W **pncc.govt.nz** | E **info@pncc.govt.nz** | P **+64 6 356 8199** | Private Bag 11034, The Square, Palmerston North, New Zealand

PALMERSTON NORTH CITY COUNCIL

Oasis #12275855

1 March 2019

Mr Steven Bailey
Inquiry Director
NZ Productivity Commission
PO Box 8036
WELLINGTON 6143

Dear Mr Bailey

PNCC SUBMISSION ON THE PRODUCTIVITY COMMISSION'S ISSUES PAPER ON LOCAL GOVERNMENT FUNDING AND FINANCING

The Palmerston North City Council (PNCC) thanks the Productivity Commission (the Commission) for the opportunity to respond to the issues paper it has prepared as part of the Inquiry into Local Government Funding and Financing (the Inquiry).

PNCC has a vision and strategic direction which it is committed to delivering. The vision for Palmerston North is for every resident to be able to enjoy the benefits of living in a small city, with the advantages of a big city. This vision reflects the value that our community places on having a great quality of life, community spirit, and affordable access to services that come with being a small city, as well as the opportunities for well-planned growth and sustainable management of our infrastructural resources that larger cities offer. Sustainable funding and financing policies and practices will be critical to PNCC's ability to deliver on this vision on behalf of the community over the long-term.

PNCC's specific comments on aspects of the Inquiry are as follows:

1. *Escalating Cost of Infrastructure and the Onus on Local Government to Fund*

   PNCC is concerned about the escalating cost of infrastructure and the ability of councils and their communities to fund infrastructure over the long term. PNCC has funding in its 2018 LTP of $128m to upgrade the city's wastewater plant and $109m to provide for infrastructure to support growth. Capital expenditure such as the wastewater plant, ongoing expenditure on infrastructure to support growth and other unanticipated costs pose a constant challenge to PNCC's prudential borrowing limits over the long-term.

   In providing for and supporting growth for example, PNCC have a statutory obligation to provide infrastructure in advance of development occurring. In some cases, the time between PNCC providing infrastructure and then recovering the cost of that growth can exceed 20 years. In the meantime, PNCC must carry that debt burden until repaid via development contributions. Growth creates opportunities for communities but comes with challenges. This includes having sufficient balance sheet capacity to finance the level of expenditure required for growth-related infrastructure.

There is a need to identify alternative funding mechanisms that fund infrastructure in a way that that removes the debt burden from local government books. This is critical if local government is to effectively provide for growth and address the constraints associated with borrowing limits. Options that need to be considered include one or more of the following:

Allow for Greater Private Sector Participation in Funding of Infrastructure

The Commission has been asked to consider 'special purpose vehicles' (SPV) as a means of funding larger projects. A SPV is a variant of a public-private partnership. The off-balance sheet nature of an SPV makes it attractive as a means of controlling debt for councils.

As noted in SOLGM's submission, a SPV is an entity that is established off a parent entities balance sheet. The SPV model involves accepting or attracting finance from a third party who constructs or acquires the asset, for example a road. It is important that a SPV has enough financial strength to provide a third-party with sufficient confidence of a return on investment. For this reason, an SPV will require scale and a reliable revenue stream.

The SPV vehicle would be a useful tool for the local government sector in the funding of larger capital projects. PNCC encourage the Commission to investigate the merits of this funding mechanism further and address the legislative and accountability regimes required to enable the funding tool.

CCOs

SOLGM's submission to the Inquiry notes that under the *Local Government (Auckland Council) Act 2009* Auckland Transport (a CCO) cannot access development contributions for growth related infrastructure. However, the parent, being Auckland Council, may (and does) include allowances for development contributions for transport in its own policy. The amounts it raises are then passed to Auckland Transport. Both bodies are publicly accountable for the funds.

For the three-waters services section 130(3)(a) of the LGA does not allow a local government organisation such as a CCO to use the assets of its water services as security for any purpose. Unlike roading, the LGA does not allow these assets and associated debt to be removed from local government books.

One option is for the Commission to investigate the merits of a CCO being able to charge development contributions and to remove the s130(3) LGA restriction from the three-waters service to enable CCOs to operate in a similar manner as Auckland Transport.

Municipal Utility Districts (MUDs)

The MUD model is an alternative model for the financing of infrastructure previously canvassed in previous reports by the Productivity Commission. A MUD is a statutory authority set up by a developer to borrow money via the issuing of bonds to construct infrastructure. The MUD then has the power to tax home owners to repay the debt and cover operating costs. Once development is completed the control of the MUD is then passed from the developer to new residents and the MUD disestablished.

Benefits of the model include removing the debt burden from local government books; spreading funding risk; and developers not needing to wait for local government to provide and construct growth enabling infrastructure.

There are limits to the infrastructure that developers are likely to want to build and limits to the type of infrastructure local authorities would be comfortable being managed by private interests over the short to medium term.

Cost Sharing Agreements with Central Government

PNCC note the recent creation of a new Housing and Urban Development Authority (HUDA). The purpose of HUDA is to work collaboratively with councils and infrastructure providers in a partnership model when undertaking a specified development project.

The infrastructure and funding powers given to HUDA include the ability to negotiate binding infrastructure and cost-sharing agreements with councils and other relevant stakeholders. For projects that require supporting infrastructure outside of the specified project area, HUDA indicates they will work with councils to build, change or upgrade infrastructure.

There is an opportunity for the government to consider broadening out this funding model and its cost sharing component to assist councils with infrastructure costs associated with growth and enable greater financial head-room for the local government sector.

Central Government Funding of National Good Objectives

SOLGM's submission to the Inquiry refers to the 'restoration' by the government of the four wellbeings (*Local Government (Community Wellbeing) Amendment Bill)* as an invitation for the local government sector to participate in promoting the wellbing of the nation. That needs to be matched by a commitment by central government to funding national good elements of local government investment in our communities. PNCC support this request, particularly as it relates to the funding to support growth-related infrastructure.

2. *Funding Tools*

Generally, the Local Government Act 2002 (LGA) and the Rating Act provide an appropriate framework for local government funding and financing. Given rates are a form of taxation to fund local services it is prudent that mechanisms for charging rates are reasonably restrictive.

Rating, particularly targeted rates, are heavily reliant on robust and up to date land information. If councils move towards the use of targeted rates, for example separately used or inhabited portions of a property such as a second dwelling or home occupation, then the limits on the powers to gather information under the Rating Act need to be reviewed.

Targeted rates are a funding mechanism that are currently provided for under the Rating Act and are generally a targeted charge for a service. The user-pays philosophy of targeted rates is often used by local authorities for services such as recycling and waste collection. Targeted rates are well suited to managing the demand side of infrastructure use where supply constraints for services such as water and wastewater are present. However, the Ratings Act constrains the use of targeted rates that are set as a fixed amount (in combination with any uniform annual general charges) to no more than 30 percent of a local authority's rates revenue. This funding cap is inconsistent with the purpose of the Rating Act which is to provide local authorities with flexible powers to set and assess rates.

Lastly, thought needs to be given to removing the Crown exemption on paying rates. The public good element of the rationale for the exemption is weak. The cumulative demand of Crown activities on ratepayer funded infrastructure and services can be significant.

3. *Planning Tools*

The Long Term Plan (LTP) framework (including the 30 Year Infrastructure Strategy and Financial Strategy) provides an appropriate mechanism for developing a vision, determining major infrastructure and renewal implications, and assessing financial implications, including how cost of service provision should be allocated to citizens

The challenge for councils is how best to use the framework to interact and connect with the community and get them engaged to an extent that they provide meaningful feedback in the development of priorities.

There is no one right answer to how councils can better interact and connect with their communities through the LTP process. The issues facing councils are varied because their geography, infrastructure, natural and physical resources, growth profiles and communities of interest are very different. This diversity of environmental, social, economic and cultural context means councils need legislative flexibility that promotes innovative and creative approaches to achieve meaningful connection and engagement with their communities through the LTP process.

4. *Depreciation and Renewals*

It should be noted that depreciation is an accounting concept not a funding concept. Robust decisions relating to the level of depreciation and renewals rely on the quality of the underlying asset information and the assumptions made regarding where the asset(s) sit in their life-cycle. In respect of wastewater, the life-cycle of network infrastructure can be 100-years or more.

Effective asset management planning requires an understanding of the interactions between life cycle costs, technical performance of assets, levels of service to be delivered throughout the lifecycle of the asset(s) as well as the rate and location of projected growth in the area served by the asset(s). Once those factors are understood then a coherent plan can be developed for the ongoing maintenance, operations, renewal and development of the assets to meet the desired levels of service in perpetuity. A 30-year programme of development is then established in the AMP which is then reflected in subsequent 10 Year LTP planning documents. For these reasons the quality of the underlying asset information and the assumptions made regarding where the asset(s) sit in their life-cycle is critical to making robust decisions relating to the level of depreciation and renewals.

One of the big issues facing the local government sector in making these decisions is the variable level of capacity and capability across the sector in the engineering and policy areas.

5. *Asset Management and Efficiency*

The Inquiry has a focus on how the local government sector could better measure the efficiency of infrastructure provision. Asset management is a discipline with a long-term focus that seeks to meet a required level of service, in the most cost-effective manner, through the management of assets for present and future generations. Measuring efficiency of infrastructure provision over the long-term is difficult but efficiency is built into asset management processes through promoting, among other things:

- Robust information bases to support decisions;

- Considering all viable options including demand management; and

- Ensuring all lifecycle costs are included in decision processes so that the emphasis is on sustainable efficiencies not unsustainable short-term gains.

The answer to how local government can better measure the efficiency of infrastructure provision is not necessary via a metric. The focus needs to be on whether the territorial authority has robust and sound asset management practices and processes in place that will be efficient in delivering ongoing levels of service over the long-term.

6. *The Relationship Between the CPI and the Increasing Cost of Providing for Core Services*

PNCC would like to address two issues associated with this relationship:

1. One of the core roles of councils is to deliver infrastructure. Local government cost drivers have often exceeded the Consumers Price Index (CPI) due to the nature of the goods and services provided. Over the last twenty years the price of the commodities and services that go into delivering infrastructure have increased faster than the CPI. In some years the rate of increase has been three times the rate of increase in the CPI. The factors driving this increase are varied and complex. Government investigation into the factors driving the increases in construction costs would not only be useful for the local government sector but the construction sector in general.
2. Statistics New Zealand treats local and regional government property rates differently in the consumers price index from other products and services

   The CPI shows a high rate of increase in local government rates relative to the overall increase in the CPI, but some of this difference is due to the absence of quality adjustments being made to local and regional government property rates, when the CPI is calculated.

   The aim of the CPI is to measure the price change of the same goods or service at each sampled outlet or business over time. In practice, sampled products may become unavailable, may change, or may become unrepresentative. When this occurs, there may be a change in quality and an adjustment is made so that only the estimated 'pure' price change is shown in the CPI. An example given by Statistics New Zealand in the October 2011 issue of *Price Index News* notes that nominal new car prices increased by 19.1% between June 2001 and June 2011 but the quality adjusted price series for new cars showed a 1.5% decrease over the same time-period.

   Local authority rates are not quality adjusted by Statistics New Zealand because they cover a bundle of services, with the range, quantity, and quality of those services subject to change from year to year. In addition, the rates that individual households pay are not directly related to the quantity and quality of the services they use. However, applying quality adjustments to other goods and services in the CPI but not to local authority rates exaggerates the apparent level of inflation in local government rates.

7. *Financial Barriers*

The LGFA imposes lending ratios on council's that have a long-term credit rating of 'A' equivalent or higher. For PNCC the debt to revenue ratio is 250%. Any breaking of this ratio will preclude the Council from borrowing from the LGFA and trigger higher borrowing costs from other lenders. The ratio is problematic for councils facing growth pressures or large one-off capital expenditure for critical infrastructure such as a wastewater treatment plants.

One option to consider is to replace the LGFA and have the government secure sources of funding for the local government sector. Given councils have the ability to tax this is a low risk option for the government and would enable the debt to revenue ratio to be pushed out where financially prudent.

8. *Other Matters*

Development Contributions – Thought needs to be given to removing the Crown exemption on development contributions. The nexus between development, growth and demand on infrastructure networks is the same irrespective of who funds development. The scale of development associated with an educational facility or a hospital can place significant demand on infrastructure capacity. Crown exemption shifts the cost of providing this capacity to the ratepayer.

PNCC welcomes proposed LGA legislation that is reintroducing the ability to assess development contributions for 'community infrastructure'. Broadening the definition of community infrastructure will enable territorial authorities to collect contributions for new community facilities required because of growth such as swimming pools and sports facilities.

Transfer of Cost to Local Government – Consideration should be given to placing a statutory obligation on Central Government policy development to better identify costs and effects of their decisions on local government. Often Central Government legislation or regulation imposes a duty or obligation on local government without funding to meet the requirements. The National Policy Statement on Urban Development Capacity (NPS) is an example of government policy that has set stringent reporting deadlines, and requires significant senior staff involvement and cost to local government. By way of example, the cost to PNCC of developing the development capacity assessment required by the NPS will exceed $100,000.

Urban Growth, Value Uptake and Infrastructure – When a local authority approves the rezoning of land for urban development a significant increase in value occurs to the subject land. When a local authority rezones land for urban growth it is:

- Agreeing to allow subsequent development to connect to its network infrastructure; and

- Satisfied that capacity exists, or will exist, within its network infrastructure to service new development.

The ability for the land to access network infrastructure allows land use to be intensified and facilitates a significant uplift in value to occur. In these situations, there is effectively a transfer of value from the community to the land owner. In Palmerston North this occurred in 2007 where a 13-hectare Rural Zone site was rezoned to Industrial and the land value went from $265,000 to $2.6m (current land value $4m). While this land was rezoned in 2007 it remains undeveloped. In the meantime, Council has had to have available ongoing capacity in its networks to service the land. Over the next 20-years the Council has budgeted and will borrow $109m towards funding network infrastructure capacity to support growth.

There is a very real and ongoing cost to the ratepayer in carrying network capacity over time. Government needs to give some thought to funding mechanisms that allow local government to better manage the financial risk associated with being the infrastructure bank for development. One option is to consider a betterment charge set as a fixed percentage of the increase in land value when rezoning occurs.

In conclusion, PNCC supports the inquiry into the cost of services provided by local government and how they are paid for. The adequacy and efficiency of the local government framework for funding and financing is critical to the sector's ability to deliver services to their communities and enable communities to function effectively.

PNCC would welcome the opportunity to discuss the content of this submission further with officials from the Productivity Commission. If you require any further information on the content of this submission please contact Sheryl Bryant, General Manager – Strategy and Planning on 06 356 8199 or sheryl.bryant@pncc.govt.nz.

Yours sincerely

Heather Shotter
CHIEF EXECUTIVE