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THE BUSINESS OF COUNCILS

**A PUBLIC POLICY REVIEW OF THE GISBORNE DISTRICT
COUNCIL'S COMMERCIAL BUSINESSES**

PREPARED FOR THE GISBORNE CHAMBER OF COMMERCE

**G E DWYER
DWYER G LIMITED
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IMPORTANT NOTE

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LIST OF ACRONYMS

GHL	Gisborne Holdings Limited
JNL	Juken New Zealand Limited (formerly Juken Nissho Limited)
LTCCP	The Council's 2004-2014 Long Term Council Community Plan
TFL	Tauwhareparae Farms Limited
NA	Not available
The Annual Plan	The Council's 2005-2006 Annual Plan
The Annual Report	The Council's Annual Report for 2004-2005
The Centre	The Warrant of Fitness and Registration Centre
The Chamber	The Gisborne Chamber of Commerce
The Council	The Gisborne District Council
The Holiday Park	The Waikanae Beach Holiday Park
THL	Tauwhareparae Holdings Limited

EXECUTIVE SUMMARY

- The Gisborne Chamber of Commerce (the Chamber) sought a professional review of the Gisborne District Council's investment in farming, commercial forestry, the Warrant of Fitness and Registration Centre (the Centre), the Waikanae Beach Holiday Park (the Holiday Park) and housing for senior citizens.
- The review comprises a principled public policy examination of the investment in the relevant businesses by the Gisborne District Council (the Council).
- Local government has a vital role in the economy but its role is limited. Local government should fund or provide public goods and services that would be under-supplied or not supplied at all by the private sector. Local government should also administer regulations that are required to advance the welfare of their communities. Councils are likely to reduce the overall welfare of their ratepayers if they engage in activities that extend beyond these roles.
- The businesses that are reviewed produce private goods, the polar opposite of public goods. Private goods can be provided by individuals, firms and voluntary organisations.
- The Council should concentrate on those activities that are important for councils to undertake and do them well. Water reticulation and treatment, waste disposal and roads are key priorities for the Council whereas farming, commercial forestry, holiday accommodation, vehicle testing and senior citizen housing are not.
- The original rationale for some of the Council's investments appears to be no longer relevant (farming and the Centre) or doubtful on public policy grounds (commercial forestry, the Holiday Park and housing for senior citizens).
- Private ownership of business enterprises is more efficient than public ownership on average and over time. The essential problem is that elected officials face weaker incentives than the owners and managers of private firms and they often face conflicting objectives.
- The private provision of goods and services is discouraged and resource use is distorted if government agencies supply competing products at subsidised prices.
- Actual or potential competition, rather than public ownership, is the key to containing costs and promoting consumer interests generally.
- The promotion of regional development is not a valid ground for investing in businesses. Economic growth and employment in Gisborne and other districts are most likely to be advanced if councils focus on public good activities, and keep rates and regulatory burdens low.

- The Council has stated that one reason for its continued ownership of the businesses that are reviewed (with the exception of housing for senior citizens) is that they are profitable. Information on the operating income and expenses of businesses run directly by the Council is contained in the Council's 2005-2006 Annual Plan (the Annual Plan) or 2004-2014 Long Term Council Community Plan (LTCCP). However, the market value of assets and ratepayers' capital employed are not disclosed.
- A margin on turnover that at first sight appears to be satisfactory may disguise a poor return on the market value of assets or ratepayers' capital, or both. The Holiday Park illustrates the problem. It is described by the Council as a lucrative business. The return before interest and depreciation on assets is no more than 0.5 percent whereas the risk-free rate of return is around 6 percent.
- The profitability of the businesses reviewed warrants closer scrutiny. Council businesses must earn at least a normal return taking account of the risk arising from the particular activity if ratepayers are to be adequately compensated for their investment. The cost of capital for each business should be estimated and compared with actual and expected returns. This information should be disclosed to residents.
- The expected returns from Tauwhareparae Farms Limited (TFL), the Holiday Park and housing for senior citizens fall well short of the preliminary estimate of their cost of capital. Continued investment in these businesses is likely to reduce the wealth of ratepayers.
- The expected operating income from Gisborne Holdings Limited's trading activities from 2005/06 through to 2008/09, for example, provides a lower return than could be earned by realising the Council's equity and investing in risk-free bonds.
- The Council might realise up to \$70 million if it exited completely from the businesses that are reviewed. This would enable debt to be retired. Rates could be reduced by up to 22 percent for at least six years as surplus funds are returned to ratepayers. The benefit to ratepayers would be immediate and significantly larger than the meagre operating surpluses generated by the businesses.
- Council spending on public good activities should generally be funded from rates. There is no public policy ground to fund such spending from business profits. The cost of supplying public goods should not be disguised by income from businesses.
- If it were appropriate for the Council to invest in businesses to reduce rates in the future there would seem to be no reason why such investment should not be extended until the rate bill were fully funded from business income. Governments (central and local) do not generally do this either in New Zealand or in comparable countries.

- The Council should not expose ratepayers to unnecessary financial risks because they have limited opportunity to avoid them.
- The preferences of ratepayers differ. The continued ownership of businesses, the building up of investments or the retention of surplus capital by councils constrains the options available to ratepayers. Capital that is not required to fund public goods should be used to retire debt or returned to ratepayers.
- Even if a majority of ratepayers favoured continuing Council ownership, their view would be imposed on the minority whose circumstances may be vastly different from those of the majority, especially in a relatively low income area such as the Gisborne district.
- The provision of housing for senior citizens benefits relatively few people aged 55 years and over. Senior citizens who are in a similar financial position but are not allocated a subsidised house do not receive assistance. The provision of housing for senior citizens is therefore horizontally inequitable.
- The avoidance of hardship and, more generally, income redistribution is a central government responsibility in New Zealand. Councils generally do not have the information required to assess the relative needs of citizens.
- The provision of subsidised housing by the Council may impose costs on its ratepayers that would otherwise be borne by taxpayers.
- There are persuasive public policy grounds for the Council to exit from the activities examined (with the possible exception of limited forestry which is ancillary to roading and water activities). A range of options that would permit the Council to reduce its investment is suggested for each activity. The options would require detailed investigation.
- While the Council must take account of the wishes of its residents, it should lead the community to an informed understanding of the benefits and costs of the main options available and make decisions on the basis of a principled public policy analysis. Decisions which respond to ill-informed views or self-interested pleading by well-organised interest groups, do not advance the overall interests of the district. The suggested approach is consistent with the promotion of the social, economic, environmental and cultural wellbeing of communities.

1 INTRODUCTION

The Gisborne Chamber of Commerce's submissions on the Gisborne District Council's draft 2004-2014 Long Term Council Community Plan and its draft 2005-2006 Annual Plan suggested that the Council should focus on its core activities, namely those activities that only the Council can do. The Chamber argued that the Gisborne District Council (the Council) should not be in business in competition with the business community and it recommended that the Council's commercial assets or business activities be rationalised.

Although the Council welcomed the Chamber's submissions, the Council has not yet endorsed their main thrust. The Council staff report on the Chamber's submission on the draft 2005-2006 Annual Plan stated that the Chamber's approach was "based on well-founded business theory" and noted that "the Council's role in community activities is usually confined to areas in which market failure occurs". It acknowledged that the Council's involvement in commercial activities was an exception. The staff report stated, "according to a purely idealistic theoretical business framework", the Council should not invest in several of the activities that are the subject of this review. However, the Council's decisions recognised the "wishes of the community" and reflected the "social, economic, cultural and environmental wellbeings of the community and its progress towards the attainment of the desired community outcome".¹

This comment characterised the Chamber's views as being "idealistic" and based on "business theory" whereas they reflect mainstream public policy perspectives on the Council's investment in businesses. Governments in many countries have exited from commercial businesses, thereby demonstrating that such policies are feasible. Neither the Council staff report nor the 2005-2006 Annual Plan (the Annual Plan) discussed or explained how the Council's investment in commercial activities advances the "social, economic, cultural and environmental wellbeings" of the community.

While the Council must take account of the wishes of its residents, it should lead the community to an informed understanding of the benefits and costs of the main options available and make decisions on the basis of a principled public policy analysis. Decisions which reflect ill-informed views of the community do not advance the overall interests of citizens and ratepayers. The suggested approach is consistent with the statutory requirement for the Council to act wholly or principally for the benefit of its district in carrying out its role and with the purpose of local authorities.²

The Council should be careful in assessing community wishes because residents have few incentives to reveal their true preferences. The low level of participation in

¹ Elliott, R D R (2005), "Draft Annual Plan 2005/06: Report on Submission No 157", Gisborne District Council, Gisborne.

² Local Government Act 2002, ss 12(4) and 10.

consultation exercises illustrates the problem. The views of well-organised groups that stand to benefit from particular policies may receive undue attention. The costs of the policies that they advocate may be spread thinly over ratepayers who are poorly represented in the political process because it is often too costly for them to promote their interests.

Although the Council staff report defended the Council's investment in commercial activities, the Council had previously raised the possible divestment of its Warrant of Fitness and Registration Centre (the Centre), acknowledged the need for a review of some forestry blocks and noted the need to put some of the land used by the Waikanae Beach Holiday Park (the Holiday Park) to better use. The Council has also identified surplus commercial and residential land which is being sold. These steps indicate a willingness to re-examine the business of the Council.

In the light of these developments, the Chamber sought a professional review of the Council's investments in the activities that had been addressed in the Chamber's submissions. They are listed below:

- farming;
- commercial forestry;
- the Centre;
- the Holiday Park; and
- housing for senior citizens.

The Eastland Community Trust holds substantial investments in electricity distribution and port activities. This review does not include those businesses. They may warrant examination in the future. The Council's rights in respect of the Trust are limited by the trust deed.

The review comprises a high level examination of the Council's investment from a public policy perspective. In this context, the broad objective of public policy is to help maximise the overall wellbeing of the residents of the district of Gisborne (the community). The review is not aimed at promoting the narrow interests of the business sector or any other section of the community.

The discussion concentrates on general principles and arguments related to the role of government. Similar arguments apply to most of the businesses examined. To avoid undue repetition, the arguments are elaborated on the first occasion that they are advanced and summarised when repeated.

The review proposes broad options that would permit the Council to exit from, or reduce its involvement in, activities that extend beyond its proper role. Such activities should be left to the private sector (households, firms and voluntary organisations). The options are not developed. The review does not examine in detail the merits of the

relevant businesses from a commercial perspective, nor does it require familiarity with the particular activities or local knowledge.

Local authorities should compute the cost of capital of those activities undertaken on an arm's length basis by council-controlled trading organisations and apply the public sector discount rate (currently 10 percent) to activities which they undertake themselves. The purpose of such calculations is to help judge whether returns commensurate with the opportunity cost of capital, taking account of the risk involved, are being earned.

A preliminary estimate of the cost of capital for each business is presented in the Appendix. Judgements on whether the relevant businesses are yielding a return at least equal to the cost of capital are indicative only, although firm conclusions can be drawn in respect of those businesses that do not earn a return at least equal to the risk-free rate of return.

The review draws mainly on public sources of information such as the Council's informative 2004-2014 Long Term Council Community Plan (the LTCCP), the Council's 2005-2006 Annual Plan (the Annual Plan), the Council's Annual Report for 2004-2005 (the Annual Report) and the Council's web site. Statements of corporate intent for the three years commencing on 1 July of each of 2003, 2004 and 2005 for Gisborne Holdings Limited (GHL) and its subsidiaries and the 2003 to 2005 annual reports for GHL and Tauwhareparae Farms Limited (TFL) have also been used. Certain background information on housing for senior citizens and asset values were supplied by the Gisborne District Council.

The balance of this review is presented in 8 sections. The next section (section 2) discusses the role of local government. Each business is then discussed in turn: farming (section 3), commercial forestry (section 4), the Centre (section 5), the Holiday Park (section 6) and housing for senior citizens (section 7). Some financial implications of exiting from the businesses are discussed in section 8. Concluding comments are contained in section 9. The cost of capital is examined in the appendix.

2 THE ROLE OF LOCAL GOVERNMENT

The role of government at any level needs to be established on the basis of a proper public policy analysis.³ There are two primary functions of the government. They are to maintain order and to provide public goods and services. James Buchanan, a Nobel laureate in economic sciences, called them the protective and productive states.⁴

The protective state refers to the establishment and the maintenance of a general framework within which all social interactions take place. This entails the enforcement of rules against theft, fraud and the like, and the monopoly use of force to protect citizens from each other and from outsiders. The crucial elements include the maintenance of law and order, the enforcement of contracts and the avoidance of regulations, restrictions and excessive taxation (including rates) that would unjustifiably restrain voluntary exchange.

When the government performs its protective function well, individuals can have a high level of confidence that they will not be cheated and the wealth that they create will not be taken from them by intruders, or by the government through high taxes or inflation. Such conditions encourage individuals to focus on productive activities. In contrast, if private property rights are not clearly defined and enforced, some people will be encouraged to engage in harmful activities toward others. Resources will be used inefficiently, such as the excessive exploitation of fish in international waters and the under-utilisation of resources owned in common.

Beyond the protective state, the government might be able to enhance the overall wellbeing of its citizens by undertaking or funding productive activities that cannot be organised efficiently through voluntary exchange. Such activities focus on the production of public goods and services. A 'pure' public good or service has two characteristics:

- The good is non-rivalrous. A good is 'non-rival' when one person's enjoyment of the good does not reduce another person's enjoyment of it. Examples of non-rival goods are atmospheric quality, disease eradication programmes and free to air radio and television broadcasts. Most goods do not have this property. If one person eats an ice cream it cannot be consumed by another person.
- The good is non-excludable. Goods or services are non-excludable if it is too costly to prevent people who do not pay from using them. Examples are defence, open-access parks, street lighting, footpaths, flood control and cleaner air arising from pollution control devices.

³ This section draws heavily on work undertaken for the Local Government Forum.

⁴ Buchanan, James M (1999), *The Limits of Liberty: Between Anarchy and Leviathan*, Liberty Fund Inc, Library of Economics and Liberty, Indianapolis, www.econlib.org/library/Buchanan/buchCv7c4.html.

External benefits may arise when goods are non-excludable. External benefits (or costs) arise when one person's actions affects the wellbeing of a bystander. A person's garden may give pleasure to his or her neighbours. External benefits and costs are ubiquitous but most do not warrant government action because the costs involved outweigh related benefits.

The private supply of goods on an unassisted basis may not be feasible when both characteristics of public goods are present. Market failure may arise. The price normally charged for a product reflects the marginal cost of its supply. This may be zero in the case of a non-rivalrous good. The supply of a non-excludable good cannot be limited to individuals who are willing to pay for it. This characteristic encourages free-riding where people enjoy the product without paying for it.

Very few goods or services are both non-rivalrous and non-excludable. Private goods are the polar opposite of public goods. They are both rivalrous and excludable.

Club goods are an intermediate category. As long as there is excess capacity, a club good may share the public good characteristic that its use by any one member does not detract from the ability of any other member to simultaneously enjoy it. However, unlike a public good, people who do not pay for the club good can be excluded. Uncongested golf courses and cinemas are examples of club goods. The use of public roads by motorists (given present arrangements) is a further example.

Public goods and services can often be produced privately. Private firms may produce goods that at first sight appear to be public goods by charging for them with complementary products. An example commonly cited in the economic literature is that of lighthouses. The light provided by lighthouses is non-rival and non-excludable. It is, however, possible to charge for the service provided by lighthouses along with port dues. Radio and television broadcasts funded from advertising revenue are also examples.

The non-rival property does not automatically mean that government action is necessary. Many services traded in markets are non-rival in that extra users could be accommodated at little or no additional cost. Surplus capacities at concerts, sporting events and on aeroplanes are possible examples. Firms employ a number of techniques to use the capacity available. They often differentiate levels of associated services and set different prices for each market segment.

The technical definition of public goods is essential to a proper analysis of the role of government. The term 'public good' is commonly used very loosely, for example to imply that a service is of general value to a community. Often local government services are described as public goods or a wide pattern of benefits is alleged when a careful analysis would reveal that the services have few or no public good characteristics. 'Public' transport is an example. A seat that is taken on a bus cannot be used by another person and people who are not prepared to pay can be denied a ride. Used loosely, the term public good becomes no more than an assertion that a particular function should be publicly provided or funded, or both.

The discussion to this point has not distinguished between the functions of central and local government. There are circumstances where the role of the protective and productive states can most efficiently be undertaken by central government rather than local government, and *vice versa*. Probably the most common circumstances where local government is likely to be more efficient than central government are where local knowledge is required, where the costs and benefits of government action accrue locally, and where appropriate incentives apply at the local level.

Most activities that fall within the protective state are undertaken by central government in New Zealand. It has responsibility for defence, police, criminal and commercial laws, and the courts. Local government has some responsibilities in respect of law and order (for example certain public nuisances) and its regulatory and taxing activities affect private property rights.

The core function of councils, however, relates to the funding or provision of local public goods and the administration of regulation in their regions and districts. Local public goods include activities related to democratic, governance and representative processes, civil defence, street lighting and footpaths, open-access parks and reserves, and public health.

Local government might also provide a safety net for people who cannot be assisted in other ways. However, this role is performed by central government in New Zealand.

There should be no presumption that council funding or provision, or both, is justified simply because particular goods or services have public good characteristics. Local government is just one of many agencies which can facilitate the provision or funding, or both, of such goods and services. Councils can, for instance, contract for the supply of many public goods. Local government should not step in to assist when other arrangements might be more efficient and equitable.

A careful assessment of the costs and benefits of government action is required. The assessment should recognise that governments as well as markets may fail. There is, for example, no guarantee that elected representatives will adopt policies that advance the overall wellbeing of the community. They may instead support policies advocated by interest groups at the expense of the general public.

The approach outlined is entirely consistent with the Local Government Act 2002 which generally permits councils to decide how they can best promote the social, economic, environmental and cultural wellbeing of their districts or regions. A decision not to take any action is among the options that are open to local government.

3 FARMING

3.1 Background

The Council owns all the shares issued by GHL which owns all of the shares in Tauwhareparae Holdings Limited (THL). THL in turn owns all of the shares in its subsidiaries which are listed below:

- TFL; and
- Tauwhareparae Forests Limited.

TFL is the only entity within the GHL group that is engaged in trading activities.

The statement of corporate intent for the three years commencing on 1 July 2005 states that the principal activities of GHL are to act as a holding company for the Council and to hold shares in THL and any other companies as agreed with the Council from time to time. It is also to monitor and ensure compliance by each of its subsidiaries with their statements of corporate intent and is not to agree to, or promote any change to, such statements without the approval of the Council.

The following specific objectives have been set for GHL:

- to earn a commercially appropriate return on shareholder's funds, having regard to the risk of the business; and
- to encourage regional growth by investigating and promoting regional development initiatives in conjunction with the Council.

The performance of GHL over the three years is to be judged by reference to the targets listed below:

- GHL is to strive for a consolidated accounting return on shareholder's funds (defined as earnings before interest and tax divided by average shareholder's funds employed) of 3.0 percent in 2005/06, 3.7 percent in 2006/07 and 3.8 percent in 2007/08. The comparable targets for 2005/06 and 2006/07 set in the 2004 statement of intent were much higher at 7.6 percent and 7.5 percent respectively.

In 2004/05 GHL report a loss on shareholders funds of 0.1 percent compared with a target profit of 5.3 percent.

- GHL is to achieve a consolidated ratio of net debt to net debt plus equity of no more than 10 percent in 2005/06, and 11 percent in 2006/07 and 2007/08. Compared with the targets set in 2004, these targets are unchanged for 2005/06 but marginally higher than the 10 percent set for 2006/07.

- GHL is to aim for annual rates of consolidated revenue growth of 2.8 percent in 2005/06, 0.3 percent in 2006/07 and zero in 2007/08. The comparable rates set in 2004 were 1 percent for 2005/06 and 1.5 percent in 2006/07.

These targets are different from those contained in the Annual Plan. It noted that the statement of intent had not been finalised. The performance targets stated in the Annual Plan were much higher than those subsequently agreed for 2005/06 and higher than those agreed for 2004/05. They included a target rate of return before interest and tax on shareholder's funds of 5.9 percent in 2004/05 and a consolidated annual rate of revenue growth of 25 percent for that year.

The actual return in 2004/05 and the target returns for 2005/06 through to 2007/08 are well below the relevant yield on government bonds with a duration of 5 years (which averaged about 6 percent in 2004/05 and in the year to October 2005).⁵ This interest rate is an indicator of the risk-free return which is the minimum return an investor would expect to earn on a safe investment. On this basis, continued investment in GHL is likely to reduce the wealth of ratepayers because they are not expected to be compensated for the risk that they bear.

The shareholder's equity in GHL has increased over the past two years from \$21.8 million to \$40 million, largely as a consequence of the revaluation of farm land.⁶ The net gain on the revaluation of assets is not generally included in operating income for financial reporting purposes but is included in a comprehensive concept of economic income.

It might be argued that although GHL's operating income is low, GHL provides an adequate overall return. Net asset revaluations should be taken into account (perhaps on a smoothed basis) if a nominal cost of capital is applied.⁷ Asset revaluations are, however, unlikely to be as large as those that have arisen recently because of factors

⁵ The return on shareholder's funds is usually computed after deducting interest because interest is the return to the debt holders. This adjustment would reduce the level of returns to equity holders from those computed by GHL.

⁶ The price of farmland in the Gisborne area has been reported by the chairman of TFL to have increased faster than in other areas over an extended period because it was cheaper initially. The price of land must ultimately reflect the income earning capacity of the land. The apparent presumption that the price of land can continue to increase at an exponential rate that is faster than that recorded in other areas implies extraordinarily slow adjustment in land values in the region (which is unlikely), persistently faster productivity growth than elsewhere (which is also unlikely), consistently higher commodity prices for outputs produced in the area (for instance for lambs and wool) relative to those of other regions (for example for dairy products) or excessive optimism, see *Gisborne Herald*, 22 July 2005.

⁷ This problem is addressed by computing a real cost of capital and excluding the revaluation of assets. On this basis, the target returns fall short of the real cost of capital which might be between 4 percent (for a very low risk investment) and 12 percent (for a risky asset), see the Appendix.

such as low interest rates, high commodity prices and an increase in stocking rates from low levels. Continuing increases in operating income or lower real interest rates are generally necessary to generate persistent increases in property values.

3.2 Tauwhareparae Farms Limited

The long-term financial viability of the Port of Gisborne has been uncertain for many years. Income from farms owned by Port Gisborne Limited was used to support its port activities.

The Eastland Energy Community Trust bought the assets and undertaking of the Port of Gisborne from Port Gisborne Limited on 28 February 2003 and established Eastland Port Limited. The Eastland Energy Community Trust had been established in 1993 as part of the restructuring of the electricity industry.

Port Gisborne Limited changed its name to TFL following the sale of its port-related assets. In February 2003 TFL became a "fully-focused farming entity", although some residual port issues remain.⁸ (Litigation arising from the grounding of the *Jody F Millennium* in 2002 is an example.)

The three farms, comprising 11,262 hectares, were run down. In 2003/04 steps were taken to improve the productivity of the farms. A new general manager was appointed and a programme to increase stock units was developed. TFL owned 47,564 sheep (up 25 percent on 2004) and 5,549 cattle (up 11 percent) in June 2005. These numbers are equivalent to 74,000 stock units.⁹

TFL reported a net operating loss before tax (excluding discontinued activities) of \$0.2 million in 2004/05, compared with a surplus of \$0.7 million in the previous year. The poor operating performance was attributed to severe drought conditions, the undertaking of deferred maintenance and lower prices for wool.

TFL holds significant investments in commercial forests that have been developed on some of its land. They were stated at \$3.2 million, including land of \$1.7 million, in June 2005. The value of the forestry asset was written down in 2004/05 by \$0.7 million.¹⁰

The forest crop is valued on a net present value basis. A 10 percent post-tax discount rate was applied in 2002/03 and 2003/04 but this was reduced to 8 percent in 2004/05. According to the statement of intent the discount rate will increase to 8.5 percent for the three years commencing in July 2005. No reasons were disclosed for the change in the

⁸ Tauwhareparae Farms Limited (2003), 'Annual Report For the Year Ended 30 June 2003', p 1.

⁹ Tauwhareparae Farms Limited (2005a), 'Annual Report For the Year Ended 30 June 2005', pp 1 and 14.

¹⁰ *Ibid*, pp 1, 11 and 13-14.

discount rate. If the 10 percent rate had applied in 2004/05, the tree crop would have been revalued downward by a much larger amount.¹¹

According to its statement of intent, TFL's principal activities are to manage its farm and forestry estate in accordance with best practice and to identify any opportunities to profitably extend its activities into areas which are complementary to, and compatible with, its core business.

TFL's performance targets are to earn an accounting rate of return before interest and tax on average farm-related shareholder's funds of 5.5 percent in 2005/06, 5.6 percent in 2006/07 and 6.4 percent in 2007/08. The calculations are to be based on the valuation of property recorded in the annual report for the year ended June 2004. The target return on shareholder funds is higher than it would be if the recent substantial revaluation of farm assets were taken into account.¹²

The stock units carried on the farms are to be increased by 3 percent in 2005/06, 1.5 percent in 2006/07 and 5 percent in 2007/08. If these targets are achieved, total stock units in 2007/08 would exceed the long-term target of 80,000 units.¹³

The value of TFL's assets (including livestock and forestry assets) was put at almost \$44 million at 30 June 2005. After deducting external liabilities, GHL's net equity in TFL was \$39 million. TFL accounts for 3 percent of the total consolidated assets of the Council and exceeds its consolidated public debt of \$34 million.¹⁴

3.3 The Case for Exiting from Farming

There are no valid public policy grounds for the Council to engage in farming:

- Farming is a private good activity. There are no public good or regulatory reasons for the Council to engage in farming:
 - The previous rationale for engaging in farming, namely to subsidise the port, though doubtful from a public policy perspective, is no longer applicable.
 - The Council's real objectives for engaging in farming (other than to earn a profit) are unknown. For instance, what does the Council really want to achieve by holding the farms? Under what circumstances would the

¹¹ Tauwhareparae Farms Limited (2003), *op cit*, p 7, Tauwhareparae Farms Limited (2004), 'Annual Report For the Year Ended 30 June 2004', p 8, Tauwhareparae Farms Limited (2005a), *op cit*, p 9 and Tauwhareparae Farms Limited (2005b), 'Statement of Intent for the Three Years Commencing on 1 July 2005', p 12.

¹² Tauwhareparae Farms Limited (2005b), *op cit*, p 6.

¹³ *Ibid* and *Gisborne Herald*, 22 July 2005.

¹⁴ GHL's net equity is \$40 million. GHL has advanced \$1.1 million to TFL.

Council conclude that its long-term objectives have been satisfied and it is time to dispose of the farms? If the Council did not own the farms would it be prepared to raise rates now to buy into farming?

- Government businesses may do well on occasions but that is not a valid public policy ground for public ownership. The increase in the value of the farms over the last two years, which was due to factors such as low interest rates, favourable commodity prices and increased stocking, might be cited as an example. Large increases in the value of the farm land (and other classes of property) are unlikely to re-occur on a regular basis.¹⁵ Moreover, unless operating income increases commensurately, the future return on the market value of the asset will fall further from a low level. TFL achieved a nominal return on shareholder's funds (excluding forestry and asset revaluations before June 2004) of 3.1 percent in 2004/05 or about 55 percent of its targeted return. In contrast to the value of farm and forestry land, TFL's investment in forestry has been revalued downward by \$0.7 million because the expected value of the tree crop has reduced. It is future returns that matter most.
- Past increases in the value of the farms do not justify their continued public ownership because, as George Stigler (a Nobel laureate in economic sciences) observed, "we must base public policy not upon signal triumphs or scandalous failures but upon the regular, average performance of policy."¹⁶
- Private ownership of business enterprises is more efficient than public ownership on average and over time.¹⁷ One key problem is that elected officials face weaker incentives than the owners and managers of

¹⁵ The ASB Bank has shown that the increase in the value of dairy farms between 2002 and 2005 is similar to the increase in the price of residential houses. It concluded that a sustained period of low interest rates is the primary driver of the current boom in property prices, see Dickens, Rodney (2005), 'Dairy Farm Prices – At Risk But Not Facing a Supply Avalanche', Industry Research, 10 November, ASB, Auckland.

¹⁶ Stigler, George J (1975), *The Citizen and the State: Essays on Regulation*, University of Chicago Press, Chicago, p 185.

¹⁷ See, for example, Kikeri, Sunita and Nellis, John (2002), 'Privatization in Competitive Sectors: The Record to Date', World Bank Policy Research Working Paper 2860, World Bank, Washington and Megginson, William L and Netter, Jeffrey M (2001), 'From State to Market: A Survey of Empirical Studies on Privatization', *Journal of Economic Literature*, June, pp 321-389. A study by Australia's Productivity Commission found that nearly half of the 83 government trading enterprises that it monitors earned (before tax) less than the government bond rate of 5.7 percent in 2003/04 (that is, the relevant enterprises did not earn a return at least equal to the benchmark for the risk-free rate of return). An even greater number of enterprises failed to earn a commercial rate of return which includes a margin for risk. Similar results were obtained in the two previous studies, see Productivity Commission (2005), *Financial Performance of Government Trading Enterprises 1999-00 to 2003-04*, Commission Research Paper, Productivity Commission, Canberra, pp 2 and 9, www.pc.gov.au/research/crp/gte0304/index.html.

commercial firms and they often face conflicting objectives. The incentives that apply to owners and managers of private firms generally encourage them to take corrective action more quickly than managers of public enterprises when mistakes arise or when conditions change.

- The guiding principles contained in the statements of corporate intent for companies in the GHL group may conflict with their commercial objectives. The companies are required, for instance, to ensure the use of local services and materials to the extent practicable and to expand local employment opportunities. These objectives, though qualified, would not normally be found among the objectives of privately-owned enterprises.
- Multiple layers of decision-makers provide potential for inefficiency. The owner of most farming enterprises usually plays a leading role in the management of the farm and works on it. Large-scale corporate farming ventures have generally been limited in New Zealand, suggesting that the farmer-owned enterprise model is usually superior to other models. In the case of the Council's farming operation, there is a general manager, a board of directors for TFL, THL and GHL (though they are the same), council officials (the chief executive is a director and council staff advise the Council on matters relating to the companies that affected the Council) and the Council. Costs are incurred at every level. These costs include expenses and wider costs arising from conflicts and confusion over objectives, the setting and monitoring of policies and investments, and delays in obtaining decisions.
- The promotion of regional development is not a valid ground for investing in farming. Economic growth and employment in the Gisborne district are most likely to be advanced if the Council focuses on public good activities, and keeps its rates and regulatory burdens low. The Council cannot validly claim that it does not have sufficient funding for essential public good activities and infrastructure when it has around \$40 million invested in a private good activity.
- Political considerations often distort business decisions by public sector managers. This applies to Council businesses and other corporatised entities. It leads to inefficient investment and spending decisions by public enterprises.
- Business activities that are subject to competition, such as farming, can only earn a normal return in the long run. The marginal investor is only compensated for the investment made and the risk involved:
 - The market value of an asset is equal to the income it is expected to generate in the future, discounted at the market rate of return (that is, the risk-free rate of return plus a premium for the risk associated with the particular investment). The market value of the asset will include investors' assessments of the scope for increasing returns from the asset, for instance by better management and new investment. Existing information can be

expected to be taken into account by market participants and reflected in the market value of assets.

There is no additional income on an *ex ante* basis that can be obtained by holding an asset rather than selling it, unless the investor holds information that is not known to other participants in the market and is not reflected in the market value of assets. This is a demanding test that is unlikely to apply in the case of a business such as farming where local farmers are usually well informed on the performance and potential of farms in their district.

- The future is uncertain. Thus investors' judgements about asset values may differ. New information may also emerge over time. For these reasons, *ex post* outcomes may differ from *ex ante* predictions. There is no reason, however, to believe that such differences are systematically biased toward more favourable outcomes than initially expected. Similarly, there is no reason to assume that the Council is able to persistently bet against the market – the collective wisdom of all participants – and win.
- The Council chief executive is reported to have stated that the Council is to hold the farms in the "long term to realise growth and dividend streams".¹⁸ For the reasons outlined above, expected future income streams can generally be realised now by selling the farms.
- The cost of capital should be formally estimated and disclosed. The return earned by TFL and its forecast return could then be compared with the return required to help assess whether the Council's farming business is as profitable as claimed.¹⁹
- The statement of corporate intent for the three years commencing in July 2005 anticipates that dividend payments will start in 2006/07 at the level of \$1.5 million. (This is subject to certain conditions arising from litigation.) While dividends reflect only a part of the total expected return to the owner, the forecast future dividend would provide ratepayers with inadequate compensation for an investment worth around \$40 million.
- A council business that is funded by rates or could be sold to lower rates (directly or indirectly) must earn a normal return plus a margin to cover deadweight costs before the community breaks even. Deadweight costs are not reflected in standard cost of capital calculations. Rates, like all feasible taxes, impose deadweight costs on the community. These arise from the distortions caused by taxes. Investment and output is likely to be lower than otherwise because of rates. The level of deadweight costs is not known but they are unlikely to be trivial.

¹⁸ *Gisborne Herald*, 6 August 2005.

¹⁹ See the Appendix for a preliminary estimate of the cost of capital.

- Council spending on public good activities should generally be funded from rates. In this way the community bears the costs of the services that it demands and elected representatives are required to weigh the benefits of incremental spending proposals against the costs incurred in increasing rates. There is no persuasive case to fund such spending from the profits arising from private good activities.
- The Council should not expose ratepayers to unnecessary financial risks because they have limited opportunity to avoid them. By retaining the farms the Council is exposing ratepayers to risks that are specific to farming, such as those that arise from volatile commodity prices, exchange rates, weather and biosecurity as the Chamber observed in its submissions. The ratepayer's exposure is vastly different from that of an individual, such as a farmer, who voluntarily assumes such risks and is free to extract himself or herself from them at will. An individual ratepayer can only avoid the risk by incurring the high costs of moving to another district. It is understood that many retired people have left Gisborne for multiple reasons including the high cost of rates. The Council's rates per capita in 2003/04 were the sixth highest among the 34 provincial councils examined by the Local Government Forum.²⁰
- The preferences of ratepayers differ:
 - The continued ownership of businesses, the building up of investments or the retention of surplus capital by councils unnecessarily constrains the options available to ratepayers.
 - Even if the majority of ratepayers favoured continuing Council ownership, their view may be imposed on the minority whose circumstances may be vastly different, especially in a low income area such as the Gisborne district.
 - The ratepayers who currently pay higher rates than otherwise may well be different from those ratepayers who ultimately benefit from higher income in the future and from the possible sale of the farms. Thus an equity issue arises when councils invest in businesses or retain them for long periods.
 - Council elections, submissions on annual plans and opinion surveys generally provide inadequate information on the true preferences of residents. Voter turnout is relatively low, many people have limited information on the policies advocated by candidates and successful candidates may be unable to obtain a majority for the policies that they advocate. Few ratepayers participate in local authority consultative

²⁰ The Council's rates per capita in 2003/04 (\$713) were the sixth highest among the 34 provincial councils examined by the Local Government Forum in its analysis for the Forum's 'Hot Councils Awards 2004'. The average for such councils was \$605. Allowing for the fact that Gisborne District Council is a unitary council would not make much difference to its ranking.

exercises, perhaps because they think they are a waste of time. A person's true preferences are only revealed when the person voluntarily exchanges a good, service or asset for another, often money.

- An opportunity cost arises when capital is invested in council businesses:
 - Debt could, for instance, be repaid with the proceeds from the farms (which implies lower rates than otherwise in the future) or surplus capital could be returned to ratepayers by lowering rates, perhaps on a temporary basis.

Assuming the valuations reflected in TFL's annual report for 2004/05 reflect current market valuations, TFL's assets could be realised for \$40 million (net of liabilities that are external to the GHL group). The Council's debt could be repaid in full as it falls due, saving \$2.1 million a year in interest and allowing rates to be reduced by about 6 percent.²¹

- The Council and its staff are required to focus from time to time on issues that arise in relation to TFL and GHL. Their time would be better spent on activities that must be undertaken by the Council.

3.4 Some Options

The options available to the Council may include the following:

- Sell the farms and forests, TFL or GHL. This would enable the Council to exit completely from the farming and forestry activities undertaken by TFL and realise the best possible return for ratepayers. The option would only be possible if there are no significant restrictions on land sales. GHL should be wound up if the farms or TFL are sold. The Council would need to provide alternative undertakings to those made by TFL in relation to litigation arising from the stranding of the *Jody F Millennium*.
- The Council could lease the farms and sell the livestock, farm supplies and motor vehicles. This option would reduce the ratepayers' exposure to farming and forestry risks, realise some capital and provide a more stable income stream for the Council.
- The Council could enter into a joint venture. This option would enable some of the ratepayers' investment to be realised, reduce the risk carried by ratepayers and impose strictly commercial disciplines on the farming and forestry activities.

²¹ The financial implications of exiting from the businesses reviewed are examined in section 8.

- The forestry assets could be dealt with separately. The Council could sell the rights to TFL's forests or alternatively it could sell the land (as provided above) but retain the rights to the forests.
- The shares in TFL (or GHL) could be given to ratepayers or residents. They could then decide whether to hold them or sell them. Several variants of this option are possible. Ratepayers could, for example, be given the opportunity to assign their share entitlement to a trust (formed for the purpose) which would hold shares for the benefit of those residents who favour the collective ownership of the farms.²²

²² Legislation may be required to allow councils to distribute shares to ratepayers or residents.

4 COMMERCIAL FORESTRY

4.1 Background

The Council has two separate commercial forestry estates. They are known as the GDC and Pamoia blocks. They are additional to the forests held by TFL.

Some of the GDC forests were established on parcels of land that are part of, or adjacent to, a legal road. Such plantings were apparently intended to stabilise land vulnerable to erosion and were encouraged by grants provided by central government. The Council also holds some rights to forests on private land. The forests are managed by a private firm with oversight from Council staff.

The GDC blocks are now stated to contribute to the 'prosperous communities' outcome by generating income on harvesting from a source other than ratepayers. The Council noted in its LTCCP that its involvement in the GDC blocks is largely historical and may need to be revisited on a block-by-block basis.

The Pamoia blocks comprise a larger forestry estate of over 1,600 hectares that is the subject of a joint venture with Juken New Zealand Limited (JNL), formerly Juken Nissho Limited. The Pamoia station was bought and planted in forests to stabilise land through which Gisborne City's water supply was piped, following the loss of supply during Cyclone Bola which struck in March 1988. The Council entered into an agreement with JNL whereby the Council provided the land and JNL undertook and funded planting. The Council is entitled to 16.75 percent of stumpage. JNL has the first right of refusal if the Council wishes to reforest the property after the first crop rotation.

The Council's forests (excluding land) were stated at \$0.7 million (GDC and Pamoia blocks) and \$2.2 million (also including TFL's forests) in the Council's statement of financial position at 30 June 2005. These amounts largely reflect the present value of the expected future value of the crop, net of the expected costs of tending the forests.

The Pamoia blocks are said to further three community outcomes: 'positive leadership – environmental', 'prosperous communities – economic', and 'safe and healthy haven – environmental'.

The LTCCP appears to have been prepared on the assumption that the GDC blocks will be replanted. The revenue generated by harvesting is to be used to fund replanting. The LTCCP indicates that commercial forestry was expected to generate a cumulative net operating surplus from 2003/04 to 2005/06 of \$0.3 million but would require cumulative funding from rates in 2006/07 through to 2013/14 of about \$0.8 million. In addition, capital spending of \$0.5 million would be funded from reserves.

According to the LTCCP all commercial forest lots are to be managed to maximise returns, subject to approved management and financial programmes developed by independent forest managers. However, the performance targets contained in the LTCCP are imprecise.

4.2 The Case for Exiting From Forestry

There are no valid public policy reasons for the Council to engage generally in commercial forestry, although limited forestry activities that are necessary for the protection of the water supply and the stabilisation of land used for roading may be warranted:

- Forestry is a private good activity. There are no public good or regulatory reasons for the Council to engage generally in commercial forestry:
 - The initial objectives of protecting Gisborne City's water supply and stabilising land reserved for roading could not possibly justify the level of the Council's current investment in commercial forestry.
 - The LTCCP indicates that the Council has no firm knowledge as to why forests were established on some GDC blocks in the former Cook County.
 - The undertaking of commercial forestry on private land is doubtful on public policy grounds. While stabilisation of slip-prone hill country may generate environmental benefits (for instance, less soil and debris would be washed into rivers) that may not accrue to the land owner (external benefits), most of the benefit accrues to land owners. The Council would need to demonstrate that government intervention is warranted, that the establishment of commercial forestry is the most efficient form of intervention and that public ownership of the forests is required. These tests are likely to be difficult, if not impossible, to satisfy.
 - The Council's real objectives for engaging in forestry (other than to earn a profit) are unknown. For instance, what does the Council want to achieve by investing in forestry? If the Council continues to replant the land when are ratepayers likely to benefit from lower rates than otherwise? Under what circumstances would the Council conclude that its long-term objectives have been satisfied and it is time to dispose of the forests? If the Council did not own the forests would it be prepared to raise rates to buy into forestry?
- Private ownership of businesses is more efficient than public ownership on average and over time.
- From 2006/07 rates are forecast to be higher than otherwise because of the need to fund commercial forestry. The proceeds from harvesting the forests may subsidise future spending or could be reinvested in forestry. Council spending on

public good activities should generally be funded from rates. There is no persuasive case to fund such spending from business profits.

- Political considerations often distort business decisions by public sector managers. This leads to inefficient investment and spending decisions by public businesses.
- Business activities that are subject to competition, such as commercial forestry, can only earn a normal return in the long run. The marginal investor is only compensated for the investment made and risk involved.
- The Council should not expose ratepayers to unnecessary financial risks because they have limited opportunity to avoid them:
 - The Council is exposing ratepayers to risks that are specific to forestry, such as those arising from volatile commodity prices, exchange rates, weather, disease and fire.
 - The past return on the Council's investment in forestry is likely to have been poor. The forestry industry is being restructured because (among other reasons) returns from forests have been inadequate. There is no systematic analysis of past returns and future prospects in the LTCCP. The normal return expected from the Council's forest businesses should be estimated and disclosed to residents.²³
- The preferences of ratepayers differ.
- An opportunity cost is incurred when capital is invested in businesses. Debt, for instance, could be reduced. Leaving aside forestry assets owned by TFL (which were included in the estimate given in section 3), the Council's forestry interests might yield up to \$0.7 million if they were sold. Related land could also be sold. The value of such land is not known.

4.3 Some Options

The options available to the Council could include the following:

- The Council could sell its forestry land, except that required for roading or water supply purposes, or where the sale of such land is infeasible because of legislative or contractual constraints. This might enable the Council to exit from much of its commercial forestry activities and realise the best possible return for ratepayers.

²³ The preliminary analysis contained in the Appendix indicates that commercial forestry is expected to yield a return equal to its cost of capital in 2005/06. The question of whether forestry is likely to yield an adequate return over the life of the investment is not examined in the Appendix.

The Council should not wait for the forestry cycle to pick up because potential investors would value the forests on the basis of their expected future earnings.

- The Council could lease the land required to secure its water supply and sell the rights to forests on the land. Other forestry land could be sold.
- The Council could sell its rights to forests on private land and the GDC blocks. This option would enable the Council to scale down its commercial forestry activities and permit some of the ratepayers' investment to be realised.
- The Council may be able to sell its rights under the JNL joint venture.

5 WARRANT OF FITNESS AND REGISTRATION CENTRE

5.1 Background

The Council has conducted vehicle warrant of fitness inspections for over 50 years. The present business also includes vehicle registration and driver licensing activities.

Compulsory fitness inspections for licensed passenger service vehicles were introduced in 1931. Goods vehicles and school buses were required to be inspected from 1936. Until 1987, the issue of certificates of fitness was the responsibility of the Ministry of Transport (and its predecessors). Since then other authorised agents have been permitted to carry out fitness tests.²⁴

Fitness inspections for private motor cars became mandatory in 1937. Warrants of fitness were initially issued by local authorities or authorised garages. Private provision of warrant of fitness testing (other than in country areas) was subsequently prohibited to achieve a greater uniformity of standards.

In 1987 private testing of light vehicles in all localities was re-introduced.²⁵ Since then most councils have disposed of their vehicle inspection businesses. Very few councils currently provide inspection services either directly or indirectly through council-owned businesses.²⁶

The Council's LTCCP states, "the local Motor Trade Association agreed that they would not compete and would take all their WOF requirements through Council's VTS" (vehicle testing service). This statement is surprising because the Commerce Act 1986 generally prohibits any person or firm from entering into an agreement that has the purpose, or has or is likely to have the effect, of substantially lessening competition in a market. Any such agreement to restrict competition is unenforceable.

In 2000 Toyota and Ford announced their intention to compete for the business in response to queuing for inspections and a 15 percent increase in prices. The cost of taking cars for inspections is understood to have been too expensive. The Council is, however, the dominant supplier of private motor car inspection services in Gisborne City. The Council's LTCCP put the throughput at 3,000 to 4,000 vehicles per month. In addition, 2,200 registration transactions are undertaken each month.

²⁴ Department of Statistics (1990), *New Zealand Official 1990 Yearbook*, Department of Statistics, Wellington, p 552. Land Transport New Zealand is now responsible for the licensing of agents who are authorised to undertake certificate and warrant of fitness tests.

²⁵ *Ibid.*

²⁶ This assessment is based on an informal discussion with Land Transport New Zealand.

According to the LTCCP, the Centre is expected to earn \$1.19 million in revenue, incur \$0.86 million in costs and produce an operating surplus of \$0.32 million (27 percent of turnover) in 2005/06.^{27 28} The Council's long-term forecasts assumed steady growth in the levels of revenue and surplus. The Council aims for a 20 percent margin on turnover and a return of between 15 percent and 30 percent on capital invested.

The Centre was charged an internal rent of \$58,000 a year which is set by an external market valuation and Vehicle Testing New Zealand Limited, which carries out certificate of fitness inspections on the same site, pays \$22,000. The land and buildings used by the Centre and Vehicle Testing New Zealand Limited were stated at \$0.8 million in the Annual Report.

The expected return on the Centre in 2005/06 appears to exceed its cost of capital. The Centre might be worth as much as \$3.4 million based on the Centre's forecast earnings before depreciation and interest for 2005/06 and assuming a cost of capital of 10 percent. However, forecast earnings have been reduced to \$0.16 million a year to reflect of the risk of a fall in throughput from increased competition, giving an estimated value of \$1.6 million. This is a preliminary estimate which is based on a number of assumptions.

5.2 The Council's Consultations on Divestment of the Centre

The LTCCP stated that if a realistic offer for the business were received, the sale of the business as a going concern would be considered. The possible divestment of the Centre was subsequently highlighted for consultation in the draft 2005-2006 Annual Plan. A key concern was the possibility of increased competition.

Vehicle Testing New Zealand Limited has apparently indicated that it intends to move to a new site when its lease expires in February 2006. Vehicle Testing New Zealand Limited, a national provider, could offer warrant of fitness inspections and registrations, in addition to certificate of fitness inspections, as it does in many other localities.²⁹

The Annual Plan lists three predominant reasons for divesting the business. They are noted below:

- The dominant position of the existing business which may face increased competition. The level of returns cannot be guaranteed into the future.

²⁷ The forecasts contained in the Annual Plan are not as detailed as those contained in its LTCCP. However, the Annual Plan forecasts for 2005/06 are the same as those contained in the LTCCP for that year, with a handful of exceptions that are noted in the Annual Plan. The consistency between these forecasts is commendable.

²⁸ The allocation of costs (for example overhead costs) among Council activities has not been examined.

²⁹ Vehicle Testing New Zealand Limited, which previously focused on certificate of fitness inspections, was sold by the government to Motor Trade Investments in 1999.

- There may be better uses for the capital invested in the activity in terms of risk or returns, or both.
- The Centre is not a core business of Council. The Council should divert all of its energies into its key activities and do these well.

While observing that it was difficult to predict the outcome of increased competition, the Council speculated that a single national provider could take up to 50 percent of the Centre's current throughput. Each 10 percent fall in throughput was forecast to reduce expected returns (before internal charges) from \$0.45 million by almost \$0.06 million.

The Council stated that it has never operated the Centre to maximise profits as profits are not the Council's main focus. It suggested that if it exited from the business, a single alternative operator may become the dominant supplier and prices could rise by as much as 30 percent to bring them into line with prices charged in New Zealand as a whole.

The Council also noted that most of the money generated by the Centre stays in Gisborne. This would not necessarily be the case if a national service provider were to fulfil the role currently performed by the Council.

A key consideration raised by the Council related to the land used by the Centre. The land was given to the Council by central government. The Council would need to obtain the agreement of the ministers responsible for Treaty of Waitangi negotiations and Land Information New Zealand before it could be sold.

Preliminary consultations undertaken on the draft 2005-2006 Annual Plan indicated that a majority of the public who made submissions wished the Council to continue operating the Centre (113 out of 134) but the support of a significant number of such respondents was subject to the Centre continuing to make a profit.³⁰ On this basis, the Council resolved to retain the Centre but to investigate options for establishing some form of joint venture.

5.3 The Case for Exiting from the Centre

The key argument for the Council to exit from its warrant of fitness and registration business is that such activities are not an appropriate role for local government. This was the third reason cited by the Council in its Annual Plan. The Council should focus on public good and regulatory activities (that is, its core activities), and exit from those activities that the private sector is able to undertake. In this way the Council can make the best possible contribution to the welfare of its ratepayers and citizens:

- The provision of vehicle testing activities is a private good activity. There are no impediments to the private supply of testing services. The service can be denied to people who are unwilling to pay and its supply to one person cannot be enjoyed

³⁰ *Gisborne Herald*, 18 May 2005.

by another. Such services are commonly provided by the motor vehicle servicing industry and, more recently, specialist entities.

Similar arguments apply to the registration business which comprises the administration of vehicle registration, road user charges, driver licences and a payment service.

- There are no persuasive public policy arguments for vehicle safety inspections to be undertaken, or registrations to be processed, by a government agency. The mandatory requirement for warrant of fitness inspections is aimed at promoting the use of safe motor vehicles for the benefit of all road users:
 - The inspections and standards required can be specified. They are similar to the tests that motor mechanics apply during the regular servicing of cars. Thus the feasibility of establishing and monitoring agreements with providers is not a ground for the public provision of inspection services.
 - The proper implementation and monitoring of warrant of fitness tests can be satisfactorily achieved by the licensing of authorised agents. The performance of inspections and registration activities do not involve the exercise of police powers where valid concerns about individual liberty lead to the public provision and funding of law enforcement, although the enforcement of offences such as the operation of a motor vehicle without a valid warrant of fitness may do so.
 - The quality of inspections by authorised agents is monitored and licences can be withdrawn from those agents who fail to maintain satisfactory standards. Such agents may also be prosecuted for any offences committed. While some authorised agents may perform poorly or even act unlawfully, government agencies are subject to similar performance risks, as the Cave Creek tragedy and other incidents demonstrated. The incentives facing business owners to protect their reputations and business investment are generally stronger than those facing government agencies. This points to lower risks on average and over time with private ownership.

The outcome of the preliminary consultations implies that the Council can properly engage in private good activities so long as they enable rates to be lower than otherwise. This proposition is doubtful for the following reasons:

- It implies that there is no limit to the range of private good activities that local government should engage in provided that they are profitable.
- If it were appropriate for the Council to invest in businesses to reduce rates there would be no reason why such investment should not be extended (where feasible) until council spending is fully funded from business profits. Governments (central and local) do not generally do this either in New Zealand or in comparable countries.

- Private ownership of business enterprises has been shown to be more efficient than public ownership on average and over time.
- Political considerations often distort business decisions by public sector managers.
- Business activities that are subject to competition can only earn a normal return in the long run. Thus the marginal investor is only compensated for the investment made and the risk involved.
- The Council should not expose ratepayers to unnecessary financial risks because they have limited opportunity to avoid them.
- The preferences of ratepayers may differ. They have little incentive to reveal their true preferences.
- The building up of investments by councils or the retention of capital not required for the proper role of councils unduly constrains options that are available to ratepayers.
- An opportunity cost is incurred when capital is invested in council businesses. Debt could, for instance, be repaid with the proceeds from selling businesses (which implies lower rates than otherwise in the future) or surplus capital could be returned to ratepayers through lower rates.
- It is virtually impossible to lower current or future rates by using business income to fund spending without having kept rates higher than otherwise in the past, providing a lower level of services than otherwise or incurring debt to build up the capital invested.
- A Council business that is funded by rates or could be sold to lower rates (directly or indirectly) must earn a normal return plus a margin to cover deadweight costs before the community breaks even.

The Council suggested that prices could rise by up to 30 percent if the Council were to exit from warrant of fitness and registration activities and another provider were to establish a dominant position. There are several reasons for discounting these concerns in deciding whether the Council should divest the Centre:

- Actual or potential competition rather than public ownership is the key to containing costs and promoting consumer interests generally:
 - Competition is fostered where barriers to entry into and exit from an industry are low. The number of suppliers is not important in assessing the extent of competition because new firms can enter the industry if the barriers to entry are low. The high cost of investment and economies of scale, which may limit competition in some industries such as

telecommunications, do not arise in relation to inspections and registration activities. Similarly, public policy does not seem to impede competition.

- The prospect that the Council could charge artificially low prices is a potential risk for a new entrant that would need to invest in facilities. In contrast, a dominant private sector supplier would face the risk of enticing new entrants to compete if prices were excessive. It is not in the interests of a dominant supplier that is subject to normal commercial disciplines to lower prices excessively to deter competition.
- Consumers should generally bear the true economic costs of supplying the services that they demand. This generally promotes efficiency. Thus even if higher prices were to result that is not a valid public policy reason for the Council to retain the Centre:
 - The Centre charges \$38 (including GST) to carry out a warrant of fitness inspection on a private motor car. Comparable charges in Auckland City, where specialist providers compete with the motor vehicle service industry, seem to generally range from \$38.00 to \$45.00, depending on location and presumably the level of competition in the nearby area. The New Zealand Automobile Association has set uniform charges of \$39 for members and \$42 for non-members at all locations within New Zealand where testing is undertaken. (These rates were recently set.) The Automobile Association does not undertake independent testing in Gisborne. Vehicle Testing New Zealand Limited charges \$42 at Whakatane which it gives as the location of warrant of fitness inspections closest to Gisborne. This survey information, though unsystematic, suggests that the risk of much higher prices for warrant of fitness inspections may not now be as large as suggested in the Annual Plan.³¹
 - If prices were to increase by up to 30 percent on a change of ownership, this would suggest that users are being cross-subsidised by other ratepayers. There are no persuasive reasons why ratepayers should subsidise car owners.

The Council faces the risk that the value of its business may erode over time. Specialist organisations that provide inspection and registration services have emerged and appear to be establishing modern facilities and services in many localities. The Council is aware of this risk.

There are two other related risks. The first is the possible introduction of vehicle exhaust emission tests. If such tests are introduced, additional equipment would need to be installed. Provision was made for such spending in the Council's LTCCP. The second risk relates to possible policy changes that could affect throughput. Cars up to

³¹ Prices were surveyed in October 2005.

six years of age are tested once a year. Other cars are tested twice a year. New Zealand's requirements are understood to be out of step with those of comparable countries. Most vehicles pass the inspections. Thus a case could be made to relax the frequency of tests. Such a move is possible, perhaps to help reduce the cost to motorists of emission testing if it is introduced.³²

5.4 Some Options

There are strong public policy grounds for the Council to exit from the Centre. This might be achieved by adopting one of the following options:

- The Council could sell the existing business as a going concern. This approach is likely to extract the largest market value for the existing business and enable the Council to exit entirely from the business. However, this option is only available if the land can be sold.
- The Council could sell the business but retain ownership and use of the property involved. The buyer would obtain access to an existing customer base. The use to which the site is put is an issue and that would affect the financial benefits of this option to the Council.
- The Council could sell the business as a going concern except for the land which could be leased to the buyer. This approach might be possible if the sale of the land is unlikely to be approved by central government.
- The Council could seek to enter into a joint venture agreement with another business. The Council proposes to explore this option. This approach is, however, less attractive from a public policy perspective than the above options because the Council would continue to hold an interest in the business and ratepayers' capital would continue to be at risk.

³² The points noted were raised in an informal discussion with Land Transport New Zealand.

6 WAIKANAE BEACH HOLIDAY PARK

6.1 Background

The Holiday Park offers camping and holiday accommodation, and recreational facilities. The Holiday Park has 20 modern self-contained tourist units, 24 ranch-house cabins and 166 camp sites.

The occupancy rate for the tourist units is around 70 percent, which is substantially higher than the national average for motels of around 55 percent, but only 35 percent for the cabins and 10 percent for camp sites (which is below the national average of about 14 percent for caravan parks and camping grounds).³³ The occupancy rate is close to 100 percent for all categories over the peak summer period.

The high occupancy rate for the tourist units reflects the prices charged. The tariff for two persons is \$65 or \$70 a night (peak season rates) compared with motels which generally charge at least \$85 and often considerably more.

The LTCCP states that the principal objectives of the Holiday Park are as follows:

- as a service to the holidaying public;
- to provide camping facilities and low cost accommodation alternatives to expensive motels and hotels; and
- as a lucrative business venture which returns good revenue and profits to the ratepayers of Gisborne.

The LTCCP estimates total revenue for the Holiday Park in 2005/06 to be \$0.61 million with external costs of \$0.36 million and internal charges, including rent, of 0.14 million, giving a forecast operating surplus of \$0.11 million. Aggregate capital spending of about \$0.2 million in each of 2004/05 (which was subsequently deferred) and 2005/06 was included in the LTCCP. No further capital spending was forecast through to 2013/14.

The land and buildings used by the Holiday Park were valued at \$24.5 million and \$2 million respectively in the Annual Report. The value of the land reflects the recent rapid rise in the price of coastal property. The expected return on the investment is trivial and falls massively short of the opportunity cost of capital. The expected return would indicate a low valued use of the assets even on the basis of the 2003 valuation of the land (\$7.9 million).

³³ Statistics New Zealand (2005), 'Accommodation Survey: July 2005', Statistics New Zealand, Wellington.

The LTCCP noted that the Council had signalled its intention to relocate the camp site and to seek better opportunities for the current site as a significant issue facing the Council and community. The Council also intends to compete more directly with the backpacker market to improve the occupancy rate of its cabins.

6.2 The Case for Exiting from the Holiday Park

The main grounds for exiting from the provision of tourist accommodation, camp sites and related facilities are summarised below:

- The provision of accommodation for the travelling public is a private good activity that should be left to the private sector.
- There are no persuasive public policy grounds for the Council to seek to provide holiday accommodation or to lower its cost:
 - The market for holiday accommodation is competitive. Private providers whose capital is at risk have the strongest incentives to supply accommodation of the type and quality that tourists demand and are willing to pay for. They typically provide a range of accommodation at different prices.
 - The private provision of such accommodation is discouraged if government agencies that are not subject to commercial constraints supply accommodation at subsidised prices. The Council staff report on the Chamber's submission on the draft 2005-2006 Annual Plan stated that if the Council sought to achieve a market return on the assets used by the Holiday Park, prices would be so high that nobody would stay at the Holiday Park. The information noted above supports this view. The Holiday Park is not a 'lucrative' business as claimed in the LTCCP but constitutes a low-value use of the land.
 - The Council's key role should be to ensure that its regulatory activities do not unduly restrict the supply of holiday accommodation by the private sector, for instance through inappropriate restrictions in the district plan, overly burdensome building and other regulatory requirements, or excessive rates or development contributions.
 - While inbound tourism may benefit a city or region generally, the grounds for subsidising the Holiday Park and similar activities are weak. The users of the Holiday Park may be residents of Gisborne City, other areas of the Gisborne district, or other districts. External benefits and costs (those that do not accrue to the parties to an agreement) arise in respect of most activities and most do not warrant government action because the costs outweigh the benefits. If such benefits did warrant subsidisation, then all providers should be treated alike.

- The Council's activities will reduce the *intra-marginal* cost of supply of motel-type accommodation without affecting the *marginal* cost of supplying such accommodation (that is, the cost of the next motel unit). In a competitive market, such as the provision of holiday accommodation, the price charged in the long run will equal the marginal cost of supply. Thus the price that generally prevails in the market will be unaffected by the Council's supply.
- The main effect of supplying accommodation at a relatively low price is to subsidise those people who stay in the tourist units. Ratepayers are also subsidising the cost of cabins and camping spaces which are poorly utilised. There are no persuasive equity grounds for subsidising holiday accommodation. The personal circumstances of the users of such accommodation are not known and are not taken into account in letting the facilities. The users may be better off than some ratepayers who bear the cost. The grounds for the subsidy are doubtful and the subsidy is poorly targeted.
- The profitability of a business is not a ground for public ownership of businesses.
- The Holiday Park is not a 'lucrative' business as the Council implies. A proper assessment of its profitability would take account of the opportunity cost of the resources, including land, committed to the business. The Holiday Park occupies prime beachfront real estate. The economic value of that land is very substantial as noted above. The expected return to the community falls massively short of providing an adequate return on the assets employed.³⁴

6.3 Some Options

There are public policy grounds for the Council to exit from the supply of holiday accommodation. The Council previously exited from a similar business. The Council might exit by adopting one of the following options:

- The Council could sell the existing business. This approach is likely to extract the highest market value for ratepayers and enable the Council to exit entirely from the business. The property would be put to an alternative use (if the district plan permitted) which would confirm that the provision of holiday accommodation yields a low return. However, this option is only available if reserve land can be sold. This may not be feasible and, even if feasible, may not be desirable from a community perspective (see below).
- The Council could sell the business as a going concern except for the land which could be leased in whole or part to the buyer. This approach might be possible if

³⁴ See the Appendix.

the land cannot be sold. The Council could require the land to continue to be used for the provision of holiday accommodation. However, some of the land, such as the camp site, might be made available for other uses.

- If the Council does not wish to exit from the provision of tourist units, it could examine alternative uses for the camping site only. The Council has noted that camping over the summer peak might be able to be accommodated in other areas. Thus some of the land could perhaps be sold or leased for private development, or made available for community use.

The beachfront property occupied by the Holiday Park is close to the centre of Gisborne City. In addition to the benefit of exiting (in whole or part) from the provision of holiday accommodation, some of the land, together with adjacent land, might be put to better community use by the Council rather than being sold or leased as discussed above. The Chamber, for instance, recommended that the Council examine the future development of the area from Waikanae Stream to Grey Street. It noted that Napier City had developed land adjacent to its waterfront as a central attraction for visitors and residents, and proposed a similar approach. The Chamber's suggestion warrants examination.

The key objective should be for the Council to exit from private good activities and to put at least part of the land to a higher valued use from the perspective of the overall community. The provision of open spaces and recreational areas is a public good activity. The issue for the Council and residents is whether the overall benefit from developing the land for community use would justify the investment involved.

7 HOUSING FOR SENIOR CITIZENS

7.1 Background

Central government provided advances and grants to local authorities, and welfare and religious organisations, for the construction of housing until the early 1990s. Local authorities often constructed pensioner, rural and community housing (which was generally available to anyone) with such assistance. Council-provided housing was usually limited other than in Wellington and Auckland cities.

The government announced major changes to welfare assistance, including housing, in the 1991 budget. Targeted income assistance was to be provided through a new Accommodation Supplement, and market rents and interest rates were to be charged for government rental housing and home mortgages respectively. Loans for the construction of new pensioner housing were abolished.

Income-related rents for Housing New Zealand units were reintroduced in December 2000. At the same time its tenants became ineligible for the Accommodation Supplement.

The Council owns around 120 single or twin housing units for senior citizens. They are let to single or married people aged 55 years and over who are without children or dogs. Applicants are interviewed to determine their suitability, for instance their capacity to live independently. People who are deemed to be suitable tenants are put on a waiting list. Units are allocated to those who have been on the waiting list the longest.

Most units are occupied by superannuitants or welfare beneficiaries, although the financial circumstances of applicants are not taken into account in allocating units. The Council aims to achieve a 95 percent occupancy rate but this target was not achieved in 2004/05. The lowering of the minimum age of tenants to 55 years a few years ago is understood to have assisted the Council to fill the units.

The Council aims to provide housing for senior citizens at no cost to ratepayers. This is interpreted to mean that operating revenue should be at least equal to operating costs. The Council increased forecast rental income in the Annual Plan by \$34,750 to partially recover higher insurance and depreciation charges than predicted for 2005/06 in its LTCCP. These adjustments suggest that the net operating cost of providing senior citizen housing is expected to be about \$90,000 in 2005/06. The land and buildings were valued at \$9 million at 30 June 2005.

The Council does not aim to earn a return on the ratepayers' investment (aside from any increase in the value of the units). The Council therefore provides an annual subsidy of

up to \$0.8 million which comprises the opportunity cost of capital, net of adjusted income.³⁵ This is equivalent to a subsidy of up to about \$125 a week for each unit.³⁶

The market value of the implicit subsidy provided to tenants is equal to the difference between a market rent for equivalent accommodation and the rent charged by the Council. Weekly rents are either \$75 or \$85 for a single unit and between \$105 and \$130 for a twin unit. The highest rent for a twin unit is understood to be a top rent for accommodation of equivalent quality. A waiting list, however, suggests that some rents charged are less than what the market would bear.

Housing New Zealand provides about 1,100 rental units in Gisborne City. About three-quarters of its units are understood to be let to beneficiaries and superannuitants. The balance are mainly let to families on low incomes.

7.2 Should the Council Provide Housing?

Public policy grounds for the provision of housing, including housing for senior citizens, by local authorities are generally weak:

- The provision of housing services (the services derived by renting or living in an owner-occupied house) is a private good activity:
 - If a house is occupied other people cannot live in it. Similarly, people who are not prepared to pay can be excluded. The vast majority of people of all ages acquire their housing services privately by living in owner-occupied housing or renting private accommodation.
 - Although it is sometimes suggested that inefficiencies affecting housing markets justify government intervention (for instance, because people are inadequately informed about housing services and investment in housing) such arguments do not generally withstand scrutiny.
 - While poor quality housing, such as over-crowding, is associated with greater health problems, poverty rather than inadequate housing is usually the underlying cause. Some health and safety issues, such as risks arising from fire, are addressed through regulations (for instance, the district plan and building regulations). The problem, however, is that excessive or poorly designed regulation may unduly increase the cost of housing services. Unwarranted restrictions on the supply of land for urban

³⁵ The increase in the value of property has not been taken into account. The estimate may therefore overstate the level of the implicit subsidy. See the Appendix for the calculation of a preliminary estimate of the cost of capital.

³⁶ The tenants are unlikely to benefit from a subsidy of this level. It may indicate that housing provides a poor return on the ratepayer's capital.

development (for instance, to restrict the expansion of urban areas) are an example.

- The provision of subsidised housing may be a relatively inefficient way of addressing income insufficiency and related social objectives:
 - Full-time, full-year employment is the key to the alleviation of poverty among people of working age (other than those with significant disabilities). Thus policies aimed at alleviating poverty among those aged up to 65 years should focus on employment. The stability of family relationships is also important because sole-parent households are often on very low incomes.
 - The main objective of most government housing schemes is to enable people to acquire better housing services than otherwise. All consumption and investment options are particularly constrained for people on low incomes. People generally seek to maximise their welfare, given the level of income available to them. Thus the provision of income assistance usually enables the recipient to obtain the maximum increase in their welfare, given the level of assistance. The benefit system is predicated on this approach. The recipient may not be able to maximise his or her welfare if assistance is provided in the form of subsidised housing services. They may prefer increased consumption of other goods and services. While income that may have been spent on rent may be able to be reallocated to acquire other goods and services, this process may be constrained.
 - Some groups such as people who suffer from mental illness or drug and alcohol dependency may face special difficulties in obtaining suitable housing in the private sector. The provision of income assistance may not be appropriate in some such cases because of the high risk that it would facilitate harmful behaviour. In these circumstances, the supply of subsidised housing may be preferable to income assistance. The affected groups are not, however, generally accommodated by the Council. (The Council has one unit which is suitable for people with disabilities.)
 - The costs incurred in providing housing assistance may be high. The recipient may not value the subsidy at an amount which reflects its cost to ratepayers. Indirect costs, for instance in managing and maintaining the housing stock, may be significant relative to the value of assistance (the subsidy) provided. Some costs are not transparent. Judgments about the real cost of the subsidy provided by the Council and the efficiency of its housing activities depend on assumptions about the comparable level of market rents and the market return that would normally be expected on the Council's investment in housing.
- The avoidance of hardship and, more generally, income redistribution is a central government responsibility in New Zealand. The benefit system, together with New Zealand Superannuation, are intended to assist people who would otherwise

face hardship. Councils generally do not have the information required to assess the relative financial circumstances of citizens.

- The Council's housing assistance benefits relatively few citizens:
 - The main grounds for the provision of housing assistance is to support people who are on low incomes. The assistance is provided to those who gain access to a Council unit. Other people in comparable or worse circumstances are not assisted by the Council. For this reason, such schemes are horizontally inequitable.
 - People who suffer from ill health, injuries or misfortune should be assisted on compassionate grounds. Beyond the alleviation of hardship, the case for supporting people whose circumstances arise from the choices that they make are weak. Decisions that individuals make during their lives about their education and training, occupation, hours of work, work intensity, saving and life-style affect the level of their income and wealth. Consider two people (A and B) who are identical in all respects except A spends all of his income on current consumption during his working life whereas B consumes less and saves a modest proportion such that he retires with a freehold house. Both receive New Zealand Superannuation in retirement and have no other income. On what basis is it deemed equitable to subsidise A but not B?
 - Single people, couples without children and superannuitants without dependants who are in good health generally face less hardship than beneficiary and low income families of working age.
- The provision of subsidised housing by councils may impose costs on ratepayers that would otherwise be borne by taxpayers:
 - The level of assistance provided by the Accommodation Supplement depends (among other things) on the level of rents paid. Based on the rents charged by the Council, all tenants who are superannuitants or welfare beneficiaries would seem to satisfy the entry criterion for the Accommodation Supplement. If they would receive a higher Accommodation Supplement but for the Council subsidy, a proportion of that subsidy would otherwise be borne by central government.

The issue for the Council and the community is whether the Council should continue to provide housing for senior citizens now that central government no longer assists councils to acquire houses for this purpose and whether the provision of housing for single people or couples without dependants aged 55 years and over is a high priority.

The number of houses owned by local authorities declined from 19,095 in 1981 to 14,115 in 2001, or by 26 percent. The share of all private occupied dwellings owned by

local authorities declined more sharply (from 1.9 percent to 1.1 percent) during the same period because the number of private occupied dwelling units increased.³⁷

A few councils have exited entirely from the provision of rental housing. Auckland City sold its pensioner housing stock (about 1,600 units) to the government in 2002 mainly to avoid the large capital and maintenance expenditure (estimated to be \$75 million over 20 years) that had been projected. The agreement protected the tenants from rent rises.³⁸

Auckland City Council incurred a significant loss on the value of its housing stock which had not taken account of the low level of net rental income. The same issue would arise in Gisborne if its housing for senior citizens were sold with rental protection for existing tenants.

Although Auckland City's decision was highly controversial at the time, the present left-leaning Auckland City Council has stated that it has "no intention of returning to full ownership and management of housing in Auckland".³⁹

7.3 Some Options

There are public policy grounds for the Council to exit from the provision of housing for senior citizens. It could adopt one of the following options:

- The existing units could be sold. This would obtain the highest value for ratepayers but could unduly affect existing tenants.
- The existing units could be sold to existing tenants on a concessional basis, or sold to a third party or parties with rent guarantees for the present tenants.
- The units might be sold to Housing New Zealand. Existing tenants would then qualify for income-related rents.

³⁷ Statistics New Zealand (1990), *op cit*, p 164 and Statistics New Zealand (2002), *New Zealand Official Yearbook 2002*, David Bateman, Auckland, p 144.

³⁸ Auckland City Council (2002), 'Government and Auckland City Agree on Housing', press release, 3 October, Auckland City Council, Auckland.

³⁹ Casey, Cathy (2005), "Facts on Affordable Housing", press release, 2 March, Auckland City Council, Auckland.

8 FINANCIAL IMPLICATIONS

The Council could exit entirely from the businesses reviewed. If the Council were to do so it might realise about \$70 million (see table 1).

Table 1
Assumed Realisable Value of Businesses
June 2005

Business	Assumed Realisable Value \$million
Tauwhareparae Farms Limited	
Net equity ¹	38.9
Advance from Gisborne Holdings Limited ²	1.1
Commercial Forestry	
Forest crop	0.7
Land ³	NA
Warrant of Fitness and Registration Centre: capitalisation of earnings	1.6
Waikanae Beach Holiday Park: land ⁴	24.5
Housing for Senior Citizens: land and buildings ⁵	9.4
<i>Sub total</i>	<i>76.2</i>
Assumed provision for rent guarantee, selling costs and rounding	6.2
Assumed net realisable value⁶	70.0

1 The main assets (farm land, livestock and forests) were valued by independent valuers at 30 June 2005.

2 GHL has made an advance to TFL. Thus if TFL's assets are sold at valuation and debt repaid, the Council could realise net equity in TFL plus the proceeds from the repayment of the loan.

3 The value of Council land used for commercial forestry has been omitted. Some of the land is required for water supply and for roading. Some forests may not be able to be sold for similar reasons. The inclusion of the forest crop alone is assumed to provide a reasonable estimate of the overall amount potentially realisable from commercial forestry.

4 The fair market value of land only has been included because it is assumed that its highest value is in an alternative use. Any value that could be realised from the sale of improvements, or furniture or fittings has been omitted.

5 The fair market value recorded in the Annual Report.

6 Excludes TFL's contingent liability arising from the grounding of the *Jody F Millennium* and assumes that all assets could be sold on the market without constraints arising from the Treaty of Waitangi or other legislation.

Table 1 contains a preliminary estimate of the net realisable value of the businesses. It largely reflects the valuations adopted in the balance sheets of TFL and the Council, and assumes that they are an accurate estimate of the realisable value of the relevant assets at 30 June 2005. Independent valuations have not been made in preparing this review.

The Centre has been valued by capitalising its earnings before depreciation, interest and tax. Those earnings have been discounted to reflect the possibility of a large fall in throughput arising from increased competition. The assumed valuation is double the value of the Centre's land and buildings, which may provide a lower bound for the value of the business.

Forest land (other than TFL's forestry land) has not been valued. Some such land is required for water supply and roading purposes. Some forests may not be able to be sold for similar reasons, although they have been included in the estimate. Taken together the aggregate estimate for forestry is likely to be conservative.

The total value of the businesses has been reduced by \$6.2 million to provide for a rent guarantee for present tenants, selling costs and rounding. Treaty of Waitangi obligations and other possible restrictions on the sale of land and other assets have not been taken into account.

A more efficient owner who could increase earnings would pay more for the businesses than they are worth to the Council. This factor has not been taken into account.

If the Council were to sell the businesses it would lose the future dividends and net operating surpluses that would otherwise be generated by those businesses. It would, however, pay less interest on debt (assuming that the proceeds from the sale are used to reduce debt) and avoid future capital spending.

If the Council were to realise \$70 million from the sale of its businesses, it could repay all of its external debts (\$32 million) as they fall due.⁴⁰ This alone would reduce interest costs by \$2.1 million a year (at an assumed average interest rate of 6.5 percent) and, after taking account of the loss of income from the businesses (\$0.6 million), allow rates revenue to be reduced by 4 percent while holding the Council's operating surplus constant.⁴¹

A further \$38 million would be available for other uses. If this amount were invested at the risk-free rate, rates could be reduced indefinitely by a total of about 10 percent (\$3.7 million). There is, however, no economic grounds to build up financial assets by realising investments in risky businesses. Instead, the aim should be to return surplus funds to ratepayers. If the Council were empowered to do so it could return the \$38 million directly to ratepayers just as a company would return surplus capital to its shareholders.

⁴⁰ TFL has been valued on an equity basis (that is net of debt). Its debt is therefore omitted.

⁴¹ The calculations are based on asset values at 30 June 2005. The assumed interest rate is the risk-free rate plus a margin of 70 basis points.

Another option would be to reduce rates by, say, a further \$6 million a year, or \$7.5 million in total (equal to a 22 percent reduction) and budget for an operating deficit until the proceeds from the sale of assets are effectively returned to ratepayers through lower rates than otherwise over at least 6 years.⁴² This would provide an immediate and substantially larger benefit for ratepayers than that currently provided by the businesses.

The Council could alternatively undertake some priority spending on public good activities such as roading and other infrastructure, provided the benefit of such spending outweighs the related cost. Surplus funds are not a reason, however, to engage in low priority or poor quality spending.

The two largest businesses are TFL and the Holiday Park. If both of those businesses are not sold, the Council's ability to reduce rates or undertake additional spending would be limited.

If the Council were to give shares in TFL (or GHL) to ratepayers or residents rather than sell TFL or the farms, it would not be able to reduce rates to the extent suggested above. On the other hand, ratepayers would benefit by deriving income from the shares or by selling the shares.

If the Council were to adopt other options discussed in this review, such as leasing the farms or using the Holiday Park land for community purposes, the reduction in rates would be much lower than if the Council exited completely from all businesses that are reviewed.

⁴² The reduction in rates comprises interest saving on debt that is repaid (\$2.1 million), net of the loss of operating income from the businesses (\$0.6 million), and the return of \$6 million of surplus capital a year via a temporary reduction in rates. Savings in capital spending have not been taken into account. The calculations are based on data for 2005/06 only.

9 CONCLUDING COMMENTS

The following concluding comments are noted:

- The best possible contribution that the Gisborne District Council can make to the advancement of the overall wellbeing of its residents is to undertake its protective and productive (public good) roles as efficiently as possible.
- Any role beyond those will impair the overall welfare of the community by reducing individual autonomy and choice, and discouraging wealth creation and other activities that are undertaken by individuals, private firms and voluntary organisations.
- The spending and saving choices facing many people in the Gisborne district are highly constrained. The mean household income in the Gisborne district is below the national average. Yet the level of rates per capita charged by the Council are higher than those of many other comparable councils.
- The main contribution that the Council can make to economic growth and employment in the Gisborne district is to reduce the rates and regulatory burdens it imposes on the private sector.
- The Gisborne District Council is more tightly focused on its core role than some of the larger city councils but it still holds significant investments in businesses that produce private goods and services. The Council recognises the need to review some of its commercial activities and is selling surplus land.
- The Council generally provides better information on the activities reviewed in its LTCCP or Annual Plan than many other councils provide on comparable activities in their plans. The financial information contained in the LTCCP focuses on operating performance. It could usefully be complemented with information on the value of related assets and ratepayers' equity. This would permit returns to be assessed in relation to the value of assets or capital committed. Such returns would provide ratepayers with a better indication of the commercial return on Council investments than the ratio of profit to turnover.
- The cost of capital for each business should be computed and compared with actual and forecast returns. Unless Council businesses earn a return at least equal to their cost of capital, the wellbeing of ratepayers is reduced.
- The expected return from Tauwhareparae Farms Limited, the Waikanae Beach Holiday Park and housing for senior citizens fall well short of the preliminary estimate of their cost of capital. Continued investment in these businesses is likely to make ratepayers less well-off than if the Council exited from the activities.

- There are no compelling public policy grounds for the Council to engage in the private good activities that were reviewed: farming, commercial forestry, the Warrant of Fitness and Registration Centre, the Waikanae Beach Holiday Park and housing for senior citizens. The Council should exit from those activities where feasible. A range of options have been suggested that would achieve this objective in whole or part. Detailed studies of the options would be necessary.
- The Council might realise up to \$70 million if it exited entirely from the businesses examined. This would enable public debt to be retired and rates to be cut by up to 22 percent for a period of about 6 years.
- Councils should lead their communities to a better understanding of the benefits and costs of the choices available and make decisions based on a principled public policy analysis and hence in the best interests of all residents.

APPENDIX

PRELIMINARY ESTIMATE OF THE COST OF CAPITAL

Local authorities should compute the cost of capital for those activities undertaken on an arm's length basis by council-controlled trading organisations and apply the public sector discount rate (currently 10 percent) to investments which they undertake directly. The cost of capital should be applied to help assess whether returns commensurate with the risk involved are being earned. The Treasury's handbook provides guidance on the calculation of the cost of capital.⁴³

Because this review focuses on broad public policy issues rather than commercial issues, the industry-specific costs of capital for the businesses reviewed have not been estimated.⁴⁴ For TFL, an arm's length business, a range for the cost of capital, using readily observable data and assuming lower and upper bounds for plausible asset betas suggested in the Treasury handbook, has been calculated. The public sector discount rate has been applied in respect of other businesses. The latter approach is suggested by Bryce Wilkinson.⁴⁵

The preliminary estimate of the cost of capital is applied to TFL's combined farming and forestry investment because the range for asset betas are so wide. A separate cost of capital would normally be estimated for each activity. The preliminary cost of capital could also be applied to GHF because its only trading activities are undertaken through TFL.

The computation of income has not been examined in assessing whether each business is expected to yield a return at least equal to the preliminary estimate of its cost of capital. Reported income (TFL) or forecast income (other businesses) before depreciation, interest, tax and asset revaluation has generally been used. Forecast income for 2005/06 is taken from the LTCCP. In the case of housing for senior citizens forecast income has been adjusted to take account of information on cost and revenue increases noted in the Annual Plan.

A real cost of capital has been applied to TFL. This overcomes the problem caused by uneven changes in asset valuations when a nominal cost of capital is used. Further attention should be given to the treatment of asset revaluations. The public sector discount rate is used to discount cashflows stated in constant prices and therefore indicates the real cost of capital for investments undertaken by the Council.

⁴³ The Treasury (1997), 'Estimating the Cost of Capital for Crown Entities and State-Owned Enterprises', The Treasury, Wellington, www.treasury.govt.nz/publicsector/costcapital/. Also see Wilkinson, Bryce (forthcoming), 'Local Government Asset Decisions and the Cost of Capital', Local Government Forum, Wellington.

⁴⁴ There was insufficient time within the scope of this review to obtain the necessary data and resolve analytical issues that arise in estimating the cost of capital.

⁴⁵ Wilkinson (forthcoming), *op cit*.

The cost of capital for TFL has been calculated on an all equity basis. Interest-bearing debt accounted for about 10 percent of TFL's debt plus equity at 30 June 2005. The impact on the estimated cost of capital of taking such debt into account is likely to be insignificant having regard to the wide range for asset betas that is assumed and has therefore been omitted from the preliminary calculation.⁴⁶

The Council's equity invested in the businesses (other than in TFL) is based on incomplete information on assets and liabilities. The Council's equity is assumed to equal the value of the main assets. Other fixed assets and current assets have been omitted. The Council's capital and thus the required return may be understated as a consequence. None of the Council's businesses hold interest-bearing debt.

The formula for calculating the nominal cost of capital (k) for a taxable activity undertaken on an arm's length basis is:

$$k = R_f(1 - T) + \emptyset b_a$$

where:

R_f = the risk-free rate of return at the beginning of the reporting period;

T = the marginal personal tax rate on interest income;

\emptyset = the tax-adjusted market risk premium; and

b_a = the relevant asset beta for the reporting entity.

The real cost of capital (k_r) is:

$$k_r = [(1 + k)/(1 + i)] - 1$$

where:

i = the expected rate of inflation.⁴⁷

The main assumptions used in calculating the cost of capital are listed below:

- The risk-free rate of return is assumed to be about 6 percent. The risk-free rate of interest is indicated by the yield on government bonds with a duration of 5 years. The monthly average yield in July 2004 reported by the Reserve Bank is used.

⁴⁶ There are also analytical reasons for assuming that the application of a weighted average cost of debt and equity capital would lead to the same conclusion on the adequacy of the return earned by a business as an all equity calculation.

⁴⁷ The formulas are taken from The Treasury (1997), *op cit*.

- The appropriate rate of tax is assumed to be 33 percent.⁴⁸
- A tax-adjusted risk premium of 9 percent, as suggested by Treasury, is assumed.⁴⁹
- Asset betas of 0.3 to 1.19, which is the most plausible range suggested by Treasury, are assumed to apply.
- The expected rate of inflation in July 2004 is assumed to be 2.3 percent. The expected rate of inflation in July 2005 is assumed to be 2.5 percent. The expected rate of inflation takes account of the difference between the nominal yield on government bonds and the yield on inflation indexed bonds.
- The public sector discount rate of 10 percent is applied.

A preliminary estimate of the cost of capital for each business reviewed is presented in table A-1. The table shows the assumed level of capital employed, the preliminary cost of capital and the expected return (adjusted income) for each business.

The returns from commercial forestry and the Centre appear to equal or exceed the cost of capital for those businesses. The expected returns for other businesses fall short of the preliminary estimate of their cost of capital.

The expected returns for TFL, the Holiday Park and housing for senior citizens are less than the risk-free rate of return. In the case of housing for senior citizens, this is a matter of policy. Ratepayers could expect to be better off in 2005/06 if the capital were simply invested in government bonds. They would earn a higher return and be exposed to less risk.

Judgements on whether the relevant businesses yield a return at least equal to the cost of capital are indicative only. Further work is required to arrive at firm conclusions.

⁴⁸ The Treasury handbook was prepared when the top personal tax rate was 33 percent and assumed neutral rates of tax on returns from debt and equity. The top personal rate is presently 39 percent but the company rate has remained at 33 percent. Because the Council is not taxed, income earned through a council-controlled trading organisation is effectively taxed at the company rate. Tax on interest earned by ratepayers could, however, be taxed at 19.5, 33 or 39 percent, or higher if the abatement of family and other income assistance were taken into account. The preliminary calculations presented assume that interest is taxed at 33 percent. This issue requires further examination.

⁴⁹ The unadjusted risk premium is 6.4 percent. If a tax rate of 39 percent were used, the tax-adjusted risk premium would increase to 10 percent, that is $6.4/(1-0.39)$.

Table A-1
Preliminary Estimate of the Cost of Capital
2005/06¹

Business	Assumed Capital² \$million	Assumed Cost of Capital³ %	Assumed Cost of Capital⁴ \$million	Adjusted Income⁵ \$million	Does the Return Exceed the Cost of Capital?³
Tauwhareparae Farms Limited	43.6	4-12	1.7-5.2	0.9	No
Commercial Forestry	0.7	10	0.1	0.1	Yes
Warrant of Fitness and Registration Centre	0.8	10	0.1	0.3	Yes
Waikanae Beach Holiday Park	26.5	10	2.7	0.1	No
Housing for Senior Citizens	9.4	10	0.9	0.1	No

1 Data for TFL relates to 2004/05.

2 Based on a partial list of assets, except for TFL. All assets are assumed to be financed by equity.

3 The cost of capital for TFL reflects the *real* return required for a taxable activity, computed on an all equity basis. The cost of capital for other activities, all of which are non-taxable, is calculated using the public sector discount rate. It is also a measure of the real cost of capital.

4 The data presented are the product of the assumed level of capital and the cost of capital.

5 Income before depreciation, interest, tax and asset revaluation.