New Zealand Productivity Commission
Via email: info@productivity.govt.nz

15 February 2019

Local Government Funding and Financing

Mercury (NZ) Limited (Mercury) welcomes the opportunity to provide feedback on the Productivity Commission's (the Commission) draft report 'Local Government Funding and Financing'.

Mercury is supportive of the Commission's approach to investigate all factors that drive local government efficiency, including cost and price escalation. The Commission also considers local government funding and the delivery of compulsory functions, including the delivery of resilient, efficient infrastructure, which in turn delivers benefits for all New Zealanders.

Mercury is a private sector infrastructure provider established under a mixed ownership model with the New Zealand Government as a majority shareholder. We have a range of interactions with local government, and an understanding of local government functions and the Local Government Act through such interactions. Our submission is framed from a New Zealand Inc perspective and reflects on opportunities to gain greater efficiency in the delivery of critical local government functions. The scope of the conversation needed is wide. Paramount to any conversation is the environmental outcomes associated with local government service delivery, including clean, safe drinking water, effective wastewater and stormwater management, and the improvement of water quality within all of New Zealand's freshwater and coastal water bodies. Mercury supports systematic change that will help achieve these environmental objectives.

Mercury Overview

Mercury is one of New Zealand's largest electricity generators and retailers providing energy services to homes, businesses and industrial consumers throughout the country. We have a long heritage in renewable energy in New Zealand serving about 1-in-5 homes and businesses under the Mercury brand and other speciality brands. We also have proven capability and technical expertise in solar. Our goal is to be the leading energy brand in New Zealand, inspiring our customers, owners and partners by delivering value, innovation and outstanding experiences.

Mercury operates nine hydro-generation sites on the Waikato River and five geothermal stations in the Central North Island. We are a major employer, particularly in the regions. We have over 850 skilled staff located in offices in Auckland, Hamilton, Rotorua and Taupo. We also have joint ventures with a number of Maori Land Trusts in geothermal power stations.

Mercury is highly committed to opportunities that deliver sustainable benefits to its customers, communities and the country. The long-lived nature of its assets has meant *kaitiakitanga*, or guardianship, of New Zealand's natural resources such as hydro and geothermal is a vital foundation for Mercury.

Issue 1: Financial Planning

Part 4, of the report "Key funding and financing trends", identifies the issue of creating a balance between inter-generational equity and depreciation. In short, if local authorities underestimate depreciation then come time to replace infrastructure, there is no money available for the replacement costs. If Councils over-estimate depreciation,

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then this affects inter-generational equity, as the current generation pays proportionally more for future replacement of infrastructural assets. Mercury supports the concept of inter-generational equity, where the method of payment for future infrastructure matches the benefits that will be received in the future by future generations.

The report acknowledges that *"Borrowing enables the cost of assets to be matched with their benefits over their life"*. This highlights the need for financial mechanisms to support long term benefits from infrastructure such as roads, wastewater and water supply, which local government is obligated to provide. Decision makers need to be cognisant that the efficient end use of natural resources associated with infrastructure delivery has a direct effect on when capital investment is required. For example, more efficient end use of water per household could help defer capital investment in replacement infrastructure. The report identifies a systemic failing by local government in their service delivery. The report acknowledges that the renewal expenditure of 28 local authorities was less than 60% of depreciation value. This equates to 41% of New Zealand local authorities that will fall short of the funding required, when the time comes to replace aging assets.

What seems illogical from the outside looking in? Local government capital investment is forecasted through a financial plan. This predetermined budget is then clawed back through various rating mechanisms, Long Term Plan consultation, and political decision making. Is the shortfall in capital investment then a symptom of a faulty system or poor decision making, or a hybrid of both?

The report sets out many statistics, which do not appear to differentiate examples of good local government outcomes from bad. Mercury would support a more granular investigation into those 28 local authorities as to why the systemic failures are occurring. Are there similar factors which point to a logical solution? Likewise, case studies where local government has been successful in their delivery of key functions to communities should be undertaken, as learnings will be valuable for wider communities.

There are examples where local bodies have installed water meters, which have resulted in significant reductions in the end use of water (e.g. Tauranga City). Such savings in system capacity directly allows for the deferral of capital investment required for future infrastructure capacity. This is not saying meters should be installed everywhere, but better-informed discussions can educate and raise awareness within the general population. The use or not of water meters is a good topic to distinguish politically motivated and emotional viewpoints[1], which need to be addressed with factual responses[2]. The only free water is the water that falls from the sky. As soon as water is stored and reticulated, someone has to pay for the infrastructure and cost of delivery to the consumer. It is only once an infrastructural service is not functional that people are made acutely aware of its value to society. Such awareness is increasing through media reports of contamination of drinking water supplies, wastewater overflows into freshwater bodies, and aging stormwater systems that were not constructed with contaminant discharge treatment in mind.

Case studies may assist in analysis of the following topics.

- Have Council financial plans been adequate? Is better execution required to ensure capital investment reaches intended areas?
- Have financial plans been cognisant of timeframes required to realise community benefits over the entire lifespan of major infrastructure?
- What were the financial mechanisms that supported the long-term benefits?
- Is there a person or entity that can provide more efficient financial mechanisms, e.g. with lower interest rates, such as central government or the provision of private sector equity.
- Are there more efficient financial mechanisms, to achieve better outcomes for communities, to realise benefits from infrastructure services, and improve environmental outcomes?
- What is required to improve decision making for infrastructural assets to ensure the long term delivery of infrastructure and its timely replacement?

1 https://www.stuff.co.nz/national/110253161/warning-shot-fired-over-water-meters-in-hamilton
2 https://www.radionz.co.nz/national/programmes/ninetonoon/audio/2018680017/massive-water-infrastructure-reform-2019-who-will-pay

- Is local government burdened by tax regulation (such as the approach to depreciation)? Could improvements be made to the tax system to assist local government to better manage their depreciating capital assets.
- What models are there for better service delivery of their functions to their respective communities and customers?

Issue 2 - Fairness and Equity of a Rating System

Section 7, “Desirable characteristics for a funding and financing framework” identifies a range of rating mechanisms as well as tax attributes, including efficiency, equity and fairness. Mercury questions how rates gathered by land value or capital value affect efficiency, fairness and equity.

Generally speaking, those who benefit from infrastructure or a local government service should be burdened with the cost. It is not equitable or fair to cross-subsidize costs to a party whose landholding or capital improvements do not receive benefit from such infrastructure or services. There are services for which a broader community benefit is derived, and all may be called on to pay a share. However, the benefits from the capital expenses associated with infrastructural services ought not be charged to a landholder simply because they have a high capital value. To do so places an undue burden on activities that contribute to the economy and potentially raises the cost of goods and services for consumers.

Issue 3 Efficiency – Land Value vs Capital Value

Commercial businesses who add capital value to land, through investment in assets, generally stimulate the economy, provide employment, and add value to New Zealand’s natural and physical resources. All of these contributions are good outcomes for communities in New Zealand and should be incentivised. Any cross subsidisation of cost from one sector to another, if the burden of cost is unfair or inequitable is a disincentive to operate or locate within an area. Commercial entities will wherever possible pass the cost of public service provision on to consumers through a service fee or product cost.

Mercury supports the use of land value as opposed to capital value as the basis upon which to charge general rates. The report identifies that;

> *“A trend in recent decades has been for councils to abandon land value rating in favour of capital value rating. Underpinning this shift was a view that capital value is more equitable owing to a better fit between capital value and a person’s ability to pay. However, available evidence at a national level suggests that a system based on land values may be more progressive, and therefore more equitable (NZPC, 2015, 2017). Additionally, a land value rating system encourages land to flow to its highest value use and, at the margin, discourages holding undeveloped land.”*

It is considered a general rate based on capital value is not equitable and disincentives landowners who add capital value to their land. Generally adding capital value to land generates economic activity and grows the local economy. Local government is reliant upon a healthy economy to deliver its functions in an efficient manner. If a standard land value rate was implemented, the equity inherent in any differential between land uses (business and residential) would become the relevant metric to be decided by decision makers and scrutinised by rate payers.

Residential land with no capital value added uses a limited physical resource (land) and creates unnecessary need for new greenfield land to be developed to provide the same level of housing/commercial stock. Councils also need to fund new public infrastructure to service new growth areas, which is required to provide the same level of housing stock.

Page 57, Section “Existing Funding Tools” sets out some principles that may assist decision maker with the use of financial tools to better deliver their functions. Page 59, Box 4, refers to “Value capture”, which identifies that some private landowners gain a windfall from increases in land values, as a result of the location of infrastructure. The report touches on whether this increase should be taxed. A tax on a net gain in land value from public infrastructure would be contrary to the government’s objective to provide affordable well serviced land for housing, as the cost will be passed onto purchasers of land. Local government should be required to consider the prospective location of new infrastructure within brownfield and greenfield land, and how the benefits of new infrastructure affects land value. Councils could utilise this strategy to leverage the maximum land value increase out of infrastructure upgrades, which can be clawed back through general rates based on land value. Consideration of infrastructure service delivery and function also needs to be considered. However, infrastructure initiated by local government which raises land value, results in greater general rates revenue being raised that Councils can then use to provide local government services to those who get the benefit from infrastructural services. Maximising land value increase also lessens reliance on the proportion of funds from a targeted rate in theory. The report identifies that local government have under-utilised targeted rates, which are a fair and equitable way of recovering costs from those who directly benefit from the provision of public assets or services.

Conclusions

Mercury invests significant capital into its renewable electricity generation assets, to ensure it can provide electricity for New Zealand to enjoy. Mercury has commented upon efficiency, fairness and equity for the specific reason that if local government gathers funds in a way that meets these principles, then commercial entities such as Mercury will not be targeted for general rates in an unfair and inequitable manner.

- Mercury encourages the Commission to consider systematic changes which result in;
- Improvements to the efficient end use of New Zealand's natural and physical resources.
- The delivery of infrastructure that enhances the environment, through better environmental outcomes associated with local government service delivery, including clean, safe drinking water, effective wastewater and stormwater management, and the improvement of water quality within all of New Zealand's freshwater and coastal water bodies.
- More robust controls to guide local government decision making on rating or any alternative local tax mechanism to ensure an efficient, fair and equitable tax system.
- Rating systems which incentivise capital investment from commercial and industrial activities which add value to New Zealand's natural and physical resources.
- The use of land value as opposed to capital value as the basis upon which to charge general rates.

We would be happy to discuss any aspect of our submission with the Commission. You can contact Fraser Graafhuis at fraser.graafhuis@mercury.co.nz

Yours sincerely

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