

Better Local Services: Improving Local Government Delivery Through Innovation and Partnerships: Lessons from the New Zealand Experience

**A Presentation to the Commonwealth Local
Government Forum Asia-Pacific Regional
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Contents

	<i>Page</i>
1. Introduction	1
2. Context: Public Management Reforms.....	2
Public Management Reforms	3
A more commercial approach	5
3. The Current Situation	6
4. Experience with Market-Based Options: Examples and Lessons.....	8
Contracting Out.....	8
Lessons	10
Corporatisation.....	11
Lessons	13
Public-Private Partnerships.....	144
Lessons/Issues	14
5. Corporatisation/Arms Length Arrangements Generally	16
Matching Activity to Structure	16
Keeping Your Distance.....	17
Good People -- and Accountability.....	17
"No Surprises"	18
6. Conclusion	19

1. INTRODUCTION

This presentation has been prepared as a New Zealand contribution to the Commonwealth Local Government Forum Asia-Pacific Regional Symposium "Better Local Services: Improving local government delivery through innovation and partnerships".

It will begin by providing some historical context for the New Zealand local government sector, including a brief overview of New Zealand's public management reform process. This part of the presentation will conclude with a description of recent changes, including question marks over the place of the "more market" approach in the ownership and delivery of services.

The presentation will then provide three brief case studies of different forms of innovation and partnerships selected to highlight lessons that should be of interest for local government generally. Those three case studies will set the scene for considering the place of corporatisation and arms length arrangements generally, including a New Zealand perspective on the governance issues that need to be addressed.

2. CONTEXT: PUBLIC MANAGEMENT REFORMS

Compared with many countries whose systems of government had been influenced by the so-called Westminster tradition originating from the United Kingdom, New Zealand has a comparatively simple system of government. It has no written constitution. Since 1951 it has had a unicameral legislature -- a single house of Parliament at the national level with relatively unrestricted power to legislate.

Central government has not only been responsible for funding major public sector activity such as education, health, social welfare, social services, defence and police, but has also been the service provider. Although in the late 19th century there were some signs that New Zealand local government might follow the United Kingdom example of local government having responsibility for major service delivery, the relatively small size of the country (at least in terms of population and economic base) and the weak nature of local government both resulted in central government assuming the responsibility for most major services.

Local government's responsibilities, until the passage of the Local Government Act 2002, were restricted mainly to local infrastructure (water, wastewater and stormwater; local roads -- state highways remain a central government responsibility) local regulation; environmental management; waste disposal; and the provision of local arts, culture and recreational facilities. A number of other activities which were seen as essentially local or regional in their nature were assigned by central government to what were referred to as "special-purpose authorities". Typically these were locally elected bodies with responsibility for a single function. They included Harbour boards, Catchment boards, Reserve boards (responsible for managing local recreational and other reserves), various pest destruction and noxious weeds management boards and a miscellaneous range of others.

Against this background, it has been usual to describe New Zealand local authorities as being in the business of "roads, rats and rubbish" with the implication that their main responsibility amounted to "housekeeping" for the local community with the serious decisions being taken elsewhere -- typically by central government as a whole or central government departments. Unusually, at least when compared with jurisdictions such as the United Kingdom and Australia, New Zealand local authorities have long had a substantial degree of discretion in deciding the level of rates (property taxes) they should impose on their communities in order to fund their activities. This has increasingly included additional discretions about how to allocate the burden of rates amongst different groups within the community (through legislative powers to target rates and/or set rates on a differential basis).

Until the 1990s they were quite tightly controlled in terms of borrowing, with a body known as the Local Authorities Loans Board (appointed by and accountable

to central government) having the power to decide when and how councils could borrow.

For most of their existence, New Zealand local authorities had relatively limited powers to contract out services or undertake them through commercial arrangements. In this respect, they were little different from much of the rest of the public sector. Until the mid-1980s, New Zealand was a very highly regulated economy based on a mixture of protection against the outside world through measures such as import licensing and tariffs, and a high degree of government intervention internally with a commitment to working through what, in public management terms, were very traditional structures.

Public Management Reforms

In 1984 a new government came to office at a time of economic crisis. It quickly implemented what was almost certainly the most comprehensive programme of public sector reform ever undertaken by a democratically elected government. The emphasis was on a "more market" approach to the role and design of the structures of government. Heavy reliance was placed on public choice theory with its emphasis on transaction costs and agent/principal theory -- a combination of insights from economics which stressed the need to design public sector structures to protect against the risk that people working within them would act to advantage themselves whenever they had the opportunity to do so.

Catch words of the day, and still significant now, were terms such as "transparency" and "accountability". Transparency meant an emphasis on reporting mechanisms that would provide good information to ministers and others responsible for monitoring performance in the public sector. New Zealand was the first country to adopt accrual accounting for its public sector. Today, New Zealand government, local authorities, and other public sector entities are required to prepare their accounts on the same generally accepted accounting principles that apply to the private sector.

Accountability was seen as requiring not just good monitoring, but even more importantly ensuring that the different functions undertaken within the public sector were separated out whenever there was perceived to be a risk of significant conflict of interest. As one illustration of what was meant in practice, policy was separated from operations. A number of major government departments were restructured so that the policy function was placed in a separate policy Ministry removed from operations.

The relationship between ministers and their departments were changed. The previous direct responsibility which ministers had for activity within departments was substantially removed. Instead, chief executives were given the primary responsibility for determining within their departments, what activities would be undertaken to meet the Minister's objectives. In turn, the Minister's role was recast as one of purchasing from the department the outputs the Minister required to meet the policy objectives the Minister had.

These changes were accompanied by a very comprehensive programme of corporatisation and, in many cases, privatisation based on the belief that government owned activities which produced goods or services broadly similar in character to those provided in the market should themselves be run on market principles. At the very least, this meant shifting them into a company structure with shareholders (ministers on behalf of the government) and commercial directors. In a number of cases, this meant outright sale where the activity was seen as broadly equivalent to normal commercial activity -- privatisation affected a range of what were previously government owned activities including forestry, farming, railways, the national airline, telecommunications, part of the electricity sector, insurance, banking and a number of others.

The same government also made a number of very significant changes in regulation of the economy generally. The previously very substantial subsidies to the farming sector were withdrawn, the import licensing system dismantled, tariffs reduced, financial markets deregulated (when the government came to office in 1984, there were stringent interest rate, capital markets and price controls in place all of which went) and the taxation system substantially reformed.

Against this background, it was no surprise that central government should turn its attention to the reform of local government. This began in 1989. First, central government addressed the question of structure. There were more than 800 local authorities including 600 "special-purpose" authorities. Structural reform reduced the number to (now) 86 of which 74 were what we term territorial local authorities -- with the responsibility for service delivery within their districts -- and 12 are regional councils. These were formed to have an oversight role for environmental management and regulation. Rather than being a separate tier of local government, they normally work alongside the territorial local authorities within their region.

Structural reform was followed by significant changes in the powers and accountability requirements for local government. Councils were given wide ranging commercial powers including the power to corporatise activities and, if they so chose, to sell. These powers were balanced with greater accountability including accrual accounting, comprehensive "before and after" requirements to report to their communities, and a shift towards the same kind of chief executive model as had been put in place in central government.

The reporting requirements included the preparation of a long term financial strategy which was to set out, for at least 10 years, the intended activities of a local authority, how they would be financed and, applying economic principles, how costs would be allocated to different sectors within the community.

Councils were also given extensive powers to provide financial assistance, guarantees and other support for activities that they regarded as beneficial to their communities -- in practice this amounted to a very wide ranging charter which could be used by councils to undertake, through arms length entities, any activities for which they themselves lacked the power.

Finally, a note on electoral arrangements. In New Zealand, local authorities have always been elected. Currently, any person who is aged 18 years or older and who has lived within the district or region of the local authority for at least three months, is entitled to vote (the franchise is the same as for central government and in practice the same electoral rolls are used for both). At the territorial level, councils are made up of a Mayor, who is elected at large by the whole community, and by elected councillors. At the regional level, councillors are elected directly and themselves choose their own chairman.

A More Commercial Approach

Central government's focus on encouraging local government to become more efficient included legislating to require corporatisation of certain local government activities. These included electricity undertakings (some, but not all, councils owned their local electricity distribution networks and, occasionally, some electricity generation as well), and activities associated with government subsidised roading -- business units which undertook the maintenance and construction works, professional advisory services and public passenger services.

A number of councils also took advantage of the new legislation to corporatise other activities which they themselves believed were best run on business principles. Examples include forestry, local government treasury operations and property development.

These very seldom involved private sector partners. Instead, they had a focus on applying commercial structures and principles to activities which remained wholly owned by local government but operating under the Companies Act and related commercial legislation. What this early experience did provide was some very useful insights into the results of imposing a commercial structure on activity which had previously been undertaken within a conventional local government framework -- more on this later.

3. THE CURRENT SITUATION

Although the reforms of the late 1980s and early 1990s were widely supported at the time, they gradually fell out of favour. The stock market crash of 1987, and the resultant decline in economic activity worldwide had a significant impact on the New Zealand economy. Economic growth declined, unemployment rose, and a number of parts of New Zealand which had lost significant activity because of public sector restructuring and/or economic reform were suffering considerably. Repeated assurances from politicians that there was "no gain without pain" and that we should look forward to the benefit of the reforms which would eventually come were not sufficient to restore public confidence.

In 1998 there was a change of government, ironically back to the political party which had initiated the reforms of the 1980s, but which now had a very different attitude to the role of government. For the past six years, New Zealand has seen a partial retreat from the application of "more market" principles to the public sector. Although the current government is still very focused on things like fiscal discipline, further privatisation and even corporatisation of central government assets is off the agenda.

In local government, central government's focus has been on making local government more responsive to its communities, reflecting the current trend internationally to the region/locality playing a much more significant part in helping determine the strategic direction of communities, and acting as the focal point at which central government activity is coordinated.

In 2002 New Zealand's Local Government Act was rewritten. The purpose of local government was redefined. Instead of a series of responsibilities related to local infrastructure and other services, the purpose of local government was stated in terms of promoting community well-being. Councils now have a statutory responsibility to promote the economic, cultural, environmental and social well-being of their communities in the present and for the future. This is coupled with a further responsibility to promote local democratic decision-making by and on behalf of communities.

As well as reflecting international trends -- for example the shift in 2000 in England and Wales to giving local government the power to promote the economic, environmental and social well-being of communities, or the increasing practice in Australian local government of undertaking strategic planning on behalf of communities -- the New Zealand change also responded to a specific government objective. Central government had become concerned that many of its own objectives required working collaboratively at a regional or local level -- both collaboration amongst its different departments and agencies which had been very much reduced as a result of the reforms of the 1980s and 1990s, and collaboration between those departments and agencies and the local interests and networks which often hold the crucial knowledge, resources and leadership potential to make things happen.

This has seen a significant shift, still in the process of taking place, towards a much more strategic role for local government (more background on this can be found, for those who are interested, at www.mdl.co.nz).

The legislation also reflected central government's growing distaste for the widespread use of market-based initiatives. Under the previous legislation, local authorities had the power to corporatise, or if they wished, privatise their water and wastewater assets (subject to a requirement that they first consult with their communities).

The current Local Government Act includes an effective prohibition on the privatisation of water and wastewater assets and severe restrictions on the involvement of the private sector in long-term management -- these restrictions were significantly influenced by two factors:

- An inherent distaste, within the present government, for privatisation supported by quite widespread evidence of a public belief that water and wastewater assets are special and should not be privatised.
- The unfortunate experience (reported below as a case study) of one local authority which had entered into a long-term franchise agreement for the management of its water and wastewater assets by a joint venture of two multinational water companies.

4. EXPERIENCE WITH MARKET-BASED OPTIONS: EXAMPLES AND LESSONS

In New Zealand, local authorities have used market-based options as a means of managing service delivery in a variety of different ways including contracting out, corporatisation and public-private partnerships.

In some instances, the arrangements have been used for activities which are commonly undertaken by commercial organisations where the overriding objective, on the part of the local authority, has been a combination of passing to the private sector the responsibility for providing the capital needed for the ongoing management of the service, and introducing into management the skills of experienced private sector parties. In others, the primary objective has been to bring on board the networks and influence of experienced private sector people to achieve better management of what is intended to remain essentially a public facility.

This section will look at three examples, one of contracting out, one of corporatisation and one of a public-private partnership.

In each case, the purpose of the case study will be to highlight lessons which should be of value for others considering similar initiatives.

The three case studies are:

- Contracting out: the establishment of a long-term franchise agreement for the management and operation of a local authority's water and wastewater assets.
- Corporatisation: passing over the management of a significant public facility to an incorporated trust in the expectation that the trustees would bring to the role both considerable expertise and the ability to attract additional funding from commercial sponsors and others.
- Public-private partnership: the use of a BOOT (build, own, operate, transfer) arrangement for the development of a major indoor events centre in Auckland, New Zealand's largest city.

Contracting Out

Papakura District Council is the smallest of the seven territorial local authorities which make up the Auckland region. At the last census (2001) it had a current population of approximately 40,000.

During the reforms of the 1980s, it was one of the local authorities which was most attracted by the opportunity to use commercial options for the management and operation of council activities. It adopted a philosophy of "If private enterprise can do the job quicker, better and cheaper, then they got the work".

The Council, as was the case with all New Zealand local authorities, owned and managed its local water, wastewater and stormwater infrastructure. It decided that it should seek private sector options for the ongoing management and operation of that infrastructure. To do so, it sought proposals from multinational firms with experience in the operation and management of water and wastewater infrastructure.

After going through a tender process, the Council entered into a franchise agreement for a term of 30 years, with a right of renewal for a further 20 years, with a joint-venture the main partners in which were the UK-based Thames Water and Compagnie Generale des Eaux from France.

A subsequent review of the tendering process, and the terms of the arrangement which the Council entered into, highlighted a number of lessons.

From the perspective of the Council, there were two critical issues that needed to be guaranteed by the franchise arrangement. These were the standard to which the assets should be maintained and returned to the Council at the end of the franchise period, and the prices which the joint-venture could charge users for water and wastewater services.

For the first issue to be dealt with effectively, the essential prerequisite was an asset management plan which identified the assets which made up the water, wastewater and stormwater system, their current condition, and standards for their ongoing maintenance. No such plan existed.

On pricing, at the time that the franchise agreement came into effect, Papakura had the lowest charges for water and wastewater services in the Auckland region. It agreed with the franchisee that, after an initial two-year period during which prices were to be fixed, prices would be capped at the average cost to consumers in the Auckland region -- in other words, the Council agreed to a potentially substantial increase, and one over which it had absolutely no control, as it had no influence on what other councils were charging their consumers.

The franchisee, in negotiating the agreement, drew on the very considerable international experience of its two shareholders with franchising, and also engaged the expertise of leading professional firms in drafting the legal documentation and setting benchmarks such as the pricing formula. In contrast, the Council relied primarily on its own staff -- who had no experience in these matters -- and on its local lawyers for whom this was the first franchise agreement of this type which they had encountered.

Lessons

The first and obvious lesson is the importance, when entering into negotiations with experienced private sector parties, of ensuring that the expertise available to the local authority matches that of the private sector. This applies both to the advisers used by the local authority, and to the local authority's own staff. If capability is lacking in either of these areas, then the risk to the local authority of entering into a long-term contracting arrangement with the private sector is simply too great -- one of the primary sources of profit for the private sector in these types of contract is leveraging off the relative inexperience of public sector partners.

The second lesson is the importance of being well-prepared. Papakura was not. The fact that it did not have a current and detailed asset management plan meant that it lacked a very necessary baseline for monitoring ongoing performance.

There is a third lesson which is crucial when considering matters of pricing and revenue. Papakura's Council exposed its consumers to risk not just because it agreed to a pricing formula that was outside its control or influence, but because it failed to take into account the implications of entering into a very long-term contract in an area of service which is subject to ongoing policy change.

At the time Papakura entered into its franchise agreement, there was a quite widespread view that the appropriate way to fix the price for water and wastewater services was to take a least cost approach -- the price should be as low as possible consistent with the operator covering its costs and earning an acceptable return on capital. Attitudes are now undergoing a significant change. First, water is increasingly seen as a scarce commodity. Secondly, there is growing concern worldwide about the impact on the environment both of extracting water for consumption and of disposing of wastewater and stormwater. In response to this, there is an emerging view that water and wastewater services should be charged for on the basis of their full environmental costs. This view has a threefold purpose:

- Making it clear to end users exactly what the cost of water services is.
- Using the pricing mechanism to encourage conservation and wise use -- there is now considerable research evidence that this can be a very effective way of restraining demand.
- Removing any price/cost bias against alternative systems such as recycling grey water.

What that implies is that pricing water services is not just a commercial matter; increasingly, it is a matter of good environmental management with the "public good" aspects of water pricing potentially more significant than the commercial aspects. Perhaps more to the point, it is very clear that prices which are set on the basis of full environmental cost would be significantly higher than prices set simply to cover the cost of operations together with an acceptable return on

capital. The problem for local authorities like Papakura is what happens if there is a move to full environmental pricing, especially if this is encouraged or required by regulatory intervention? There is a potential risk that the franchisee might capture part or all of the difference between the conventional commercial price and full environmental pricing to the detriment of consumers.

What this emphasises is an inherent risk in long-term contracts in areas of activity that are potentially subject to policy change.

Corporatisation

Corporatisation is normally thought of as the practice of restructuring a public sector owned activity as a company with the purpose of making it subject to commercial disciplines under the control of a commercial board. In New Zealand, it has been a quite common practice for local authorities to corporatise activities by converting them into what in New Zealand is known as an incorporated charitable trust -- essentially the equivalent of a Malaysian non-profit corporation.

This approach has most often been used for facilities such as art galleries, museums, zoos, recreational facilities and, in the service area, economic development agencies.

The reasons for doing so have included:

- Creating a governance structure which is focused on the activity in question. Typically, transferring a council activity to an incorporated trust includes the formation of a trust board whose sole focus is the governance of that particular activity. In contrast, if the activity remains with the council, then it will normally be overseen by a council committee which has responsibility for a wide range of other activities -- the trust approach combines being able to get people whose interest is in that activity rather than the whole range of council activity, with avoiding the problem that the activity has to compete for attention.
- Incorporated charitable trusts are able to access funding, including donations, which may not be available to councils.
- The use of a separate structure can help raise the profile of the activity, and strengthen public support for it.
- There is a very real potential for improving the efficiency and effectiveness of the way the activity is operated. The advantages range from "getting out from under" the high compliance costs and procedural requirements for council decision-making, to being able to apply private sector practices and decision-making (even although the trust itself is not in a formal sense a private sector entity).

Quite often, corporatisation of this type takes place either when the council has run into difficulty with operating the facility itself, or it wants to hand over to someone else responsibility for what may be quite contentious policy or operational issues.

Wellington, which is New Zealand's capital city, has one of the country's best-known cricket grounds, the Basin Reserve. It was vested in the Council in the late 19th century on conditions which required it to be used primarily for cricket. The Council developed a number of facilities at the ground, including a major grandstand.

In the mid-1990s, the Council undertook a review of the management of the Basin Reserve as part of a wider project looking at the advantages of ongoing Council management as compared with trust management of a number of facilities. The Basin Reserve presented a number of problems. The terms on which it had been vested in the Council meant that there was an obligation to continue using it for cricket.

Unfortunately, over the years, cricket had become relatively less popular, and the income which the Council was able to earn from admission charges and other fees associated with the use of the Basin Reserve were insufficient to cover operating costs. As well, the main grandstand was now quite old and required major deferred maintenance.

The Council decided that the best way to deal with ongoing management was to create a trust. Council would retain ownership of the Basin Reserve (because of the terms of the original vesting) but management would be made the responsibility of a trust the Council would establish.

Discussions took place with the Wellington Cricket Association. They welcomed the idea. The association's membership included a number of people with very significant commercial experience who, because of their commitment to cricket, were prepared to make their services available as trustees.

The Council went ahead and established the trust. An impressive group of trustees was appointed. The Council began the process of entering into a long-term management agreement with the trust.

The Council had not briefed the trustees on the state of the grandstand and other public facilities at the Basin Reserve. Not long after they were appointed, the trustees became aware that the Council not only expected them to take responsibility for management -- essentially fine tuning the management and promotion of the Basin Reserve as a venue with the objective of current income covering current expenditure -- it also expected them to deal with the problem of deferred maintenance. The more the trustees learned about this, the clearer it became that this would be a very major financial burden.

Relationships between the Council and the trust quickly deteriorated. The Council thought that the trustees were not meeting their obligations, the trustees thought that they had been misled by the Council.

Lessons

Corporatisation of the management of local government facilities (effectively contracting out management to a non-profit corporation established for the purpose) can be a very effective way of bringing in additional resource -- both financial and managerial. However, it needs to be carefully done.

Most importantly, both the council and the trustees or board of the future entity (charitable trust; non-profit corporation) need to be clear on exactly what they intend to achieve, and need to know that the understanding is shared by the other party.

What this suggests is that the process of establishing a trust or non-profit corporation needs to be treated in much the same way as the establishment of a new commercial entity with the objective of buying an existing business. Specifically, it is crucial that due diligence is carried out on the assets/business for which the trust will be accepting responsibility and the parties agree on how to deal with any matters which due diligence uncovers.

Had this been done before the Basin Reserve trust was established, the Council and the future trust would have had to face up to the question of what to do about deferred maintenance and who should be responsible for meeting the cost. In practice, the Council eventually accepted responsibility but only after a year or two of acrimonious discussion which did nothing to help establish the Basin Reserve trust on a positive basis. Due diligence would have avoided this and helped get the trust off to a good start.

Similar lessons can also be drawn from some of New Zealand local government's experience with the corporatisation of what are essentially commercial activities. In the early 1990s, most councils carried out a lot of the maintenance work on infrastructure such as local roads and water and wastewater assets. Typically, in order to get a better understanding of costs, the division of Council which undertook that work was set up as what was known as "stand-alone business unit (SABU)". The SABU was required to operate at arm's length, with internal contracting between it and that the divisions of Council responsible for the assets whose maintenance it undertook.

Many of these were corporatised as Council owned Local Authority Trading Enterprises in the belief that, because they had been operating "commercially" as stand-alone business units, they should be successful in the open market. As soon as they were required to tender for the Council's work in competition with the private sector, a number were quickly exposed as inefficient, and of too small a scale to be viable. This really highlights the importance, when corporatising council activities, to be very hard-nosed both about what you're doing and why you're doing it, and to really understand the nature of the activity which you are corporatising.

Public-Private Partnerships

The office of New Zealand's Controller and Auditor-General is currently undertaking a review of New Zealand local government's experience with public-private partnerships. Although the review is not yet public, it is understood that the office has identified only one transaction which it would regard as a genuine public-private partnership.

It is aware of a number of transactions in which local authorities have worked with private sector partners – with the Papakura franchise agreement being one of the oldest -- but takes the view that for something to be a public-private partnership, ownership and a significant element of risk should be transferred to the private partner.

The Auckland City Council has concluded negotiations for the development of a 12,000 seat indoor Arena which will be the Auckland region's major indoor events Centre. The centre will be owned and managed by a joint-venture between two specialist events management companies, one based in Australia and one in Florida.

The public-private partnership has been structured as a 40 year Build, Own, Operate, Transfer arrangement. At the end of the 40-year period, ownership will be transferred to the Council at no cost to the ratepayer and maintained to a standard governed by the contract between the Council and a joint-venture.

The development of this transaction has been a quite long drawn out process with the Council investing very heavily in satisfying itself that the risks which it wished to divest to the joint-venture were effectively divested. It employed leading professional advisers based in Auckland to develop and review documentation and then engaged public-private partnership specialists in Australia to provide an independent critique.

Lessons/Issues

The Auckland experience is still relatively young so that it is difficult to draw lessons from experience, so much as to identify issues that need to be addressed in any public-private partnership with which local government is involved.

First, it is important to be clear about the underlying rationale. In New Zealand, a number of local authorities are attracted to the idea of public-private partnerships because they believe that it will provide them with access to capital. The reality is that most New Zealand local authorities can borrow on more attractive terms than even major multinationals. The reason is a simple one. Because they are able to raise taxes (variously described as rates or property taxes) they are generally a very good credit risk.

The risk attached to local authorities will differ between jurisdictions depending on the exact nature of their own fund-raising powers but, if they do have a

power to tax, then any argument that a public-private partnership will allow a superior access to capital should be looked at very critically.

The next issue is the other significant justification for public-private partnerships; that they are an effective way of passing risk from the public sector to the private sector. Proponents of this argue that the private sector is inherently better placed to manage risk because of the incentives they face -- for the private sector any loss falls directly on shareholders and management. In the public sector it usually falls on taxpayers and not on public officials.

This argument needs to be considered very carefully. Any public-private partnership arrangement should be carefully scrutinised to ensure that the different risks involved (design, construction, completion, project management, long-term management) have been "unbundled" and allocated to parties who are well placed to manage them.

As well, it makes good sense to consider whether risk can actually be passed. Here the question is what happens if there is some form of project failure. The private sector partner may be able to walk away -- especially if it was established specifically to be the partner, and its backers are not themselves at risk. The public sector partner may not. If, as an example, the public-private partnership is established to build and operate facilities such as a prison, a hospital, a school, or an essential piece of physical infrastructure, then the public sector partner may be at risk regardless. If the private sector partner fails, political realities will require the public sector partner to pick up the project regardless of what is in the formal documentation.

Finally, there is an emerging view in New Zealand that someone should take responsibility for providing detailed guidance on public-private partnerships. The work of Partnerships Victoria is seen as a possible precedent (for an introduction to this, see:

http://www.partnerships.vic.gov.au/domino/web_notes/PartVic/PVSite.nsf/FrameSet/PV?OpenDocument)

5. CORPORATISATION/ARMS LENGTH ARRANGEMENTS GENERALLY

In this section we provide an overview of some of the main lessons which New Zealand local government has learnt from its experience with corporatisation and the use of arms length entities to undertake local government funded activity. The four which will be considered are:

- Matching activity to structure.
- Keeping your distance.
- Good people -- and accountability.
- "No surprises".

Matching Activity to Structure

Understand the activity which you are intending to corporatise and/or place in an arms length structure. If you're proposing to place it in a market-based structure with commercial objectives, is the activity genuinely market-based? If it is a monopoly (either natural or regulatory) placing the entire activity in an arms length commercial structure may increase the risk of monopoly exploitation as new management seek to maximise profitability. On the other hand, in a monopoly situation, there may be real gains to be made by transferring the management to an arms length entity operating on commercial principles but retaining the asset itself in public ownership. The contract between the local authority and the new management can then be drawn to focus on objectives such as efficiency, performance standards, least cost operation and so on.

It is important also to consider whether a business which may have operated successfully within the local authority, and with the protections that provides, will be equally successful in the private sector. In the mid-1990s a number of New Zealand local authorities corporatised what were referred to as their works and services activities -- which were responsible for a range of activity including road maintenance and looking after other public facilities. Typically, councils assumed that because they appeared to have operated effectively in council ownership and control, they would be successful in the private market. In practice, many turned out to lack both the scale and the management capability needed for success. Most of these were either sold off to competitors or liquidated.

Keeping Your Distance

This is one of the most difficult issues for a local authority to handle. Normally, the local authority has been used to the idea that, if it does not like what is happening with one of its activities, then it can intervene directly. If something is transferred to an arms length entity, or corporatised, all this changes.

The new entity, whether it is a trust, a non-profit corporation, or a company, will be run by a board which will expect to be free, within agreed understandings, to operate the activity without interference. In New Zealand, this is managed by a combination of:

- What is known as the statement of intent -- a document which sets out the board's key objectives and policies, the activities that the entity will undertake, and the accounting and reporting obligations it will observe.
- If the entity is dependent on council for a substantial part of its revenue -- for example if it is an art gallery, library or other facility which is largely council subsidised -- then the funding agreement between the entity and the council will also set out the expectations each has of the other.

One of the things which local authorities find hardest to understand is that the separate entities, and the boards responsible for the management, have legal obligations quite separate from those which may be imposed by the council. If the entity is a company, then the directors will have obligations to manage the business in the best interests of the company (which does not simply mean the shareholder), to respect the interests of creditors and so on. If the entity is a trust or non-profit corporation then it will be subject to legal obligations, for example, to protect trust capital.

Local authorities which have tried to intervene in the management of arms length entities have often got into difficulty. In New Zealand there are well-known examples of boards resigning in protest, and the local authority finding it hard to attract competent replacements because it is clear that it has not respected the proper conventions.

Good People -- and Accountability

One real tension which New Zealand councils have run into is who should be appointed as a director or a trustee for an arms length entity which the council controls. In some councils there has been an expectation that councillors should be appointed. Sometimes the reason has been that the council wants to keep control over the activity. Sometimes the motivation has been councillors wanting to increase their income through directors or trustees fees!

Neither of these approaches is a particularly good idea. The best way to control those things which a council wants to continue to influence, is to make sure that the statement of intent or the funding agreement contains provisions that meet the council's requirements (note that even this can be a dangerous practice; if

the council goes too far down the path of spelling out the way in which the entity should be managed, good directors or trustees will be put off -- why should they bother to contribute their management expertise if the council has already decided exactly what should be done).

The idea of councillors increasing their income through directors fees has also attracted a lot of public criticism. It can look much too like lining their own pockets at the expense of the public, especially if the councillor does not have any obviously relevant expertise.

Better practice, now, in New Zealand is for directors or trustees to be selected through an objective process against a set of predetermined criteria covering capabilities, personal characteristics etc (often with councillors able to apply but on the basis that they face the same selection process). Normally the council will make the final appointment but from a shortlist prepared by external advisers. The point of this is twofold:

- To ensure, as far as possible, that good people with relevant qualifications and experience are appointed.
- To preserve both the appearance and the reality of integrity in the appointment process.

A final point. New Zealand experience has shown that it can be quite difficult for people who have spent most of their career in the public sector to properly understand and appreciate what is involved in operating in the private sector and the same problem applies equally for people who have spent most of their lives in the private sector when they take up a public sector appointment. It can be very difficult for people from the private sector to understand that the apparent inefficiency of the public sector may simply result from the political (and often legal) importance of consulting widely, taking the interests of different groups into account, and recognising the interests not just of immediate profitability but the wider long-term impacts of the activity concerned.

"No Surprises"

This is an essential principle in the relationship between local authorities and their partners, whether those partners are arms length entities that the local authority itself has established, or the private sector part of a public-private partnership. All of these relationships are inevitably long-term. They work better if people put in the time and effort required to make the relationship effective. An essential part of this is making sure that the other party does not first get to hear about any significant initiatives through the media, through gossip, or any other indirect source. Anything which is likely to have a significant impact on the other party (and where the other party is a local authority, this includes anything which may be politically sensitive) should first be disclosed directly to the other party before any public announcement is made and before other parties are briefed.

6. CONCLUSION

The purpose of this presentation has been to provide an introduction to New Zealand local government's experience with working with arms length parties, primarily ones which the local authority itself may have established and control, but also pure private sector partners through means such as contracting out or public-private partnerships.

As is the case elsewhere, New Zealand experience has made it clear that there can be significant advantages in the use of private sector structures, and in working with private sector partners. At the same time, it is also clear that very significant care must be taken right through any such arrangement, from the initial planning, through implementation and ongoing management.

Local government needs to apply an element of scepticism to any suggestion that the private sector approach is inherently superior. There will be occasions when it is but equally there will be occasions when it is not. The nature of the activity may be such that placing it under commercial management is simply inappropriate -- for example by exposing the public to monopoly exploitation. The private sector partner may lack the skills to manage the various risks involved. The public sector partner may not have the capability to negotiate effectively with the private sector partner, and to monitor any subsequent contract to ensure that the expected benefits do accrue over time.

The New Zealand experience has done more than simply demonstrate some of the issues that need to be taken into account when using commercial structures or partners. It has also highlighted the very significant benefits that can arise through sharing the governance of public facilities with the community or communities that they serve.