THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: SOEs and Economic Growth: Proposals by Minister for State-Owned Enterprises

Date:	5 May 2006	**Treasury Priority:**	Medium
Security Level:	IN-CONFIDENCE	**Report No:**	T2006/683

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Note**	2:30pm Monday 8 May
Associate Minister of Finance (Hon Phil Goff)	**Note**	None
Associate Minister of Finance (Hon Trevor Mallard)	**Note**	2:30pm Monday 8 May
Associate Minister of Finance (Hon Clayton Cosgrove)	**Note**	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
	Principal Advisor			✓
	Director			

Enclosure: **No**

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Executive Summary

Key question: Should the Government allow cautious expansion of scope of business for some SOEs to promote economic growth, with a likely requirement for equity injections/foregone dividends?

Pros	Cons
Fiscal impact	
If financed by gearing, no impact on fiscal position	If financed by equity/foregone earnings, has fiscal impact that should be balanced against alternative economic development proposals, e.g. roading, R&D – on the face of it, alternatives represent better value for money
Fit with a discovery approach to economic development	
Support would allow SOEs to undertake activities that provide spillovers to the wider economy	It is not clear that SOEs are well-placed to undertake activities that are new to the economy, and relaxing the expectation of a return covering the cost of capital on an ongoing basis is inconsistent with the requirement to be a successful business
Nature of SOEs	
Some SOEs are 'of scale' and able to take more risk	Main SOEs 'of scale' are the energy sector SOEs and NZ Post – not likely to be strongly FDI/R&D/exporting type businesses
Diversification	
Diversification could help keep business interesting to management/boards	Risk of diverting management attention in the energy SOEs away from ensuring strong energy infrastructure - this sector is critical to the economy
Accountability disciplines	
	SOEs aren't subject to the same private sector disciplines, and the ability to monitor the entities is not that strong and may be complicated by greater diversification and economic development objectives
Project selection	
SOEs bring projects forward themselves rather than ministers 'picking winners'	Ministers still need to decide what to support or encourage, and whether to make equity injections –vulnerable to subjective judgments

Recommended Action

We recommend that you **note** this report.

[ ]
Director
for Secretary to the Treasury

Hon Dr Michael Cullen
Minister of Finance

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Purpose of Report

1. To brief you prior to being approached by the Minister for State-Owned Enterprises for a discussion on the use of SOEs to promote economic growth.

Background

2. At the Hon Trevor Mallard's request, the Treasury has participated in a couple of strategy discussions that were focused on the role SOEs could play in promoting economic growth (Treasury reports T2006/595 refers).

3. The Minister indicated that he wished to give a speech to SOE chairs on 24 May setting out some ideas, and that he would discuss those with the Minister of Finance before doing so.

4. The Minister has also commissioned a paper on this issue from Peter Harris. A copy is attached. In summary, Mr Harris supports some cautious liberalisation of some SOEs' scope of business definitions with a reduction in dividends and more aggressive gearing to enable some limited expansions. We understand his main arguments to be:

   - Innovation building on the existing skills and knowledge of businesses is an important contributor to economic growth.
   - A discovery approach to economic development suggests government support for activities that are new to the economy, with the expectation that there will be successes and failures;
   - Scale is important for a business to be able to take the risks associated with innovation;
   - Foreign-owned companies do not generally have the motivation to expand from New Zealand into other markets;
   - New Zealand lacks mid- to large-sized domestically owned private sector companies that have the right incentives to take the necessary risks;
   - Some SOEs meet the necessary criteria to provide the basis for undertaking economic development initiatives.

Analysis

5. While SOEs have to operate within a defined scope of business, the definitions are generally widely cast. In most cases they allow for activities in areas that are outside of, but related to, their core business. For example, in the Long Term Hold Review of Meridian, ministers indicated that their expectation was that Meridian's scope of business should be "the generation of electricity (including ownership and operation of related assets), marketing, trading and retailing of electricity and wider complementary products and solutions, primarily within New Zealand".

Fiscal impact

6. Any extension of SOE activity will almost necessarily require more capital. An SOE can obtain capital either by increasing the debt–equity ratio (the "gearing"), by reducing dividends paid to the Crown or by receiving an equity injection from the Crown.

7. We generally support increased gearing because it frees up capital for the Crown and improves the pressure on management to perform. In the course of determining the Government's "long-term hold" policy, Cabinet agreed that gearing should generally be increased at least to a level that is consistent with a BBB(flat) credit rating. This would not necessarily preclude the gearing being increased even further.

8. Current dividend flows are around $300-350 million per annum. These flows are already incorporated into forecasts, so the fiscal impact of reduced dividends is the same as making an equity injection – both would increase gross debt. Any agreement to reduce dividends should therefore be assessed in the same way as any other expenditure proposal.

9. The Government's Economic Transformation agenda contains a number of potential priorities to promote economic growth that will require additional resources: from support for Auckland roading to non-discretionary support for business R&D. The evidence suggests that both of these particular areas represent good value for money.

10. For example, Land Transport NZ assesses all transport projects in terms of a benefit cost ratio, including consideration of time saved by motorists, reduction in accidents, reduced congestion, pollution, noise, and so on. Funds are usually sufficient to fund all projects down to a benefit cost ratio of approximately 4:1. This translates to a rate of return on funds employed of around 50% (not including any economic development values). For R&D, empirical evidence consistently finds that the social returns to R&D are higher than the private returns, suggesting total private and social rates of return of over 80%.

11. To give some idea of scale, allowing SOEs to withhold dividends of, say, $300 million on one occasion would be equivalent in net present value terms to increasing support for business R&D by $30 million per annum on an ongoing basis – a 60% increase on the current level of support.

Fit with a discovery approach to economic development

12. Peter Harris's paper draws on Dani Rodrik's approach to economic development. Three key aspects of Rodrik's approach are:

    - support should be targeted at activities that are genuinely new to the economy;
    - there will be successes and failures, suggesting that support would not be made on a commercial basis and an ongoing government subsidy would be expected; and
    - support should be time-limited to support new activities only, rather than later imitation/adoption (i.e. to target spillovers).

13. It is not clear to us that using the SOEs would be a good fit with this approach, as opposed to considering such policies more broadly across the economy. We base this judgment on the following reasons:

- the areas that SOEs could expand into that would be genuinely new to the economy are probably limited;

- accepting that SOEs may not cover their cost of capital on an ongoing basis may, in our view, be inconsistent with the requirement to be a successful business.

SOEs

14. The SOE portfolio is by no means a cross-section of New Zealand large businesses. It comprises a group of businesses that were established by New Zealand Governments largely in the early 20th century. The current SOE portfolio is those that, for various reasons were not sold in the late 1980s and early 1990s. They are largely the kind of businesses that were seen as central to the development of early and mid 20th century New Zealand. The portfolio is now heavily concentrated in electricity generation. It is therefore doubtful whether the SOE portfolio represents an ideal platform for developing a set of growth initiatives that are most relevant to early 21st century New Zealand.

15. SOEs use the cost of capital as an investment threshold. The cost of capital is typically assessed as being around 8-11%. Expected rates of return on investments of 15-20% are usually regarded as very good. Projects with higher expected rates of return would be rare.

16. Any decision to invest additional taxpayer funds into SOEs would need to take into account the following considerations:

    - Any wider social benefits, or spill-over effects, arising for example from R&D or other forms of innovation which can be copied by other firms at no cost to them, should be added to expected commercial rate of return figures when assessing projects from a national welfare point of view.

    - Since the cost-of-capital concept is derived from a comparison with other, private sector, firms which also produce spill-over effects, it is only spill-over effects that are in excess of those produced by comparable firms, that should be added to the commercial rate of return of investments.

    - The spill-over effects that arise from any innovation or R&D in excess of those produced by comparable firms, are in practice very difficult to measure.

    - Given the roading benchmark of 50% (noting that roads may themselves produce economic development spill-overs), the value of spill-overs of an SOE project that cannot be captured by the SOE, in excess of what one would expect from other firms, would need to be substantial to raise the social rate of return of projects above that level.

Discussion

17. Even companies in old-established industrial sectors may develop extensions to their business in related areas which may be new to the economy. Wind farms are an obvious example of an activity that is new, though it is less clear to what extent they produce spill-over benefits in excess of what one would expect from the average business.

18. The assessment of projects or programmes by ministers or their advisors raises significant practical issues, in our view. Because we are considering the direct or indirect expenditure of taxpayer funds, an assessment by ministers is unavoidable and cannot be left to the Boards. At the very least, ministers would need to assess which SOEs to give the funds to.

19. Peter Harris acknowledges in his paper the weak accountability disciplines in the public sector. Even if projects are picked by SOE boards in the first instance, Ministers will still need to decide, in the context of being consulted on SOEs' SCIs for example, whether they accept those judgements. Criteria could be developed to select SOEs or projects that would be funded with additional taxpayer funds. While these would undoubtedly help to guide the selection process, it is difficult to see how they are not ultimately subjective or circumstantial and therefore vulnerable to prejudices or biases.

Conclusion

20. Considerations of weak accountability disciplines, difficulties in project selection by ministers and their advisors with multiple objectives, the industrial sectors that most SOEs operate in and the high social rates of return available to certain other kinds of Government projects, lead us to recommend that departure from the status quo should only be considered in compelling circumstances.