



[Reading Room: Local Government](#)

Assessing the Practical Impact of Changes to the Future Management of Roading and Water at Council Level

This paper was presented to the March 1999 Commercialisation of Infrastructure Assets Conference by Peter McKinlay. It was written at a time when the then National Government policy was to corporatise public roads and, it seemed, place a similar requirement on water and waste water assets. Neither approach is part of current Government policy but the principles the paper discusses are still relevant, especially for water and waste water because of the need to attract substantial capital for renewals, upgrades and new investment.

Introduction

The purpose of this paper is, as the title makes clear, to consider the practical impacts of legislative changes for roading and wastewater. To do so requires making a few assumptions as neither set of legislative changes is yet in place. The shape of those for roading may seem a little clearer than those for water and wastewater - there was for example a draft Roads Bill released in December last year with the "Better Transport: Better Roads" consultation document. The likely changes in respect of water and wastewater need to be inferred from various sources including the terms of reference for the water and wastewater review and the consultative process which the Ministry of Commerce is current undertaking with local government.

Papers presented on the first day of this conference, and Roger Blakeley's speech immediately preceding the delivery of this paper will put more definition around current expectations of what might happen. However, until the legislation is finally passed, any detailed outline of what will result must necessarily, at least to a degree, be somewhat speculative. It is clear, for example, that local government is not yet entirely happy with the proposals which have been put forward in respect of roading and has ongoing concerns about the degree of community influence. A particular area of concern is the extent to which the directors of local roading companies will be required to take account of community concerns. Certainly, local government is very focused on the fact that the primary obligation of directors is to act "in the best interests of the company" and that obligation has normally been interpreted as requiring them to act in ways which will maximise shareholder wealth. The draft bill appears to reinforce this with its stated principal objective for

local road companies as "to operate as a successful business and, to this end, to be:

- as profitable and efficient as comparable businesses that are not owned by territorial authorities; and
- a good employer; and
- an organisation that exhibits a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage those when able to do so."

We do not yet have draft legislation for water and wastewater but I believe that, for purposes of discussion, we can safely assume that legislation, also, will concentrate on the development of a commercial framework for the operation and management of water and wastewater services (including stormwater).

In this paper I have been asked to consider:

- What is the combined effect of changes to roading and water legislation
- How will the new legislation impact asset management and funding within the council
- The skills needed to prosper in the new environment
- What sort of management changes will be required to cope with the commercial environment
- What is the outlook for the size and structure of local government and its ability to sustain long term assets

The Effect of the Legislation

Both reforms are driven by the belief that roading and water services (which term I use to encompass water, wastewater and stormwater) are inherently private goods whilst recognising that, in common with many other private goods, they have significant externalities which require some form of public intervention whether through regulation or some other form of intervention on behalf of the public interest. Both are extremely capital intensive and also incur significant ongoing operating costs. From a microeconomic perspective, this suggests that both require a legislative framework which promotes allocative, productive and dynamic efficiency.

The effect of this framework is clear in the draft roads bill and the supporting documentation. Roading companies are expected to earn a return on investment; they are to adopt pricing mechanisms which, as far as possible, charge users for the impact of their usage. There is an implication that, as technology permits, this will be direct charging for actual use.

We have not yet seen the equivalent for water services but there are plenty of parallels from elsewhere and from other utilities in New Zealand such as electricity. What we do not yet know is the basis on which the providers of water services might be expected to charge. The electricity precedent suggests separate charging for the means of conveyance and the substance conveyed. It is common elsewhere for water to be charged for by direct metering with charges for sewerage disposal using water consumption as a proxy.

Expect considerable debate around charging mechanisms including issues such as:

- Impact on low income households.
- Whether charging should be purely on a consumption/usage basis or

whether there should be separate charges for the means of conveyance and the substance conveyed.

- The methodology employed to establish prices - should we repeat the optimised deprivation valuation approach employed in the electricity industry, or should we use long run marginal costs in order to signal the economic (and environmental) costs of the next increase in capacity.

Those are extremely important questions but again for the purposes of this paper relatively incidental. Instead for our purposes the fundamental issue is that both roading and water services are to be treated as commercial businesses in terms of pricing and investment decisions.

We already know that government's intention in respect of roading is that the responsibility for management should be shifted out of local authorities into local roading companies. This suggests that local authorities will cease to have the major responsibilities they now exercise in planning management and upkeep of roading infrastructure. Instead, these will be exercised by local roading companies. The role of local authorities will, instead, become that of monitoring performance including negotiating the statement of corporate intent.

However, local authorities will also remain responsible for the public good component in roading activity. Local authorities will own any road amenity "on, in or under any local road ..." and will play a significant role in corridor management - the draft bill provides for a corridor management agreement to be in place at all times.

In respect of water services, it is less clear that government will seek to impose corporatisation. At this stage, the best working assumption is that government will want to achieve a "level playing field" so that a potential owner or provider of water services enjoys no competitive advantage or suffers no competitive disadvantage merely by reason of the nature of its ownership.

It will be interesting to see how the implications of this are worked through especially when we recognise that the water and wastewater reform is being driven as an exercise in microeconomic reform. The combination of these two factors provides strong support for the belief that government will:

- Make water services taxable (there is a precedent from the electricity industry; electricity distribution became a taxable activity several years prior to the Energy Companies Act 1992).
- Require public owners to set the pricing for water services on economic principles so that pricing includes an appropriate allowance for cost of capital. In my view, unless this is done, private providers would be unable to compete against public providers (again there is a precedent from the electricity reforms. Publicly - that is local authority or trust owned - energy companies were required to adopt a statement of corporate intent. This included "the performance targets and other measures (including the rate of return on shareholders' funds after payment of tax) by which the performance of the group may be judged in relation to its objectives." Similar principles are also coming through in the reform of water services in Australia.)

There will be a set of subsidiary changes as well. At the moment the Local Government Act and other legislation gives local authorities a series of statutory privileges not available to other parties. Those will either need to be removed the legislation or made available to all owners or providers regardless of their status.

There is another feature of the legislative framework which also merits attention. At the moment, most consumers of water services are "captive consumers" in the sense that they must use, or at least pay for, council provided services whatever their preference. It would be logical for government to change the legislative framework so that those consumers who wished to do so could make greater use of grey water and of means of disposing of waste on their own premises. For both economic and environmental reasons, it is appropriate that council owned providers should face competition not just from the likes of the multinational utility companies now entering the market but also from alternative means of meeting users' needs/preferences provided these satisfy minimal health and environmental criteria.

Let me then summarise the likely impact of the two sets of legislative changes on local authorities. Their principal impacts will be:

- Both sets of services will be structured as commercial businesses applying normal commercial principles to matters such as pricing and investment including seeking an appropriate return on capital.
- The primary role of local authorities will become that of dealing with the "public good" aspects of these various services. This may include a "merit good" approach to the purchase of core roading or water services where these might not be provided through the conventional pricing and investment framework in place after the reforms have been completed.

Corporatisation will be compulsory in respect of roading but may not be for water services. This is unlikely, however, to be of major significance. If the legislation puts a full commercial framework in place for water services, then it is that framework rather than the question of whether the local authority owns the service directly, or through a local authority owned company, which will have the primary impact.

Within local authorities, but probably over quite a long transition period, there will be a growing recognition that local government's role in respect both of roading and of water services has its primary focus on the public good elements including any "merit good" purchase on behalf of the community and not on the commercial business itself except to the extent that the local authority is involved in negotiating the statement of corporate intent. This will take place within quite well understood parameters including understandings of the appropriate cost of capital.

This should not be seen as downplaying the role of the local authority. It is the public good and "merit good" elements which are of the greatest significance to New Zealand's communities. This will include questions of corridor management, of maintaining access where a roading company might conclude that a road was no longer economic, of considering the physical conditions for the provision of water services (partly under the local authority's RMA powers) and, in respect of water services, considering the pricing policy which providers should follow to recover their required revenue - should, for example, water pricing reflect any social equity considerations?

Two other impacts are likely. The first concerns the size and scale of the roading or water services business. Government has already made the judgement that there should be significantly fewer than 73 roading companies. The driver for this is economies of scale. Local authorities themselves, independently of government's intention to reform water services, already recognise that this industry faces a similar issue. A number of local authorities are engaged in discussions about the possibility of merging at least the management aspects if not all of their water services businesses. They are facing the fact that as these businesses become more sophisticated, the human resource and other

requirements needed to manage them demand a significantly larger scale than most local authorities can achieve on their own.

The second element is what happens if these businesses start generating significant financial returns. There is something of a question mark over whether roading companies will actually pay a dividend - at the moment thinking seems to be more along the lines that profits should not exceed the level required for reasonable reinvestment. However, they are being structured as companies and the draft Roads Bill clearly contemplates distribution of profit. Financially, therefore, at the very least local authorities can expect the roading reforms to result in a significant reduction in their rating requirement (they will still need to rate for the "public good" and "merit good" components). They may also result in an income flow from their shareholding.

The impact is likely to be more dramatic with water services. Here, it would be sensible to expect an equivalent of what has happened in the electricity sector, especially if public owners are required to apply economic pricing principles. It is not too fanciful to anticipate a situation in which local authorities will receive a very significant income stream from their interest in their water services business. Ultimately, I believe that it is quite possible that these two sets of reforms will result in at least some local authorities generating investment income from their infrastructure activities which cannot properly be recycled within the local authority itself. First, remember that although these reforms will significantly reduce the rates levy, at least in respect of water services the replacement charges may be significantly higher than the former rates once cost of capital is included. Ratepayers will have a strong incentive to ensure that the income the local authority receives from its infrastructure assets is not simply recycled into additional expenditure. This suggests the alternative of applying that income to replace rates levied for other purposes. There are actually quite strong arguments against this option also. Funding unrelated public good services out of investment income significantly undermines accountability and should be avoided if possible - but I expect to see major argument over this and do not believe it is possible to predict what the outcome will be.

Asset Management and Funding

The major shift in this area will turn on the business structure adopted post-reform. If the assets themselves are transferred to a separate company, then the asset management and funding responsibilities will transfer to that company. With roading, and in at least some instances with water services, transfers to a company will be transfers to a company owned by several local authorities rather than just one so that the asset management role will become one of being satisfied, particularly through the statement of corporate intent and annual reporting process, that the company itself has adopted prudent asset management.

Again, it should be noted that the primary driver in setting the framework for asset management will be the requirement to operate the assets on a commercial basis. Even if the assets are not corporatised (that is they are retained within the local authority in a business unit) or are transferred to a wholly owned LATE, the commercial framework will still apply and asset managers will be expected to comply with industry best practice (it is an area which I would expect the Audit Office to keep a close eye on, especially given the concern which it has previously expressed regarding the state of infrastructure). In each of the cases so far discussed, the local authority will retain an ownership interest in the infrastructure in such a way that it will need to have in place ongoing monitoring. This should include being satisfied that the business actually owning the assets is performing well on asset management - where the assets are held by a LATE, I would expect

to see the statement of corporate intent make specific reference to the asset management plan purely as part of the owner's own risk management.

Some local authorities may decide that rather than (or as well as) corporatisation, they would prefer to franchise out their water services. Where this happens, particularly if it is a long-term franchise agreement, the asset management responsibility passes to the franchisee. The local authority should concentrate on ensuring periodic audit/review of the franchisees asset management practices.

Effective asset management will also be promoted to the extent that the legislative regime requires the adoption of efficient pricing policies as it is inherent in that approach that proper regard is had to asset lives and the actual state of infrastructure. The responsibilities of directors support this, especially if they are making distributions to shareholders (it would be a foolhardy director who was prepared to certify that a significant distribution met the solvency test if he or she was not confident that the company correctly understood the condition of its major assets and the costs involved in keeping them at the desired level of service capability.

I do not want to leave the question of asset management, though, without commenting on the impact of the requirement in section 122J (f) of the Local Government Act (as inserted by the "No 3" Act of 1996) which permits a local authority to "omit to make provision for funding the decline in the service potential of any asset in any year earlier than the year commencing with the first day of July 1999" which is commonly understood as requiring that provision to be made with effect from that date.

A number of local authorities have been telling their publics that rates need to rise because they have to fund depreciation. In my view, that explanation is not correct. What is actually driving increased rates is the recognition, driven amongst other things by the asset management planning which the No 3 Act has effectively required, that much infrastructure is in a parlous state and there is an urgent need for substantial expenditure.

If the issue is purely one of funding depreciation, and not one of actually spending on infrastructure, then there is ample provision under that Act to mitigate the financial impact on ratepayers. Section 122J(e) permits a local authority to "fund operating expenses from sources other than operating revenue in order to adjust is equity as provided in its long term financial strategy". Personally, if a local authority believes that the appropriate provision for depreciation (loss of service potential) significantly exceeds the amount that it needs to spend on maintenance, then I would be comfortable to see that authority using section 122J (e) as the rationale for operating at a deficit equivalent to the difference between depreciation and required maintenance. The practical effect of this would be to manage cashflows so that the actual payments from ratepayers were equivalent the actual expenditure on maintenance.

The situation is otherwise where the whole of depreciation (or perhaps more) is required for ongoing maintenance expenditure. In that case, the use of section 122J(e) would still be possible but the practical effect would be that any deficit would have to be made good through borrowing - again perhaps justifiable given the relatively strong balance sheets of most local authorities but not necessarily something which councillors or ratepayers would be comfortable with.

I turn now to the question of funding. Although there is much which could be said on this issue, I want to make just two principal points.

The first is that the way in which the capital structure of the new companies is set

up will be quite critical, both in terms of tax liability and in terms of the freedom which those companies have to undertake discretionary activity.

Both the roading network and water services are natural monopolies. Both can sustain a very high level of borrowing. A commercial owner of such a business would have a strong bias towards using debt rather than equity. The reasons for this would include:

- The more debt, the less of the owner's own, and usually scarce, equity is required.
- It is tax efficient.
- A highly geared balance sheet imposes quite strong commercial disciplines on directors and management. In particular, it means that any new investment they undertake is likely to receive strong scrutiny both from owners and from lenders. On the other hand, if they have very strong balance sheets, then they may be able to undertake additional activity with a minimum of scrutiny - not something which is necessarily in the owner's best interests.

The same arguments apply to local authority owned companies but may not necessarily be in the best interests of the local authority or its ratepayers. The critical issue, here, is whether there is an alternative use for the capital. Expect very considerable debate over this issue, especially as it offers local authorities the opportunity of generating substantial capital in ways which may disguise the true costs to ratepayers.

The second point I want to make relates particularly to water services, especially if they remain in the direct ownership of local authorities. This is that local authorities should take particular care when looking at off balance sheet financing options such as build, own, operate, transfer. These proposals are typically offered to local authorities on the argument that they bring significant benefits including risk management and avoidance of debt.

Analysis of these transactions should always be concerned with unbundling the different risks involved. They include design, completion, and operational risk as well as risks associated with the financing itself. Wellington City Council developed the new sewerage outfall under such a transaction. Until it was completed, the impact on ratepayers was minimal. No debt was incurred. The Council is now explaining to ratepayers that rates need to rise by \$29 million a year to meet the cost of operation, a cost which includes servicing the capital involved.

It may be true that multi-national utility companies have significant skills in accessing capital markets and generally enjoy a good credit rating. However, councils need to keep in mind that they also are credit worthy borrowers. Perhaps more to the point, they enjoy a significantly better risk weighting than even the largest multi-national. Thus, although a multi-national may bring considerable benefits in terms of managing design completion and operational risk, the cost of financing may turn out to be significantly higher than if the local authority took the debt onto its own balance sheet.

Skills

The first thing we should be clear on is that, in the new environment, local authorities will require high level skills in the managing and monitoring of their ownership interests in roading and water services businesses. They will need the capacity to define the set of capabilities required for the governance of the new businesses and these will not be significantly different whether (say) the water

services business is still an inhouse business unit or is transferred to a separate local authority owned company. The local authority will also need to be satisfied that it can monitor the performance of the business. This will include having the skills to determine what the performance targets should be - for example, is the local authority going to take an economic value added approach to ensure that the real value of the ratepayers' investment is maintained? What risk management policies does it want to see in place?

The best known example of this kind of skill base is the governments' Crown Company Monitoring and Advisory Unit which includes a mix of skills focused on business planing and management, director selection and economic analysis. Some local authorities have, to a degree, sought to replicate this through using a holding company structure or setting up their own internal capability.

In my view, it would be appropriate for local authorities to recognise the shortage of high level commercial skills in New Zealand and seek to develop one or several jointly owned monitoring services - in other words do not try and keep this particular skill in house - contract it out but know what it is that you are contracting out (some of New Zealand's largest local authorities may have the scale to handle this in house and be prepared to meet the costs of doing so in order to attract people of the necessary calibre but they will be the exceptions).

The second set of skills will be around the public good and "merit good" aspects. The shift of these key functions into a corporate or commercial form will heighten public concern about how they will perform. Rather than perhaps taking it for granted that because the council owns it, it will more or less understand what the community requires, the public is likely to see commercial operation as relatively ignorant of community needs.

As a separate stream from monitoring their ownership interest, councils will need to ensure they have the skills to monitor community concerns/needs and ensure that those are properly communicated to the new commercial structures. This will place a strong emphasis on ongoing consultation and on the development of means of community input. Strategies the likes of customer advisory boards, customer charters or ombudspersons to deal with payment difficulties in water may be warranted.

Management Changes

Much of what is required in this respect has already been signalled with comments on funding and on the skills needed to prosper in the new environment. The management challenge for local government will be recognising that what is happening is a growing recognition that there are (at least) two streams of activity within local authorities:

- A commercial stream - the ownership/operation of major commercial businesses either standalone or in partnership with other local authorities (or possibly under some form of franchising arrangement if water services in New Zealand follow the French approach).
- An increased emphasis on representing the public interest in the operation of infrastructure.
- Plus the traditional regulatory and public amenity roles.

The skillset within local authorities will become more diverse than it is at present. Some skilled staff will be almost exclusively commercial in their focus and may have no particular sympathy for the public interest role of local government - they will have been recruited because they have the skills needed to protect the local

authority's commercial interests. Others will have a primary emphasis on the public interest and "merit good" aspects of local authority activity. Their role will be one of ensuring that the public's concern around, for example, the amenity values in roading, the maintenance of the roading network as an essential service, the environmental impacts of water services, non-traditional options for providing such services, and the impact of charging systems on low income households are all properly recognised. It is quite likely that they will have been recruited for their particular skills in planning or social analysis.

Ideally, the local authority will be managed to ensure that there is exchange between these two streams (and the third, the traditional regulatory/public amenity stream) so that, ideally, each skillset understands the role of the other.

The particular challenge will come at the level of the chief executive. He or she will need to combine a high level understanding of both the commercial and the community skillsets if the operations of the local authority, as a whole, are to satisfy its various stakeholders. The task will not be an easy one.

The Outlook for the Size and Structure of Local Government and its Ability to Sustain Long Term Assets

I well remember a question asked at about the time when the Roading Advisory Group report was released: "why is the Ministry of Transport responsible for restructuring local government?"

The questioner knew, of course, that this was not what the Ministry of was doing. Instead, he was pointing to what seemed the inevitable consequence of roading reform. Roading is an important activity for all of New Zealand's local authorities, especially for some of its smaller and more rural authorities it takes up the major part of their business.

If this is stripped away from the local authority and transferred to a company with several local authority owners, then the ongoing involvement may be very small - a meeting once or twice a year to consider things like the statement of corporate intent and the annual report.

In practice, there will be other functions. I have referred on a number of occasions to the public good and "merit good" aspects. Inevitably, though, there will be a sharp fall off in activity. This will be compounded if water services are also commercialised. Even if the legislation makes no stipulations as to the structural form, it seems certain that commercialisation and the impact of economic pricing will lead to considerable rationalisation. In the larger local authorities this may take the form of corporatisation (especially if there is an interest in balance sheet leverage). Medium sized and smaller local authorities may opt for establishing joint venture companies or for franchising their operations.

The practical effect will be the stripping out from most local authorities of two of their largest functions.

It does not necessarily follow that some kind of commercial integration of functions should lead to a political integration as well - the two are quite different issues. However, stripping away from local authorities the bulk of what is currently their two largest activities will inevitably have a major impact. Administrative structures which have been put in place based on the current scale of activity will look extremely top heavy and expensive (this may apply both to the elected members and to employed officers).

Superficially this suggests that we can expect another round of merger as councils (government or the local government commission) respond to the reduction in local authority responsibility.

Personally, I would argue that this expectation is superficial. It overlooks other changes which are taking place in the role and responsibility of local government. World-wide there is a significant trend towards devolution driven by factors such as:

- The impact of globalisation on the capacity of national governments to intervene at a micro level.
- A growing recognition that "one size fits all" solutions mandated from Wellington are less and less appropriate in what is an increasingly complex and heterogeneous society.

A number of local authorities, large and small, are already responding to the shift. It is now quite common for local authorities to see their role as quite explicitly including advocacy on behalf of their communities to central government on key services such as health and welfare (whilst, at the same time, remaining on the defensive against any load shedding from central government).

One interpretation of the impact of the roading and water services reforms is that they will mark what is really the final stage in a shift from seeing local as primarily a provider of infrastructure services ("roads, rats and rubbish") to a different role centred around provision of amenities governance of the local community and managing its access to services of whatever kind.

It seems likely that, if this happens, local government of the future will be quite different from local government as we know it today. It may still hold substantial assets. This will not, though, be the main focus of the local authority's activity. Instead, its focus will be on the quality of outcomes for its community.

This view is not yet widely shared but I have noticed, with much interest, that it is attracting increasing attention. It is an evolutionary process which may not reach a full flowering until sometime after the roading and water services reforms are put in place, at least if central government is able to keep to its preferred timetable. What it does emphasise is the need to ensure that the response to the loss of the major part of roading and water services activity is more than just a knee jerk reaction to an immediate downsizing but is based on a considered understanding of the future role of local government.

Finally, because this is the last item mentioned in my brief, what about the ability of local government to sustain long term assets? This I believe will be crucially dependent on the quality of the monitoring arrangements which local government puts in place. At a simple level, the ability to sustain long term assets is primarily dependent on access to an adequate income stream. The proposed reforms will increase the income stream generated by roading and water services assets. The more serious question concerns the ability of local authorities to monitor their ownership interest. If that is not effective, then there could be significant risk at least to some

More speculatively, the second issue may arise around the question of the sheer value of the assets which local authorities will hold. They may lose much of the direct operational responsibility, but this could be offset by a significant increase both in the value and in the negotiability of long term assets - again, the electricity sector provides a parallel. The reforms will undoubtedly lead to an increased level of debate over the amount of ratepayer equity which local

authorities hold and the case for them continuing to do so.

Conclusion

The practical impacts of changes to the future management of roading and water at the council level flow substantially from the intention that these activities should be structured as commercial businesses even though the changes recognise that there are substantial public interest factors in both areas. Requiring that these activities be run primarily as commercial businesses changes the way in which councils will interact with them. Instead of being able to influence them directly and to internalise tradeoffs between commercial and non commercial aspects, councils will be required to deal on an armslength basis. Influencing the public interest component of these activities will be formalised through means such as statements of corporate intent, corridor management agreements and contracts for services.

The structural impacts on councils themselves will be major. Roading as such, including design aspects, will pass from the council to a roading company. Even although corporatisation may not be compulsory for water services, the creation of a commercial framework will have much the same impact. Inhouse business units will almost certainly need to be subject to governance arrangements and statutory requirements not significantly different from those imposed on LATEs in order to comply with legislative requirements.

The skill requirements within local authorities will shift from responsibility for physical management and provision to governance, monitoring and managing the public interest aspect including ensuring that there are appropriate mechanisms in place, within the roading and water businesses themselves, to capture the nature of public concerns.

Inevitably, these changes will require a rethink of the structure and role of local government. For many local authorities, loss of these major functions will make their existing administrative and democratic structures top heavy. On the other hand, the shift in responsibility from physical provision to monitoring and representing the public interest can be seen as reflecting a wider shift towards more of a governance role. Thus, while the restructuring may reduce the physical responsibilities of local authorities, it can equally be seen as a further step towards the shaping of what in the long term will be the much more significant role of providing governance. This role is still not well understood and will require considerable rethinking of the governance, representation and administrative responsibilities of local authorities with consequential changes to organisational structure. Although speculative, it can be argued that this will see both an increase in the average size of local authority and an increase in the number of representational units through, for example, an increased use of community board or similar structures as the means of capturing the unique concerns of individual communities.

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