitate local authorities' access to the capital market to issue their own debt. The Panel also considers that overseas borrowing should be permitted provided appropriate foreign currency hedging arrangements are made.

Commercial investments

10.13 As noted in Chapter 4, local authorities vary widely in their ownership of commercial ventures, which include investments in operating activities such as ports, airports, forests, and farms, as well as in financial assets such as bonds and shares. Revenue from such investments amounted to 6% of total operating revenues in 2006 but varies widely between councils from zero to 45%. The rates of return being achieved also vary widely between individual councils, ranging from zero to 40% in 2005. On average, the rates of return are low relative to commercial benchmarks.

10.14 The Panel considers that councils should be required to manage such investments so as to achieve a commercial rate of return, consistent with the requirement for State-owned enterprises in central government to act as businesses. This would involve councils reporting accurately on the returns earned from such investments and clearly articulating the reasons for holding such investments, particularly in cases where a commercial return is not being earned. In cases where there is limited commercial or strategic reason for investing in operating activities, councils should consider selling these assets.

10.15 Subsidiary organisations such as council-controlled organisations established to provide council services (for example, water services) should not be regarded or managed as commercial investments. They should be commercially managed on an actual and reasonable cost-recovery basis but there should be no cross-subsidy from these activities to other council functions.

Reserve funds

10.16 Most councils have significant levels of financial reserves, which in some cases are earmarked for particular capital expenditure. For example, councils may purchase additional land for reserves using funds levied on developers for this purpose. However, there is no comprehensive information available on the level of these funds or the amount of expenditure financed from them.

User charges and fees

10.17 The Panel considers that volumetric user charging based on actual and reasonable cost recovery should apply as far as possible to water supply, waste-water disposal (as discussed in Chapter 9), and to solid waste collection and disposal. Greater use of such charging as a demand management tool will potentially result in reduced expenditure on infrastructure. However, the Panel recognises that such decisions are a matter for individual councils. Nevertheless, to facilitate the adoption of such policies the Panel recommends that the Government consider providing assistance for local authorities to install water meters. As discussed in Chapter 9 local authorities should also be able to charge for waste water by volume without the requirement to establish a council-controlled organisation.

10.18 Consistent with the above the Panel considers that greater user charging for roads and, in the longer term, road pricing on a 24/7 (user charges) basis are appropriate measures to assist in reducing the high forecast expenditures on roads. Chapter 11 recommends an increase in the current local authority petroleum tax (LAPT) consistent with this approach.

10.19 The Panel considers that there is scope for regulatory and user charges to be increased where these do not currently reflect actual and reasonable levels of costs being incurred. This includes those cases where Government regulations set fixed charges that do not enable cost recovery. This issue is also discussed in Chapter 8 in the section on "Unfunded mandates".

Legislative basis for choice of funding mechanisms

10.20 The Local Government Act 2002 (LGA 2002) defines the range of financing options available to local authorities. Section 101(3) provides considerable scope for selecting from these options:

- (3) The funding needs of the local authority must be met from those sources that the local authority determines to be appropriate, following consideration of,—
 - (a) In relation to each activity to be funded,—
 - (i) The community outcomes to which the activity primarily contributes; and
 - (ii) The distribution of benefits between the community as a whole, any identifiable part of the community, and individuals; and
 - (iii) The period in or over which those benefits are expected to occur; and
 - (iv) The extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity; and
 - (v) The costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities; and
 - (b) The overall impact of any allocation of liability for revenue needs on the current and future social, economic, environmental, and cultural well-being of the community.

10.21 However, the balance between each of these considerations is for each council to determine.

Public finance principles

10.22 Two types of principles emerge in examining non-rating tools:

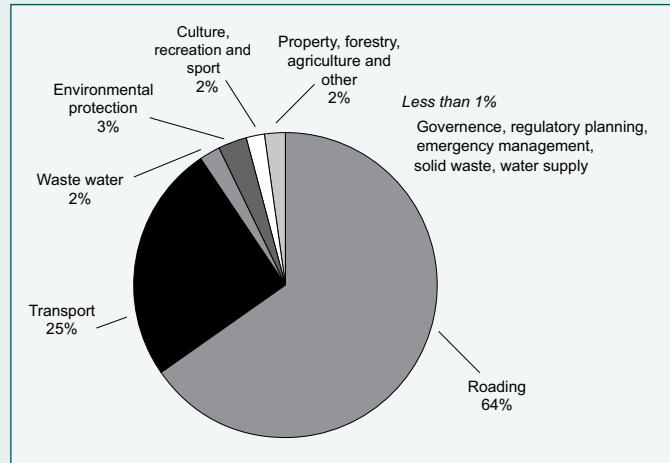
- efficiency principles, which are concerned with behavioural effects and include effectiveness
- equity principles, where the fairness of cost burden allocations is key.

10.23 Efficiency principles are concerned with behavioural effects – how people will react to different price signals. Two principles are particularly important. The first is that behaviour is minimally distorted. Thus, property rates have good efficiency properties because there is little that people can do to avoid them – except perhaps to move. The second is that, for certain activities, changes in behaviour may be desirable. For example, when a council officer issues a parking ticket, the main purpose is to deter behaviour deemed to be undesirable. Also, in the absence of a user charge, the cost of council-provided services would be spread across all ratepayers. The lack of a price signal may then lead to over-use and over-investment in infrastructure assets. Provided user charges can be levied in a reasonably accurate and low-cost manner, they are likely to result in more efficient use of council-provided services.

10.24 As noted in Chapter 9, there are two important equity principles. One is “horizontal equity”, which requires that people in similar situations face similar charges. The other is “intergenerational equity”, which is closely related to the concept of sustainability. For local public finance it is most relevant to the financing of long-life infrastructure, where it points towards debt financing so that

Chart 10-1
Grants received, all local authorities,
year ended 2006

Source: Statistics New Zealand.



the capital costs are allocated across all benefiting generations. More detailed discussion of these principles is contained in Chapter 9.

Transfers from central government

10.25 Local authorities receive targeted transfers from central government for a range of functions. In the year ended June 2006 funding transfers amounted to \$684 million. Such transfers are dominated by roading and public transport, which amounted to 64% and 25% respectively of total transfers (see Chart 10-1). Regional councils receive funding for public transport but not for roads. Other significant grants are to help regional councils to fund work to control bovine tuberculosis (environmental protection). New subsidies for water and waste-water capital expenditure commenced from 2003. Overall central government transfers to local government increased by 70% in the five years from June 2001 to June 2006, driven mainly by central government's share of increased road maintenance and construction costs, and additional special road and transport funding.

10.26 As noted in Chapter 9, the Panel was advised by some councils that they are reluctant to apply for funding under some schemes because of the high transaction costs involved and the uncertainties around funding. It was indicated that there are often changes to grant criteria during the process, there are usually insufficient funds to meet all of the eligible applications, and funds came with considerable reporting compliance costs. Table 10-1 lists the main grant schemes currently available to local government.

10.27 There are a number of other central government funding schemes administered by local government where the funds are passed on to community organisations and cannot be spent by the local authority itself. These include funding for creative communities through Creative New Zealand, sport and recreation through Sport and Recreation New Zealand, and community safety through the Crime Prevention Unit of the Ministry of Justice.

When grants should be used

10.28 There are efficiency-related reasons for the existence of grants from central government, including

- tax efficiency

Central government has access to more elastic sources of revenue that are not available to local authorities (for example, fuel tax, income tax), and in some cases it may be more efficient to use these than to rely (or rely more heavily) on local sources.

Table 10-1 Central government transfers

Grant scheme	Total grants available	Date started	Current status
Financial assistance rate – Land transport funding through the National Land Transport Fund	Changes annually, \$549 million in 2006/07. Assistance rate varies from 43% to 67% (excluding Chatham Islands on 87%) for maintenance. Excludes public transport and special funding arrangements. ¹	Current structure since 1989 but carried out in some form for many years	Ongoing
Sanitary Works Subsidy Scheme (SWSS), Ministry of Health. Communities up to 10,000 people, targeted at low population and high deprivation.	\$150 million over 10 years.	July 2003	Modified late 2003 and 2005. Available funds fully committed. 5-year review under way.
Drinking Water Assistance Programme through Ministry of Health. Small communities (up to 5,000 people), technical advice and capital matching subsidies.	\$132 million capital assistance over 10 years, \$17.5 million technical assistance over 7 years.	July 2005 (technical) and July 2006 (capital)	Under way
Tourism Demand Subsidy Scheme	\$11 million over 3 years to support water and waste-water infrastructure needs driven by tourism.	2006	Closed. One funding round fully utilised funds.
Tourism Facilities Grants Programme	\$0.3 million a year for small tourism-related facilities. Open to all organisations (not just local government).	Ongoing	Ongoing
Building Consent Authority Accreditation Assistance Package	\$3 million. \$2.3 million to June 2007 with balance to 2009.	2007	Under way
Conservation Biodiversity Advice Fund (Department of Conservation)	\$4 million a year, open to all organisations (not just local government).	2000/01	Ongoing
Sustainable Management Fund (Ministry for the Environment)	\$4.32 million a year, open to all organisations (not just local government).	early 1990s	Ongoing. Priorities change annually and always significantly oversubscribed.
Sustainable Farming Fund (Ministry of Agriculture and Forestry)	\$9.5 million, open to all organisations (not just local government).	1999	Ongoing
Enterprise Partnership Scheme (Ministry of Economic Development)	\$3 million in 2006/07, \$10.5 million 2007/08 and 2008/09, \$11.5 million per year from 2009/10.	2006/07	Ongoing
National Bovine Tuberculosis Pest Management Strategy- Bovine TB vector control scheme, (Ministry of Agriculture and Forestry)	\$34.2 million in 2007/08. Funding for Animal Health Boards in bovine TB control areas. Government 50%, industry 40%, local government 10%.	1998	Ongoing

Source: Rates Inquiry, Government department websites. Table footnote: ¹Ministry of Transport briefing on land transport funding arrangements prepared for the Rates Inquiry.

• **policy efficiency**

Some central government policies impose obligations on local governments, for example, the need to meet national environmental standards. When at least some of the cost of those obligations is covered by grants, there is greater discipline on central government policy makers in developing such policies. The obligations are therefore more likely to be more efficient. Consequently, there is a strong case for linking the pattern of grants with the pattern of costs imposed by such standards.

10.29 Equity is also a justification for central government grants, and such grants may reflect explicit redistribution goals. Alternatively, the pattern of central government grants may reflect a desire to shift funds between activities rather than individuals. As discussed below, roading grants appear to involve a redistribution of roading revenue from urban to rural areas. Such a policy could

reflect a view that rural roads provide a benefit to urban residents, either in the form of an “option to use” or as an input to nationally important industries such as agriculture and tourism.

10.30 The underlying point is that under a principles-based approach there should be a reasonably consistent logic that explains the pattern of grants. However, there is no single explanation of the existing pattern of transfers to local authorities, or even of what is intended to be achieved. The grant process operates through a range of different agencies, each of which pursues its own objectives largely in isolation from the others. The Government’s annual budget round provides some potential for considering the rationale and relative priority of these transfers. However, the apparent lack of a firm conceptual basis for them suggests that the effectiveness of grants could be improved.

10.31 Excluding the existing land transport funding system (which the Panel regards as working reasonably well), the Panel considers there is a need for a more consistent rationale for the pattern of grants. This rationale should be based on equalisation principles – that is, assisting councils to provide similar levels of service, taking account of differences in costs and the rateable base and also of national benefits. These principles are already recognised in the FAR scheme.

Recommendation

16 That, as part of the establishment of the proposed Infrastructure Equalisation Fund (recommendation 36), the existing pattern of grants (excluding the financial assistance rate) including the allocation of the increased local authority petroleum tax (recommendation 34) be reviewed in due course to better reflect equalisation principles.

10.32 The above discussion identifies some possible circumstances in which transfers to local government would be economically desirable. Three cases seem especially relevant:

- spill-over benefits

When local facilities have national benefits there is a good case for funding them from national rather than local taxation bases. As discussed above, roads deliver benefits well beyond their local communities, partly because New Zealanders travel around, but also because roads facilitate economic activity that has widely dispersed benefits. Similar arguments apply to environmental protection. This is valued by New Zealanders (the option to visit nice places) and is also an input into the tourism industry that has dispersed benefits.

- cost efficiency

Some public goods exhibit economies of scale such that it is cheaper to provide them nationally than regionally. Emergency management services such as Civil Defence are an example. All localities are exposed to the risk of weather-related emergencies, but pooling that risk across local authorities through a grant system can reduce total costs.

- cost causation

If legislation or other actions of central government create costs in local communities, grants may be an effective and efficient funding mechanism. A similar argument applies when such costs are not caused deliberately. The existing problem with leaky buildings may be a good example to the extent that this is a systemic failure in which central government is at least partly culpable.

Road and transport grants

10.33 Overall, a high proportion of local authority operating expenditure (and by inference rates) is allocated to road and transport expenditure. However, it is not possible to ascertain the exact amounts. Some local authorities disclose this information but many do not.

10.34 The government operates a National Land Transport Fund (NLTF) to fund all land transport activities. The fund is managed by Land Transport New Zealand (LTNZ). The total amount of funding allocated through the NLTF is estimated at \$2.3 billion in 2006/07 and is budgeted at \$2.4 billion in 2007/08. This funding is derived from road users through a portion of fuel excise duty (FED), charges on diesel and heavy vehicles (road user charges), and motor vehicle registration and licensing fees. Although the Government determines the levels of the various user charges, the amount collected depends on the level of economic activity and changing patterns of fuel consumption. Currently, only a portion of the FED is paid into the NLTF. In 2006/07 \$600 million was paid into general Government revenues to offset the cost of such expenditures as traffic police and health expenditures related to road accidents. However, since 2004/5 the Government has provided additional funding from general taxation either in the form of top-ups or appropriations for specific regional needs. In 2006/07 this additional Government funding of \$608 million makes up approximately 25% of total funding, and is budgeted to rise to \$657 million in 2007/08.

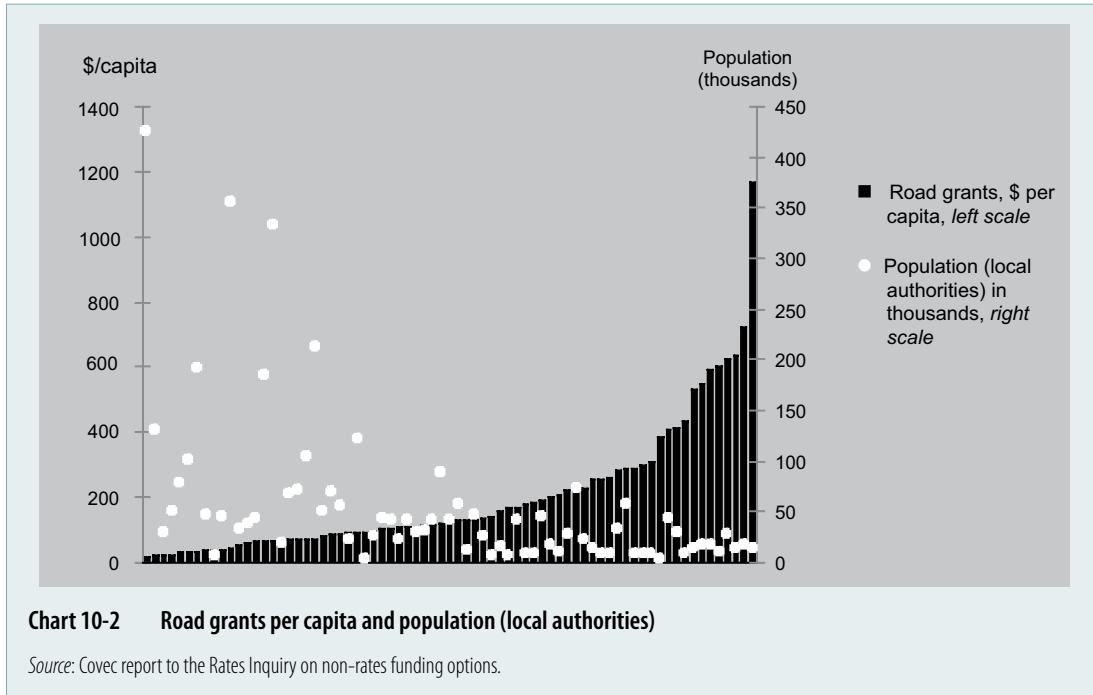
10.35 Land transport funding is categorised as national, regional, or Crown funding, each broadly targeted at different transport programmes. Over the past few years there has been an issue in the control and matching requirements of much of the new regional funding, which was introduced as special additional funding to address perceived regional funding shortfalls. However, local government has been concerned that the use of these funds is controlled by LTNZ and some of the funding has been allocated to State highways. Where regional funds are made available for local roads there is a requirement for local authorities to match the funding under the financial assistance rate (FAR) formula.

10.36 Many submissions suggested that all FED funds should be paid into the NLTF. Government has recently announced that in future all of the FED, road user charges, and motor vehicle registration and licensing fees will be paid into the NLTF. This revenue does not include the LAPT.

10.37 Local roads (which cover most roads except State highways) are the responsibility of territorial authorities; they are co-funded by LTNZ and territorial authorities. The FAR for maintenance varies across territorial authorities from the minimum of 43% to a maximum of 67%¹¹⁴ with an average of 50%. The FAR provided to each territorial authority for construction is 10% above their maintenance FAR. The FAR varies across local authorities in proportion to the ratio of approved roading costs to the total value of rateable land. Areas with higher costs and lower rate bases that receive a higher FAR. Twelve local authorities, seven of which are metropolitan local authorities, are on the minimum FAR of 43% for maintenance.

10.38 Local authorities are required to make up the difference between FAR funding and the total costs of maintenance and construction. This requires local revenues, mainly from rates. A number of submissions sought an increase in the FAR, with the suggested average levels varying from 75% to 100%, with the objective of removing rates funding of roading expenditure. The Panel does not support increasing the FAR except for a future review of the funding rate for major urban arterial roads, as discussed below. It considers that the current cost-sharing arrangements reflect an appropriate partnership between central and local government and that the requirement for matching with local funds acts as a useful check on excess demand for roading expenditures, which would likely occur if the FAR were substantially increased. The Panel also notes that local authorities

114 Chatham Islands Council is a special case at 87%.



may have the option of funding their matching expenditures from the recommended increase in the LAPT, as discussed in Chapter 11.

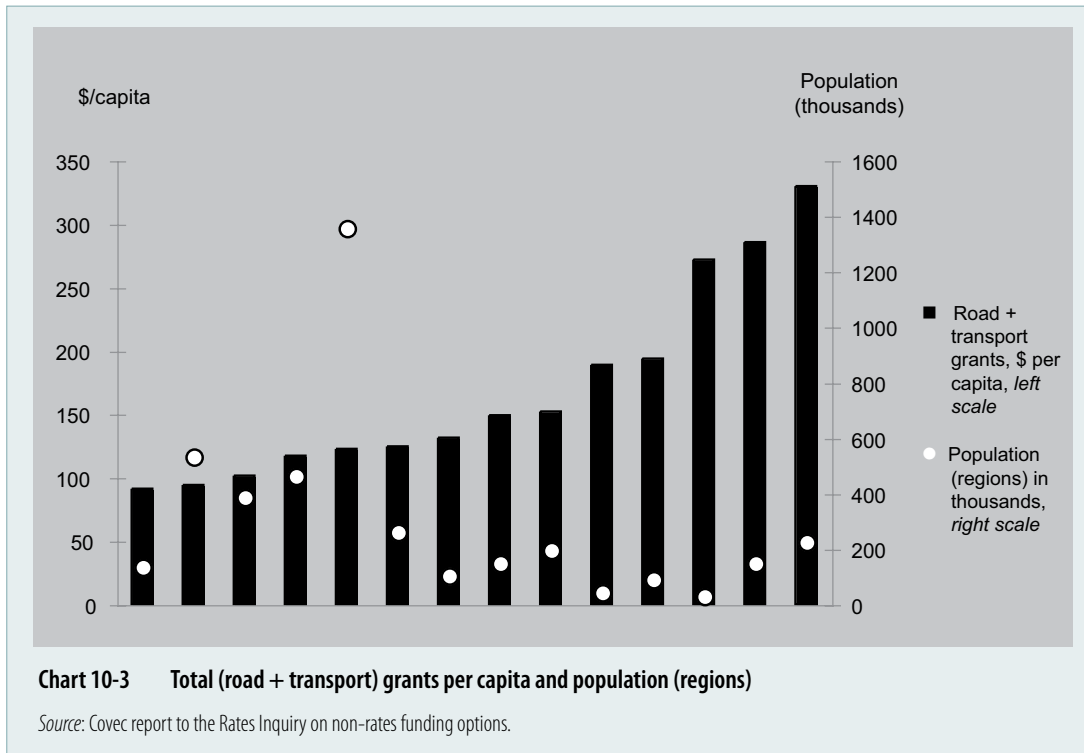
10.39 It can be noted that although these central government payments towards roading costs may be referred to as grants or subsidies from central government, local authorities usually view them in a different light. These payments are transfers from funds raised through fuel excise duty for the maintenance of the roading network. Local roads are owned by local authorities, and much of the fuel excise duty are raised from travel on this network. Local authorities thus regard the grants as a return of funds to the asset owners from which they were raised. Viewed this way, central government is acting merely as an efficient tax agent for the local government sector. The Panel notes that the FAR arrangements might thus better be regarded as a funding partnership between central and local government rather than as a system of grants or subsidies from central government.

Distribution of transport grants

10.40 Given the financial importance of road and transport grants from central government, the distribution of these funds across local authorities has been analysed for the Panel.¹¹⁵ The base data for roading and transport grants for the 2004/5 financial year (sourced from Statistics New Zealand) were compared with other features related to local authorities and to road costs, such as

- ♦ length, type, and seal status of roads (excluding State highways) within a local authority area (sourced from LTNZ)
- ♦ vehicle kilometres travelled within the area per year (LTNZ)
- ♦ vehicles per day using local roads (LTNZ)
- ♦ population (Statistics New Zealand)
- ♦ incomes (Statistics New Zealand)
- ♦ local authority expenditure on roads (Statistics New Zealand).

¹¹⁵ Covec, *Non-Rates Funding Options Available to Local Authorities*, Covec Ltd, May 2007 (available at <http://www.ratesinquiry.govt.nz>; referenced subsequently in this chapter as the “Covec report to the Rates Inquiry on non-rates funding options”).



10.41 The analysis shows that road grants are only weakly correlated with population. Chart 10-2 plots road grants per capita against population by local authority area. It shows that localities with high populations tend to get low grants on a per capita basis, and vice versa. Road grants per capita ranged from \$17 (Auckland City Council) to \$1,167 (Rangitikei District Council). Across the country, the average roading grant in 2005 was \$105 per person.

10.42 A similar pattern emerges when road grants per capita are compared with congestion (vehicle kilometres travelled per km of road network).

10.43 Transport grants are more closely associated with these indicators of road use. Transport grants are used to fund alternatives to roading, including public transport investments, so a more complete picture is gained by looking at the aggregate of road and transport grants at a regional level.¹¹⁶

10.44 In 2005, the total (roading plus public transport) grants averaged \$139 per capita across the country, ranging from \$91 (Marlborough) to \$330 (Manawatu-Wanganui). The latter may have been skewed by flood repair grants from the 2004 floods. Chart 10-3 plots total grants per capita against population. These figures show that the basic lack of correlation between road grants and usage indicators at the local authority level is still present when transport grants are included.

10.45 The analysis results in the following conclusions for roading and transport grants. Per capita roading grants from central to local government are

- + lower for urban than rural roads
- + lower in locations with more traffic (vehicle kilometres travelled)
- + lower in densely populated areas (population/total road length).

10.46 This analysis suggests that roading grants are currently skewed towards lightly used rural roads.

¹¹⁶ In the analysis, Franklin was included in Auckland; Taupo and Rotorua were included in Bay of Plenty; Stratford was included in Taranaki; and Waitaki was included in Canterbury.

Rationale for differential road grants

10.47 Assuming the findings of the above analysis are robust, they raise the important policy issues of whether rural roads are over-funded compared with urban roads, reflecting both lower usage and smaller populations. It could be argued that if funds were concentrated away from locations with substantial employment, national productivity would be reduced. However, rural roads do create national benefits. Everyone has the option to use them, which is itself a benefit, and many urban dwellers do use rural roads while on holiday. Additionally, tourism is a major export-earning industry that provides benefits spread through the whole country. These spill-over benefits provide a rationale for central funding of roads, and for some redistribution away from a purely population-based allocation.

10.48 As mentioned earlier, the existing FAR scheme differentiates between local governments on the basis of ability to pay. Areas with high costs and low rate bases get relatively higher FARs. This approach is broadly consistent with efficient cost-recovery principles for an asset that has nationwide benefits.

10.49 One major issue highlighted in Chapter 8 is the large expenditures being incurred by metropolitan councils for the construction of urban arterial roads – such as the Auckland-Manukau Eastern Transport Initiative, Penlink Project, Kapiti Coast Western Link Road, and East Taupo Arterial. These key arterial roads carry heavy traffic volumes, are very expensive to construct, are complex major projects, and take a long time to plan and obtain consents. They are mainly in Auckland and Wellington and are of such magnitude that they drive the profile of capital expenditure for the entire local government sector. These projects are considered local roads for the purposes of the NLTF even though their traffic flows may be significantly higher than most existing roads including State highways although it appears that in some cases special funding arrangements are made. Local authorities are fortunate where key routes have been designated as State highways, which means that they are 100% funded by central government.

Recommendation

17 That the low funding rate received through FARs for major urban arterial projects be examined in future reviews of the National Land Transport Fund and the FAR.

Conclusions on central government transfers for roads and transport

10.50 The Panel concludes that overall the FAR system is a fair and reasonable method of funding local roads. This arrangement is broadly consistent with the principles of efficient cost recovery given the national benefits of the road network. The Panel considers that there may be scope for improving the extent to which FARs reflect those national benefits but that radical change is not required. However, the current low level of funding for major urban arterials should be reviewed.

Possible new transfers for water and waste-water infrastructure

10.51 Central government imposes obligations on local government such as the recently promulgated drinking water standards that are currently before Parliament. Whatever their merits, such obligations override local decision making about the priorities for expenditure, obliging local government to meet deadlines laid down by central government. This imposes costs, in the form of forgone opportunities to pursue local priorities.

10.52 To the extent that the cost of meeting such obligations is not borne by central government, there is a risk that this category of local government costs is (or will become) excessive. Confronting

governments with the true economic cost of their decisions will help ensure decisions are more efficient.

10.53 Where locally provided services have spill-over benefits for the country as a whole, central government should contribute to their costs. Consistent with this principle, there is scope for some expansion in the current range of transfers from central government for local government infrastructure expenditures in the three waters area.

10.54 There are currently three relatively small assistance schemes for water supply and waste-water treatment and disposal. The first is the recently commenced Ministry of Health's Drinking Water Assistance Programme, which will provide subsidies for capital expenditures for small communities (population less than 5,000) with a high deprivation index and high health risk. The projects most likely to receive funding will receive a subsidy greater than 65%. For example, a community with a population of less than 3,000 and a deprivation index greater than seven will receive a subsidy of 70%. The second is the Ministry of Health's Sanitary Works Subsidy Scheme (SWSS), introduced in 2003, which is focused on providing reticulated networks to a wide variety of small communities (population less than 10,000) with inadequate septic tank soakage. Subsidy levels are typically 50%. The scheme's major beneficiaries are Southland, Far North, Whangarei, Rodney, and Rotorua District Councils. However, all funds provided for this scheme are fully committed. The scheme is currently being reviewed. Thirdly the Tourism Development Subsidy Scheme also provides smaller amounts of funds for water and waste-water schemes in tourist areas, but all available funds are now fully committed. Some \$11 million over the three years has been provided. The scheme has been heavily over-subscribed, with applications totalling about \$59 million. The scheme was aligned with the Ministry of Health's SWSS and aimed mainly at small communities struggling to meet the costs of necessary water infrastructure.

10.55 The Panel considers that there is a strong case for greater Government assistance towards the capital and operating costs of new water supply and waste-water schemes and that this should apply to councils as a whole rather than be limited to small communities. In Chapter 11 new institutional arrangements and sources of funding for such an approach are discussed.

Development contributions

10.56 Under the LGA 2002, councils are able to levy property developers to help cover the capital cost of providing additional services to new populations. Development contributions have rapidly been embraced since they were introduced. Previously local authorities could levy only financial contributions under the Resource Management Act 1991, which covers only past (rather than forecast) expenditure and may be appealed under the Act. However, some councils continue to use this mechanism. The trends and forecast for these charges were outlined in Chapter 7. In 2006/07 development contributions, estimated at \$243.6 million, are expected to fund 7% of all local government capital expenditure. In 2015/16 this proportion is forecast in the long-term council community plans to be 17%. Given recent litigation on this issue, discussed below, councils are likely to adopt a more cautious approach to development contributions, and this forecast figure may therefore be overstated.

10.57 Properly applied, development contributions are consistent with both the efficiency and equity principles outlined above. Efficiency is promoted by forcing developers to internalise the cost of additional infrastructure that is caused by the development. If this were not done, excessive levels of development would be expected. A corollary is that if development contribution charges exceed the cost imposed on existing communities by new developments, development will be discouraged. Development contributions are also equitable, because they avoid some sections of the community (those already living in a location) subsidising others (new residents). There are clear limits on the extent to which councils can and should use development contributions. Councils should ensure

that they reach those limits, because doing so is efficient and equitable. But there is no economic rationale for exceeding them.

Current situation

10.58 Many councils have adopted policies on levying development contributions, as required by section 106 of the LGA 2002.¹¹⁷ The design and implementation of these policies is fraught with difficulties, at the conceptual level and in their detail. Local government as a whole is struggling to develop credible methods for assessing development contributions.

10.59 The recent judicial review of development contributions in North Shore City illustrates some of the difficulties. Although the council's policy was not overturned, the court found in favour of the plaintiffs in respect of the allocation of costs of the Northern Busway, over 90% of which was allocated to development. The key implication of this finding is that councils must seriously analyse the benefits all residents receive from infrastructure projects as compared with benefits for residents of new developments.

10.60 Of potentially wider concern was the court's ruling that no more than two developments at a time can be accommodated within a single application of the development contribution policy. Effectively, this means that councils cannot assess a development contribution for an area of land unless that land will be developed in at most two distinct projects. This finding, which derives from a strict interpretation of the Act, is likely to add substantially to the burden on councils to review their policies on development contributions.

10.61 Notwithstanding the difficulties currently being experienced, the overall merits of development contributions suggest that councils should persist with their efforts to formulate and implement such policies. Significant work is required to get on top of these issues, and it would be efficient to share this work between councils rather than have each one incur its own costs. Possible coordinating bodies include Local Government New Zealand or the Society of Local Government Managers. It would also be appropriate for councils to fully consult with developers to better ensure that the policy adopted is equitable, clear, and well understood.

Regional councils and government agencies

10.62 The Panel received a number of submissions from regional councils, as well as the joint submission from Local Government New Zealand and Society of Local Government Managers, seeking to broaden the power to charge development contributions. Regional councils are currently not able to levy these charges. The two main areas that impact on regional councils from new housing developments are the provision of public transport and flood control schemes.

10.63 The Panel can see no rationale as to why regional councils cannot levy development contributions. Although fairly attributing new regional infrastructure costs to new developments is more difficult than in the case of territorial authorities' costs, clearly costs are imposed by new developments on regional council activities. The economic analysis set out on the previous pages supports regional councils being able to levy development contributions, and any difficulties should be capable of resolution.

10.64 Transit New Zealand also considers that it should have the power to levy development contributions for impacts on the State highway network. In this case the issue is not clear. New developments will be paying taxes on profits, and new residents and businesses will pay taxes on their ongoing incomes. Visitors and residents to new developments will also pay excise duties and

¹¹⁷ Part 8 of the Local Government Act 2002 also contains 15 separate other sections concerning development contributions.

road user charges. The Panel considers that central government, the owner of State highways, will already receive additional revenue to fund any upgrades that would be required as a result of new developments and therefore does not support giving Transit New Zealand the power to levy development contributions.

Conclusions on development contributions

10.65 Development contributions are being used by many councils as a way of recovering infrastructure costs associated with accommodating growth. In principle, development contributions have a sound rationale based on efficiency and equity criteria. In practice, it has been difficult for councils to formulate and execute development contributions policies that are consistent with those criteria.

10.66 The current difficulties are likely to be temporary ones caused by the need for councils to understand and properly accommodate the additional flexibility offered by development contributions. The Panel does not consider that any changes to the LGA 2002 are required. There should also be close consultation with developers.

10.67 The Panel notes that regional councils manage a number of important network assets (flood control schemes) and public transport services that are affected by new developments. The Panel considers that regional councils should be given the same powers to levy development contributions as territorial authorities.

10.68 The Panel does not support these powers being expanded to Transit New Zealand.

Recommendation

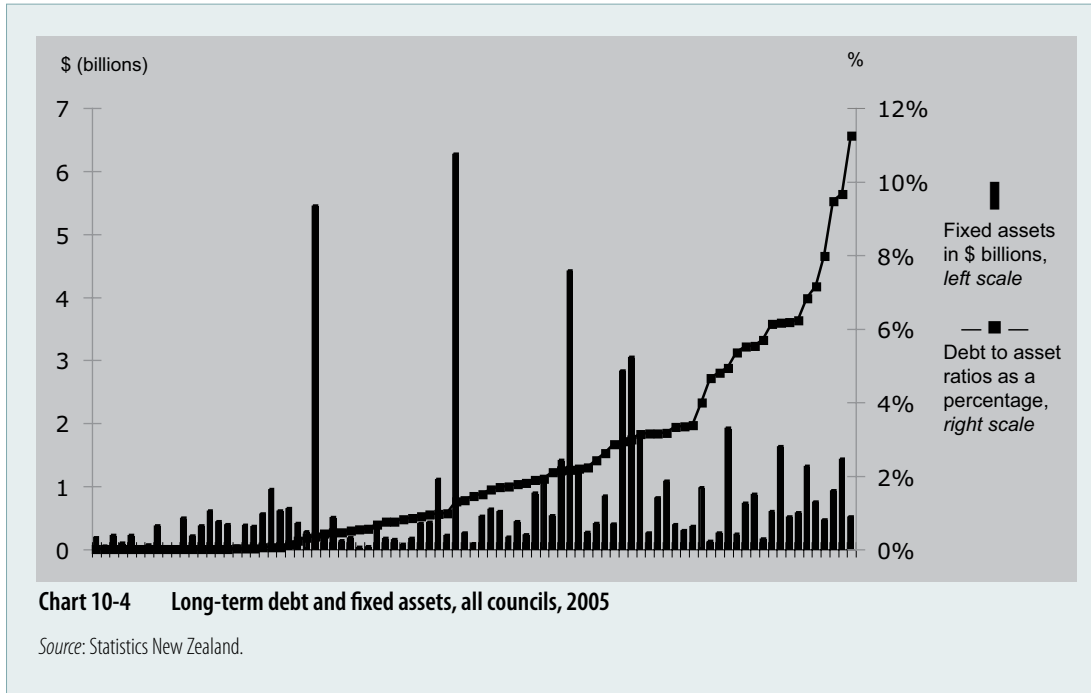
18 That, with respect to development contributions,

- **councils consult closely with one another and with developers in any necessary review of their development contribution policy**
- **regional councils be given the same powers to levy development contributions as territorial authorities**
- **these powers not be extended to include Transit New Zealand.**

Debt funding

10.69 There are very good reasons for local authorities to use debt to finance long-life investments. Doing so may advance the date at which the infrastructure can be provided, and spreads the capital cost more equitably across the generations that benefit from that service. Moreover, local authorities are very low-risk debtors so they enjoy lower interest rates in debt markets. Because ratepayers face higher borrowing costs and could invest additional funds left in their hands at market rates, the cost of debt to a local authority is relatively low. At current interest rates debt financing is actually less costly for councils than paying cash, and the total cost of an investment project need not increase in real terms as a result of debt financing.

10.70 Councils have enjoyed direct access to debt markets in the recent past, and indeed some bonds issued in this way are still outstanding. However, this is no longer an active source of financing, and since 1998 when such borrowing came under the requirements of the Securities Act 1978 in relation to prospectuses, only one council, Auckland City, has issued bonds. The main reason seems to be that many councils simply do not view debt as a long-term financing mechanism and prefer the flexible repayment schedules offered by trading banks rather than the fixed pattern repayments



required by bondholders. It can be noted that issuing bonds has the additional advantage of allowing local investors to invest directly in their own communities.

Debt loadings of councils

10.71 Chart 10-4 shows the ratio of debt to fixed assets for all local authorities in 2005 at 30 June and the size of the associated asset base. The five authorities with the largest asset bases have debt-to-asset ratios that are well under 4%. Only one authority has a debt loading in excess of 10%. As with all aspects of local government, the individual local authority situation is diverse and it may not be prudent for all councils to take on more debt. A small number of councils are forecasting to reach their debt policy limits by 2016. This issue is outlined in Chapter 7. However, the clear conclusion is that local authorities generally have very low levels of debt. In view of the benefits of debt financing mentioned above it is surprising that debt levels across the sector are so low.

Availability of debt

10.72 Local authorities have two main sources of debt financing. They can issue bonds, or they can borrow from trading banks and other intermediaries. Under a 1998 amendment to the Securities Act 1978, local authorities are no longer exempt from obligations on bond issuers, including the publication of a prospectus that all elected members must sign. This amendment made the issuing of bonds more costly and politically difficult for local authorities. One councillor could therefore prevent borrowing on the market, regardless of the majority view. However, the Government has recently announced that it will seek to amend the Act to remove the requirement for a prospectus for local authorities.

10.73 Additional local government borrowing through bonds could be expected to have a beneficial impact through the further development of New Zealand's capital markets. This view is supported in the submission by the Reserve Bank.¹¹⁸ Foreign currency borrowing should also be permitted, provided appropriate hedging arrangements are made.

118 Submission from the Reserve Bank [S166].

10.74 Although borrowing from the commercial banks has been very common, some local authorities felt that this source of debt was overpriced. As a result, Civic Assurance, a risk management firm owned by 76 of the local authorities, set up a finance company in 1999 to repackage debt for retail markets. This allowed a single prospectus to be used for bonds that were ultimately backed by many local authorities. Although initially successful (taking in over \$100 million at rates only slightly above those for Government bonds), this channel has now fallen into disuse. It appears that this is a result of two factors:

- sharper pricing by banks
- demand from councils for more flexible terms.

10.75 Requirements by councils for flexible terms include the desire to repay loans (or parts of loans) as financial circumstances allow. This may reflect that councils view debt as a relatively short-term financing channel rather than a useful way of spreading capital costs over time. It can be noted that interest rates will generally be higher on flexible-term debt than on bonds.

Impact of additional borrowing on rates

10.76 Greater use of borrowing for long-life assets can enable rates to be held at a lower level over a considerable period of time, even allowing for interest costs. There is some aversion amongst ratepayers to the taking on of debt, which is seen by some as financially unsound. Reflecting this, some councils perceive being debt-free as a virtue. This ignores the benefits of being able to undertake expenditures earlier than would otherwise be the case. It also ignores the interest cost that ratepayers bear by paying the rates earlier to fund the capital expenditures than would otherwise have been the case.

10.77 It is true that beyond a certain level debt financing may create financial risks. Debt funding should not be seen as a “licence to print money”, and prudential limits should be set.

10.78 A recent case in point is Auckland City Council, which has determined that in future all new (as opposed to replacement) capital expenditures will be debt-funded, replacing funding from rates of \$23 million in 2007/08. Various prudential limits have been established, including a limit on debt to total income of 3.0 times and interest expense to income of not more than 20%. Based on the long-term council community plan, this policy is predicted to reduce previously forecast rate levels until 2036.

Infrastructure bonds

10.79 An infrastructure bond is simply a debt instrument issued for the purpose of financing infrastructure. As discussed above, it is already feasible for local authorities to issue such bonds. It would be a way for investors to invest locally to support necessary infrastructure projects.

Conclusions on debt financing

10.80 The Panel considers that there are very good reasons for local authorities to make greater use of debt to finance long-life investments. Doing so may advance the date at which the infrastructure can be provided and spreads the capital cost more equitably across the generations that benefit from that service. Moreover, central and local authorities are generally low-risk debtors so they enjoy low interest rates in debt markets.

10.81 Local authorities use very little debt, with debt-to-asset ratios that are generally well under 4%. Although the existing long-term council community plans project significant increases in debt, these levels are still projected to be low when assessing debt-to-asset ratios.

10.82 Greater use of debt has potential to reduce rate increases for a considerable period over the longer term. This issue is analysed in further detail in Chapter 8.

10.83 The Panel considers that it would also be desirable for more local authorities to issue their own debt by way of bonds, rather than borrow largely from the commercial banks.

Recommendations

19 That local government look favourably on making more use of debt to finance long-term assets. This should include the issuance of bonds (including infrastructure bonds) on the capital market, not just shorter-term borrowing from commercial banks.

20 That borrowing in foreign currencies be permitted, subject to appropriate foreign currency hedging arrangements being adopted.

Public-private partnerships

10.84 Public-private partnerships (PPPs) are used in some countries with the aim of getting private sector financing and expertise for public projects. They have been used extensively in Australian state government. They have had mixed success, with the result that costly lessons have been learned, and New Zealand can benefit from these. Risk and its management is central to the case for a PPP. In principle, governments and private investors differ in their ability to manage particular types of risk.

10.85 Now that all PPPs must be reported in local authorities' balance sheets one of the previous reasons for Australian local government to engage in PPPs has disappeared. However, PPPs remain a particular way of using the private sector in delivering public services. They differ from more standard competitive procurement processes in that the private party invests capital or provides other financing assistance. PPPs are usually large-scale, long-term contracts. They are costly to arrange, requiring very careful consideration of a wide set of risks. The anticipated benefit is better value for money as a result of innovation in service delivery and the allocation of risks to those best equipped to manage them

10.86 For local government, PPPs are worth considering for very large projects that would otherwise be difficult to finance, or where ongoing participation of a private partner offers the potential for better risk management. It is desirable that there should be several qualified bidders, and a detailed financial analysis should support the proposition that a PPP will give better value for money than the alternatives.

10.87 In New Zealand a few build, own, operate, and transfer ("BOOT") schemes with the private sector have occurred, for example for waste-water schemes in Wellington and Hutt City, for a major Canterbury landfill, and for water in Papakura District. The LGA 2002 has a 15-year limit on contracts with the private sector for the provision of water services,¹¹⁹ effectively preventing PPPs in that sector. Providing more flexibility in this area would allow individual communities a wider range of options to construct key infrastructure. Public control of the level and costs of service of such investments would need to be retained.

10.88 Tolling of new roads is generally accepted as being required to progress PPPs in the transport sector. The Land Transport Management Act 2003 makes tolls for roads possible¹²⁰ but

¹¹⁹ Local Government Act 2002, section 136(1).

¹²⁰ Land Transport Management Act 2003, section 46.

requires a feasible, untolled alternative route.¹²¹ This requirement is very difficult to satisfy without significantly restricting the potential toll income of a new roading project. In addition, the Minister of Transport's consent for tolling is required.

10.89 The Panel considers that a greater ability to access PPPs would benefit the sector, for example, by allowing comparison of PPP project costs with more traditional project practices.

Recommendations

- 21 That the Government remove legislative barriers to the funding of transport projects through the use of tolls.**
- 22 That the Government extend the limit of 15 years on contracts with the private sector for water and waste-water services.**

Income from investments

10.90 Many local authorities own (or part-own) business enterprises such as ports, airports, forests, and farms, or they have significant investments in financial assets such as bonds and shares. This is partly a result of the corporatisation initiatives of the 1990s, which saw shares in ports, electricity enterprises, and so on allocated to individual local authorities. In a number of cases these were sold and the proceeds used either to reduce debt or invested in financial assets to provide a continuing income stream. For the year ended June 2006 investment income represented 6% of all operating revenue for local authorities.

10.91 Two main issues are considered here:

- the rationale for council ownership
- rates of return and asset valuation.

10.92 A distinction needs to be drawn between investments held for income generation and ownership of subsidiary organisations (such as council-controlled organisations (CCOs)) that a number of councils use to provide basic council services such as water and solid waste disposal. Some of these CCOs pay a "dividend" or make other contributions to general council revenues. CCOs established to operate as a profit-making business are classed as council-controlled trading organisations. Other CCOs are established to achieve more efficient service provision rather than for income generation. The Panel notes that in a few cases they may be used to generate revenues for general council use. It considers this inappropriate and recommends that although such undertakings should operate on a cost-recovery basis, their charges should not be used to cross-subsidise other council activities.

10.93 It is also possible for councils to establish council-controlled trading organisations (CCTOs), which have an explicit profit-making objective.

10.94 Table 10-2 lists some of the largest investments held by local authorities. This is a snapshot and ownership information changes over time, consequently this is not intended to be a complete list of individual councils or their total investments. There is considerable diversity, with some councils having no income from commercial investments. Investment income as a proportion of total operating revenue varied from zero to 45% in 2006. This diversity is a combination of the result of the 1989 local government amalgamation process, as well as past decisions by councils on the sale or retention of commercial assets.

121 Land Transport Management Act 2003, section 48(e)(ii).

Table 10-2 Major investments held by local authorities

Local authority	Commercial asset	Current value
Auckland Regional Council	Auckland Regional Holdings Ports of Auckland 100%	\$1,400 million in total \$797.4 million
Auckland City Council	Auckland International Airport 12.8%	\$437.7 million
Manukau City Council	Auckland International Airport 9.6%	\$328.0 million
Christchurch City Council	Christchurch International Airport 75% Lyttelton Port 74.1% Orion Group (electricity lines company) 89.3% Selwyn Plantation Board 39.3% A number of other companies	\$1,600 million in total assets
New Plymouth District	Perpetual Investment Fund (from sale of Powerco)	\$267 million
Dunedin City Council	Dunedin City Holdings Ltd, of which Aurora (electricity) City Forests Waipoura Fund	\$578 million \$320 million \$124 million \$75 million
Environment Bay of Plenty	Port of Tauranga 55% Investment portfolio	\$320 million \$83 million
Greater Wellington Regional Council	Cash investment Forestry Investment properties (CentrePort)	\$44 million ⁷ \$15 million \$99 million
Selwyn District Council	Orion Group (electricity lines company) 10.7% Selwyn Plantation Board 60.7% Sicon (construction and infrastructure)	\$60 million
Otago Regional Council	Port Otago Investment property Other equity shares	\$67 million \$154 million \$37 million
Palmerston North City Council	Palmerston North Airport Ltd Investment fund	\$6 million \$74 million
Taupo District Council	Investments in cash and equities	\$46 million
South Taranaki District Council	Long-term investment fund	\$71 million
Hamilton City Council	Waikato Regional Airport Ltd Hamilton Riverview Hotel Ltd	\$18 million \$12 million
Hawke's Bay Regional Council	Port of Napier Investment properties	\$100 million \$10 million
Wellington City Council	Investment properties Wellington Airport 34%	\$173 million \$125 million
Nelson City Council	Port of Nelson	\$66 million

Source: Data drawn from recent annual reports of each council or council-controlled organisation listed.

Rationale for council ownership

10.95 Ports and airports are good examples to consider in terms of the rationale for council ownership.¹²² They are frequently viewed by councils as important assets from the perspective of regional economic development because they act as gateways for flows of goods and people to and from the regions. Although this is true, the question that must be asked is whether a private owner would behave any differently from a council owner.

122 The Crown is also a joint venture partner in seven airports: Hawke's Bay, New Plymouth, Whangarei, Whakatane, Taupo, Wanganui, and Westport. The first two of these are currently scheduled for corporatisation. All ports are controlled by local government.

Table 10-3 Local government ownership of ports

Port	Local government ownership stakes	Total local government %
Northland Port Co	Northland RC 55%, Ports of Auckland 20%	75%
North Port	Northland Port Co 50%, Port of Tauranga 50%	78%
Ports of Auckland	Auckland RC 100%	100%
Port of Tauranga	Environment Bay of Plenty RC 55%	55%
Eastland Port – Gisborne	Eastland Community Trust 100%	100%
Westgate – New Plymouth	Taranaki RC 100%	100%
Port of Napier	Hawke’s Bay RC, 89% horizons.mw 11%	100%
Centreport – Wellington	Greater Wellington RC 100%	100%
Port of Nelson	Tasman RC 50%, Nelson CC 50%	100%
Lyttelton Port – Christchurch	Christchurch CC 65%	65%
PrimePort Timaru	Timaru DC 74%	74%
Port Otago	Otago RC 100%	100%
South Port – Invercargill	Southland RC 66%	66%

Source: McDouall Stuart, *The New Zealand Port Sector*, 2005. Notes: RC = regional council; CC = city council. horizons.mw = Manawatu-Wanganui Regional Council.

10.96 From a day-to-day operational aspect, the main differences are likely to show up in prices. A private operator may be more cost-efficient than a council, but both would seek to maximise the value created by the asset. The owners may well differ in their definition of value; private operators would equate value with revenues, whereas a council may interpret value as including throughput (for example, tonnes of cargo or numbers of passengers). This may lead a council to set lower prices than a private operator and to achieve correspondingly lower earnings.

10.97 A different issue arises when the time horizon expands to include capital works. It is here that the most significant differences may arise between public and private ownership if councils and private firms are seeking very different outcomes. Auckland Regional Council’s ownership of Ports of Auckland Ltd is a good example. If the purpose of buying out minority interests in this firm was to actively influence the physical development of the waterfront, then that could be socially useful. If it was merely to secure the additional dividend flow, then it appears far less so. It does not appear that the purpose of that investment was made public.

10.98 Airports are another area of interest. Many local authorities have recently invested additional capital in their airports or are planning to do so.¹²³ It appears that a significant amount of this investment is for the purpose of attracting international flights from Australia, and thereby boosting the local tourism industry. Queenstown has demonstrated that such a strategy can work, but this does not imply that its experience can be replicated across the country. Although it is possible that regional expenditure intended to support direct international flights is a sound use of public funds, private investment is likely to require clear indications from an airline that flights would be scheduled before investing.

Ports

10.99 The port sector in New Zealand is in a state of transition, reflecting international developments. The volume of global trade has been growing faster than shipping capacity, which has driven up capacity utilisation in the shipping industry and reinforced the trend towards larger ships.

123 To take just three examples: Rotorua Airport is getting a longer runway and a three-tier car-park; Hamilton airport has recently spent \$15 million on a new terminal; and the Invercargill airport runway was extended by 500 metres in 2005.

Table 10-4 Rates of return on assets of council investments

Company	Council	EBIT/assets
Northland Port Corporation (NZ) Ltd	Northland Regional Council	2.80%
Waikato Regional Airport Ltd	Hamilton (and others)	2.60%
Dunedin City Holdings	Dunedin City Council	5.90%
Auckland Regional Holdings	Auckland Regional Council	13.57%
New Plymouth Airport	New Plymouth District Council	1.37%
Palmerston North Airport Ltd	Palmerston North City Council	8.10%
Hawke's Bay Airport Authority	Napier/Hastings	5.31%
WRC Holdings Group Limited	Greater Wellington Regional Council	2.43%
Port Nelson	Nelson City Council	6.40%

Source: Covec Ltd, report to the Rates Inquiry.

This, in turn, has placed pressure on the operating efficiencies of ports, and is leading shippers to rationalise the number of ports called at in New Zealand.

10.100 These dynamics are particularly relevant to local government because it controls the entire port sector in New Zealand. A breakdown of local government ownership by port was provided by McDouall Stuart¹²⁴ and is included as Table 10-3. McDouall Stuart views the sector as becoming increasingly stratified into three groups: international ports, which will continue to serve major international shipping lines but will experience considerable pressure on pricing; bulk ports, which will enjoy local monopolies on particular export trades; and regional ports, which will be obliged to adapt their business models to accommodate the gradual loss of container traffic.

10.101 There are good reasons for local authorities to hold investments in ports, but they concern more the strategic value of the land on which the port is sited rather than the port activity itself. Waterfront redevelopment can contribute greatly to the public amenities available in cities and towns. Local government has a legitimate guiding role in such activity, and holding port stock probably makes it easier to give effect to that role. On the other hand, there is considerable strategic uncertainty associated with port activity, and the sector is achieving relatively modest rates of return.

10.102 These factors suggest that there may be merit in seeking to split land holdings from port activity. Potentially, that could allow councils to pursue waterfront redevelopment initiatives around the fringes of ports, and to exit the port business itself.

Rates of return and asset valuation

10.103 The rates of return being achieved by councils from a sample of their commercial operations is analysed below, based on the annual reports of these companies.¹²⁵ Table 10-4 presents reported ratios of earnings before interest and tax (EBIT) to total assets. It shows that rates of return vary dramatically, from a low of 1.4% to a high of 13.6% per year.

10.104 The basis for asset valuation has a major influence on the interpretation of the EBIT/assets ratio. To avoid biasing the interpretation, assets should be valued at their opportunity cost. For practical purposes, this is the sum that would be paid for them if they were sold. If assets are valued at less than their opportunity cost, the rate of return will be overstated. There is considerable variation in the way assets are valued within this sample group. Several councils report that land is in the books at "fair value" while plant and equipment is valued at historic cost.

124 McDouall Stuart Corporation, *The New Zealand Port Sector*, November 2005.

125 The analysis that follows was undertaken for the Rates Inquiry by the consulting firm Covec Ltd, Auckland.

Table 10-5 Financial information from ports

Port	EBIT (\$ millions)	Total assets (\$ millions)	EBIT/total assets %
Auckland	70.1	627	11%
Tauranga	59.7	648.4	9%
New Plymouth	3.4	92.5	4%
Napier	9.9	113.4	9%
Wellington	10.7	197.3	5%
Nelson	10.5	121.4	9%
Marlborough	6.3	54.1	12%
Lyttelton	20.8	200.5	10%
Timaru	3.4	70.8	5%
Dunedin	15.5	188.5	8%
Invercargill	3.3	29	11%

Source: McDouall Stuart, *The New Zealand Port Sector*, 2005.

10.105 The financial performance of the port sector varies dramatically but appears poor on average. Basic information for the 2005 financial years is shown in Table 10-5.

10.106 Although most port companies revalue their land assets regularly (only Dunedin and Invercargill do not), only a handful (Auckland, Tauranga, and Lyttelton) apply the same discipline to operating assets.

10.107 A number of submitters expressed concerns about the low returns from some council assets and some suggested that councils should divest themselves of such assets and use the proceeds for debt or rate reduction (although in the latter case, this would have only a one-off effect). On the other hand many councils argue vigorously for retaining these investments, both for strategic economic development reasons and for the annual dividend income that is generated in some cases, thus enabling the level of rates to be lower.

10.108 The Panel considers that decisions on holding such assets must be left to individual councils, although it considers that councils should rigorously review their reasons for holding commercial investments. In any case it considers that there should be certain requirements:

- ✦ Council-controlled business undertakings should operate as a business, similar to the requirement of the State-Owned Enterprises Act 1986, which requires State-owned enterprises to “operate as a business”. This would involve all undertakings having clear financial targets, set by the council, but reflecting a commercial rate of return.
- ✦ Councils should report transparently in their annual financial statements and report the achievement or otherwise of these targets, including the actual rate of return earned on the investment.
- ✦ Councils should clearly articulate their objectives in holding such investments, and include in the annual report an assessment of the extent to which these objectives have been achieved.
- ✦ For investments held in financial assets, target rates of return should be established and the actual return reported in the annual report and financial statements.

10.109 For CCOs and other subsidiary service organisations, the Panel considers that clear operating targets need to be set and the results included in the annual report of the council. The Panel considers that cross-subsidisation between such services and other council activities should not be permitted.

Conclusion on investments

10.110 Local authorities vary widely in their investments in commercial ventures or financial assets. Such assets were the source of 6% of total revenue nationwide in the 2005 financial year, but varied from zero to 40%. The rates of return being achieved vary widely but are on average low relative to private sector benchmarks.

10.111 Subsidiary service organisations, including CCOs, are of a different nature to purely commercial investments.

10.112 Council investment in port and airport businesses could benefit from reassessment of the reasons for investing and the risks of such investments in rapidly changing business conditions.

10.113 All councils should be able to clearly articulate in their LTCCPs their reasons for investments in business enterprises.

Recommendations

- 23 **That business enterprises owned or controlled by a local authority be required to operate as a business in the same way as State-owned enterprises.**
- 24 **That councils set clear financial targets for such enterprises.**
- 25 **That councils report transparently in their annual reports on the achievement or otherwise of the financial targets that have been set for the businesses in which they have invested, including reporting the actual rate of return earned on the investments.**
- 26 **That councils clearly articulate in their LTCCPs their objectives in holding investments in business enterprises, and include in their annual reports an assessment of the extent to which these objectives have been achieved.**
- 27 **That councils identify target rates of return for investments held in financial assets and publish the actual return in their annual reports.**
- 28 **That clear operating targets for council-controlled organisations and other subsidiary service organisations be set and these results included in councils' annual reports.**
- 29 **That cross-subsidisation between such services and other council activities be not permitted.**

Other sources of revenue

10.114 There are four other sources of revenue to be considered:

- user charges and fees
- fines
- grants and donations
- asset sales.

Table 10-6 User charges and fee income as percentage of total income, 2005

Category	Minimum	Average	Maximum
Regulatory income	0%	5%	17%
Sales + all other income	4%	18%	59%
Total	6%	23%	63%

Source: Statistics New Zealand.

User charges and fees

10.115 User charges and fees arise from the sale of goods and services, or from fees associated with various types of consent application, mainly building and resource consent. Income of this type is reported by Statistics New Zealand under two headings: regulatory income and sales plus all other income. Summary statistics across all local governments for the 2005 financial year is reported in Table 10-6.

10.116 On average, local government raised 23% of its revenue from these sources in 2005, but there is very significant variation around this figure. The maximum values are distorted somewhat by the West Coast Regional Council, which has a particularly large share of “sales + other” income. Chart 10-5 shows the distribution of total income from these sources.

10.117 User charges and fees should be used where there is an identifiable cost caused by an individual ratepayer. They are price signals, so efficiency demands a close link to the cost of provision. The Panel considers that volumetric user charges should be used more extensively for water services – both water supply and waste water. Water is a scarce and costly resource to supply and dispose of. Volumetric user charging can help ensure it is efficiently used¹²⁶ and also reduce the level of capital investment that would otherwise be required. Experience in New Zealand suggests that water consumption falls by around 15%–20% after the introduction of volumetric user charging. However, water is not widely priced by local authorities,¹²⁷ with just 27% using metering for at least some of their customers [S746].¹²⁸ In the 2005 financial year, 71% of local government expenditure for water and waste-water services was funded from rates. On average, 22% of all rates are allocated to water services.

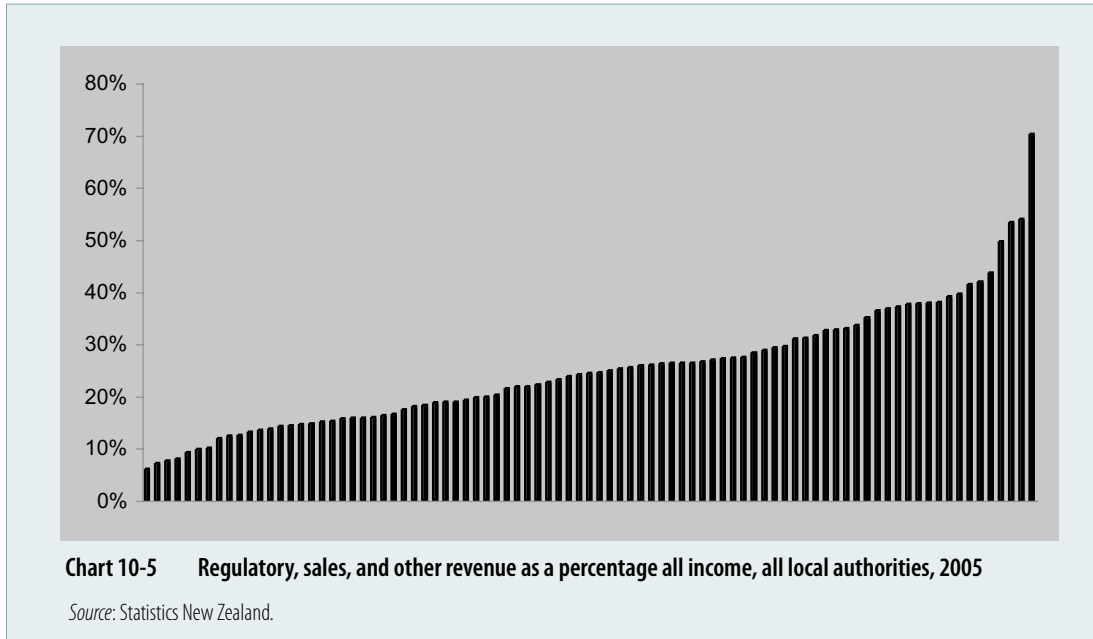
10.118 A significant barrier to more extensive water metering for many local authorities is the capital cost of buying and installing water meters, particularly in areas with low growth and plentiful water sources. Given the high national good outcomes and associated environmental benefits from reducing water consumption, there is a strong case for government assistance to meet the high capital cost of installing water meters.

10.119 At present the only way councils can charge for residential waste water by volume is to form a CCO. This seems an unnecessary requirement and should be removed (as also recommended in Chapter 9). Given the difficulty of using meters to measure waste-water disposal for residential properties (although this is commonly done for major commercial properties), water usage is generally used as a surrogate. However, there may not be a direct connection between water used by a residential property and waste water discharged (for example, some water may be supplied from tanks that collect rainwater, and on the other hand some water may be used on gardens and not

126 The Ministry of Agriculture and Forestry has done an initial survey of economic instruments for water allocation (<http://tinyurl.com/39e73o>).

127 Tauranga, Auckland, Waitakere, North Shore, and Manukau city councils are major exceptions.

128 New Zealand Water and Wastes Association [S746].



discharged into the waste-water system). However, a charging system for water disposal based on water consumption seems likely to be equitable overall.

10.120 The details of this change should be determined by a working party including the Department of Internal Affairs, New Zealand Water and Wastes Association, Local Government New Zealand, and the Society of Local Government Managers.

10.121 Local authorities also levy fees for a variety of services ranging from health inspections of hairdressers, to fairground equipment safety inspections, to fees for building permits and other resource consents. In some cases these fees are prescribed nationally by regulation and do not recover full costs. This issue is further discussed in Chapter 8 where it is recommended that all such fees be determined by councils and charged on an actual and reasonable basis.

10.122 In urban environments internationally, many local authorities use economic instruments such as tolls around city centres to manage transport demand. The Panel favours greater use of user charging in this area also, based on road user charges and petroleum excise, and possibly in the longer run on 24/7 electronic road user pricing. This issue is further discussed in Chapter 11.

10.123 The major benefit of pricing tools is that they influence the demand for the service. Local government generally responds to increasing demand by providing additional supply, often with significant infrastructure expenditures. It has rarely acted to limit the demand for infrastructure services by using price management, except in recent years by some use of water meters and trade waste charging. Greater use of charges for the purposes of demand management is consistent with the wider national goal of sustainable development. Over the longer term, pricing can act to reduce the demand and, in conjunction with public transport investments, reduce the need for very expensive roading investments.

Conclusions on user charges and fees

10.124 The Panel considers that user charging and actual and reasonable cost recovery should apply as far as possible to water supply, waste-water disposal, and solid waste collection and disposal. This could have a significant impact in reducing demand and the required level of capital expenditures. However, such decisions should remain a matter for individual councils.

10.125 The Panel considers that there is scope for regulatory, sales, and user charges to be increased where these do not reflect actual and reasonable levels of costs being incurred. This includes those cases where Government regulations set fixed charges that do not enable full cost recovery.

Recommendations

- 30 That actual and reasonable cost recovery for water supply, and waste water on a volumetric basis be encouraged.
- 31 That the Government explore providing assistance for local authorities to install water meters where this is practicable.
- 32 That the requirement that councils form a council-controlled organisation to be able to levy user charges for waste water be abolished.
- 33 That councils be permitted to set all fees and charges on an actual and reasonable cost recovery basis, and any Government regulations that limit such fees should be removed.

Fines, grants, and donations

10.126 Fines, grants, and donations are all minor categories of local government revenue. Their yield can be affected by the amount of effort councils devote to collection. Some fines revenue can be increased through greater policing.

10.127 The Panel concludes that there is little scope for fines, grants, or donations to be significant sources of increased revenue.

Asset sales

10.128 The Panel concluded above that many local government commercial investments have performed poorly in financial terms. However, this does not necessarily mean that they should be sold. The diversity of council investments precludes any general advice about the merits of asset sales. However, councils should review their business asset holdings on a periodic basis, and be able to articulate the rationale for each investment.