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LGNSW Submission to General Purpose Standing Committee No. 6 - Inquiry into Local Government in New South Wales

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Table of contents

Executive Summary

Local Government NSW (LGNSW) continues to maintain a firm policy of voluntary structural reform and no forced amalgamations. LGNSW also advocates continuous improvement in Local Government's strategic service delivery plan and underlying financial and asset management systems and practices. Regardless of how Local Government is configured, real and lasting improvement will not be achieved unless the funding framework for Local Government is reformed.

The TCorp Review of the *Financial Sustainability of the NSW Local Government Sector* (2013) confirmed what the Local Government sector has being saying for a decade since the Allan inquiry: it found that many NSW councils were financially unsustainable in the long run under current policy settings and structural arrangements. This was characterised by a large sectoral infrastructure renewal backlog of $7.2 billion, an asset maintenance gap of $389 million and a net sectoral operating deficit.

LGNSW has long maintained that this is largely the result of systemic flaws in the funding system for Local Government, both in NSW and at a national level. These will not be rectified by simply amalgamating councils.There must be an end to rate pegging, fewer rate exemptions, reform of regulated fees and charges, an end to cost shifting, and a fair go in direct funding from the NSW and Commonwealth Governments. LGNSW says Fix the Funding First:

- Rate Pegging - NSW Councils have been disadvantaged by nearly four decades of rate pegging. As a result, NSW has the lowest per capita council rates of any jurisdiction other than the Northern Territory (which relies heavily on Commonwealth funding). Rates per capita in NSW in 2012-13 were $499 compared to the national average of $633[1]. If NSW rates were brought up to the national average they would raise an additional $971 million per annum, sufficient in itself to address deficits and backlogs.

- Financial Assistance Grants (FAGs) – There is an ongoing decline in Australian Government financial support for Local Government relative to economic growth (GDP) and the growth in national taxation revenues. This has been exacerbated by the current freeze on FAG indexation. This decision will see FAGs frozen at their current level until 2017-18 and will result in a permanent reduction in the FAGs base by about 13 per cent. In NSW the FAGs indexation freeze will result in losses from forgone revenue of approximately $287.7 million over the forward estimates to 2017-18.

- Cost Shifting - According to LGNSW's cost shifting survey[2], cost shifting onto Local Government in the financial year 2011/12 amounted to $521 million which accounted for 5.6% of Local Government's total income before capital amounts.

LGNSW has long recognised the need for change in the Local Government sector. Our organisation has been actively involved in the current review process since 2011. Our main priority is to ensure the needs of NSW communities are met through a strong and financially secure Local Government sector.

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[1] Commonwealth of Australia 2015, Local Government National Report 2012–13, p. 6
[2] LGNSW, *The Impact of Cost Shifting on NSW Local Government: A Survey of Councils - Financial Year 2011/12*, 2013

LGNSW does not oppose the “Fit for the Future” (FFTF) program and has taken a leadership role for the sector in the context of its roll out. On face value FFTF is a concerted council improvement program that is supported by resources and it also provides incentives to promote voluntary amalgamations. It is commendable that the NSW Government - unlike its counterparts in in other states – has taken Local Government along as a partner on the reform journey. It is equally true that many councils have benefitted from the FFTF process, in that it has necessitated greater scrutiny and understanding of financial factors.

Even if FFTF fails to deliver the NSW Government’s amalgamation objectives, it will deliver improved council performance and sustainability.The apparent NSW Government ‘agenda’ for Local Government is a different matter. LGNSW is opposed to any agenda that involves forced amalgamations. The case for these has not been made.

The Independent Local Government Review Panel (ILGRP) had 65 recommendations but the focus has largely been only on amalgamations. The real issue – funding – is yet to be addressed in any substantive way. We urge the NSW Government to get on with acting on funding issues like rate pegging, rate exemptions and cost shifting. Funding is the core problem and it won’t be resolved by wholesale amalgamations. Fix the funding first then, let communities decide whether they need amalgamations.

1. Introduction

Local Government NSW (LGNSW) is the peak body for NSW Local Government, representing all the 152 NSW general-purpose councils, 12 special-purpose county councils and the NSW Aboriginal Land Council. In essence LGNSW is the ‘sword and shield’ of the NSW Local Government sector.

The mission of Local Government NSW is to be a credible, professional organisation representing Local Government and facilitating the development of an effective community-based system of Local Government in NSW. LGNSW represents the views of councils to NSW and Australian Governments; provides industrial relations and specialist services to councils; and promotes NSW councils to the community.

LGNSW is pleased to have an opportunity to make a formal submission to General Purpose Standing Committee No. 6 - Inquiry into Local Government in New South Wales.

2. Overview

LGNSW has long recognised the need for change in the Local Government sector. Our organisation has been actively involved in the review process since 2011, and since September 2014 has taken a leadership role for the sector in the context of the NSW Government's FFTF package including by participating in Office of Local Government (OLG) and the IPART forums, running targeted workshops to assist councils preparing their FFTF proposals and contributing to the process through the MAG and other forums. Our priority is to ensure the needs of NSW communities are met through a strong and financially secure Local Government sector.

LGNSW continues to maintain a firm policy of voluntary structural reform and no forced amalgamations. LGNSW also advocates continuous improvement in Local Government's strategic service delivery planning and underlying financial and asset management systems and practices. However, regardless of how Local Government is configured, real and lasting improvement will not be achieved unless the funding framework for Local Government is reformed. That means an end to rate pegging, fewer rate exemptions, reform of regulated fees charges, no more cost shifting and a fair go in direct funding from the NSW and Commonwealth Governments. LGNSW says Fix the Funding First.

NSW Local Government Finances

Local Government is one of the biggest sectors in the NSW economy, spending approximately $10 billion per year, managing non-financial assets (infrastructure and land) worth $120 billion and employing more than 50,000 people.

Constructive discussion on improving the financial sustainability of Local Government is undermined by political slogans/statements and media releases consisting of gross over simplifications and sweeping generalisations.

It is totally misleading to say that councils are losing a million dollars a day. While many individual councils are currently reporting operating deficits as indicated by the Operating Performance Ratio (OPR), at the same time a significant proportion are reporting very modest deficits or surpluses. Further, the OPR it is but one of many financial indicators of the financial sustainability that need to be considered holistically and in context. For example, operating surpluses can be achieved by allowing infrastructure to deteriorate.

A weakness of this indicator is that depreciation represents a very large proportion of the total operating expenses of councils on average. The reported level of a council's depreciation expenses have a large bearing on its operating result and can be difficult to reliably estimate (refer attachments A, B and C). The varying reliability of depreciation data is widely recognised. The OPR needs also analysed as a trend line over time, as annual results are subject to distortion by abnormal items such as the impact of natural disasters and the timing of grant payments.

Reports that councils are "rich and getting richer" (SMH), sitting on billions of dollars of cash and investments are also highly misleading and betray a lack of understanding of Local Government finances. A large proportion of the cash and investments are restricted funds. These include Development Contributions and funds required to cover accrued employee entitlements. These are not discretionary funds. Another large component represents funding for forward infrastructure renewal commitments. To put it in context, cash and investments represent only 5.35 per cent of total council assets. This is small but prudent proportion.

Councils require sufficient funds to provide services, maintain and renew existing infrastructure and to construct new infrastructure. However, councils with their constrained taxation power (rates on land) often do not have the capacity to raise sufficient funds on their own and are dependent on intergovernmental transfers. This is particularly the case in regional and rural areas where the rating base is small.

The TCorp *Review of Financial Sustainability of NSW Local Government Sector* (April 2013) confirmed what several previous reviews had identified, including the “Allan” Report (2006) initiated by LGNSW’s predecessors, the Local Government and Shires Associations of NSW. The review found that many NSW councils were financially unsustainable in the long run under current policy settings and structural arrangements. This was characterised by a large sectoral infrastructure renewal backlog of $7.2 billion, an asset maintenance gap of $389 million and a net sectoral operating deficit.

LGNSW has long maintained that this is largely the result of a systemic failure of the funding system for Local Government, both in NSW and at a national level. This will not be rectified by simply amalgamating councils.

There are several, sometimes interrelated reasons for this financial situation, including:

- Rate Pegging - NSW Councils have been disadvantaged by nearly four decades of rate pegging. Rate pegging has undoubtedly served to suppress NSW council rates. This is evidenced by the fact that NSW has the lowest per capita council rates than any jurisdiction other than the Northern Territory. Rates per capita in NSW in 2012-13 were $499 compared to the national average of $633. (Local Government National Report 2012-2013 p.6). This reveals a very significant revenue shortfall. If NSW rates were brought up to the national average they would raise an additional $971 million per annum.

- Rate Exemptions - An archaic system of rate exemptions has been maintained in NSW, many of which were carried over from the NSW *Local Government* Act *(1919).* Many exemptions are now poorly targeted and inequitable, for example rate exemptions on the commercial forestry operation of the Forestry Corporation of NSW. This further contributes to the revenue shortfall for Local Government and in the case of Forestry, often also adding to expenditure on repairing council roads damaged by log trucks.

- Regulated Fees and Charges – A large proportion of Local Government fees and charges remain regulated by the NSW Government. Many of these have not been reviewed or indexed for a decade or more, resulting in councils being unable to fully recover the costs of providing services. For example, s 149 (Zoning) certificates have remained at $53 since 1994.

- Financial Assistance Grants (FAGs) –There has been a serious ongoing decline in Australian Government financial support for Local Government relative to economic growth (GDP) and the growth in national taxation revenues. This has been exacerbated by the current freeze on FAG indexation. This decision sees FAGs frozen at their current level until 2017-18 and will result in a permanent reduction in the FAGs base by about 13 per cent. The quantum of FAGs will be reduced in real terms by nearly $ 1 billion nationally during the period of the freeze. In NSW the FAGs indexation freeze will result in losses from forgone revenue of approximately $287.7 million in the three years to 2017-18.

As a proportion of total Commonwealth taxation revenue in 2013-14, FAGs amounted to around 0.67 per cent, continuing a long trend of reduced FAGs as a proportion of the Commonwealth's taxation revenue. The decision to freeze the indexation of FAGs until 2017-18 will see that proportion of revenue drop to less than 0.60 per cent. By contrast, these grants represented around 1 per cent of total Commonwealth taxation revenue in 1995-96 and 1996-97.

- Cost Shifting - Cost and responsibility shifting onto councils by the State and Commonwealth Governments has taken a massive toll. According to LGNSW's cost shifting survey[3], cost shifting onto Local Government in the financial year 2011/12 amounted to $521 million which accounted for 5.6% of Local Government's total income before capital amounts. In absolute terms, cost shifting was estimated to have increased significantly from $380 million in 2005/06 to $521 million in 2011/12.

It is clear from the above that fixing the funding model would provide the means for substantially addressing the financial sustainability of NSW Local Government. Eleven of the 65 recommendations of the Independent Local Government Review Panel (ILGRP) related to fixing the funding model, and of those 11 recommendations, none have yet been fully implemented. We urge the NSW Government to act on those under its control, as a matter of urgency.

The FFTF Process

Throughout FFTF, LGNSW has advocated a consistent, impartial and balanced methodology and assessment process that includes appropriate Local Government expertise on the assessment panel. Through representation on the MAG and participation in the FFTF process (e.g. participation in working groups, consultations, submissions and reviewing materials etc.) LGNSW sought to drive positive changes to the FFTF program and assessment methodology, including:

- Dropping of the Rural Council structural model proposed by the ILGRP and replacing with the non- structural Rural Council Template (T3).
- Provision for the IPART to seek further information from councils, which may include the opportunity for councils to meet with IPART[4].
- Requirement in the Terms of Reference for the Expert Panel to operate with consistency, fairness and impartiality[5].
- Ensuring Local Government knowledge and expertise in the assessment process noting the inclusion of John Comrie on the Assessment Panel on the Assessment Panel[6] is welcome but falls short of the representation sought by LGNSW).
- Proper consideration of the social and community context of councils[7].
- Substantially increased emphasis on community consultation[8].

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[3] LGNSW, The Impact of Cost Shifting on NSW Local Government: A Survey of Councils - Financial Year 2011/12, 2013
[4] IPART, *Methodology for Assessment of Council Fit for the Future Proposals,* June 2015, Table 1.3
[5] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, pp. 3&4
[6] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, pp. 4&5
[7] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, p. 50

- A modified view on the treatment of Local Water Utilities (LWU's) [9].
- Allowing Financial Assistance Grants (FAGs) to be included in the assessment of Own Source Revenue (OSR) for Rural Councils[10].
- Modification of assessment criteria and benchmarks, which included the capacity to calculate infrastructure backlog ratio using replacement cost rather than written down value of assets.

Elements of Successful Amalgamations

Based on experience from past amalgamations in NSW and other states, it appears that the key elements for success are:

- Strong community support based on extensive and informed community engagement.
- Significant communities of interest across the areas being amalgamated.
- Evidence that amalgamation will deliver significant medium and long term benefits to the communities involved.
- Robust planning and implementation, with realistic and achievable timeframes.
- Strong, supportive leadership and management.
- Genuine and frequent communication and stakeholder involvement.
- Availability of incentives including financial support.
- A partnering approach based on mutually agreed values, rather than one involving of adversarial or takeover activities.
- Outcomes that are based on the ideology of a 'fresh start'.
- Transitional arrangements in place at the outset.
- Independent monitoring and evaluation.

These are far more likely to be present in a voluntary amalgamation.

Evidence on Benefits and Costs of Amalgamation

The push for amalgamations seems to be largely driven by blind faith in economies of scale and that bigger is necessarily better.

After reviewing research in this area, there does not appear to be any overwhelming or conclusive evidence on the relative costs and benefits of amalgamations generally. This conclusion is supported by research conducted by Brian Bell, General Manager of Lake Macquarie City Council and reinforced by the diverse findings of several recent merger business cases conducted for councils. It appears that different amalgamations result in different net outcomes, positive or negative, which are the result of a multitude of factors. These factors may include the:

- Financial condition of the councils amalgamating.
- Level of community support for the amalgamation.
- Level of resources available to assist councils with the amalgamation process.
- Time elapsed since amalgamation.
- External factors influenced or controlled by State or Federal Governments.

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[8] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, pp. 50-52
[9] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, p. 52
[10] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, p. 41

These concerns would need to be addressed in any amalgamation. This is complicated by the fact that that many costs are realised in the short term while the benefits may only emerge in the medium to long term.

Many would argue that the only certain efficiency gains from council amalgamations accrue to State Governments which benefit from simply having fewer councils to deal with. This is not a benefit to local communities and is not in itself sufficient justification for amalgamations.

What is beyond doubt, however, is that amalgamations have driven rates up in other jurisdictions. The Queensland amalgamations referred to took place in 2008. Total Queensland council rate revenue grew by 27.4% in the period 2001-08 to 2010-11. By comparison, NSW council rate revenue grew by only 13.4% in the same period. As noted previously, NSW has the lowest per capita rates of all jurisdictions except the Northern Territory. According to the Local Government National Report 2012-2013[11], Victorian council rates averaged $692 per capita compared to $499 in NSW - a difference of nearly 40%. This is despite amalgamations in 1994 that reduced the number of Victorian councils from 210 to 78.

The argument that bigger councils perform better than smaller councils lacks evidence. There is a larger body of research and real life experience that challenge that proposition. As mentioned elsewhere in this paper, the Australian Centre of Excellence for Local Government (ACELG) reported in May 2011 that:

An enduring theme is the perception that municipal consolidation will result in gains through economies of scale. Our review of the literature makes it clear there is insufficient robust research to support this proposition.

This conclusion is supported by the recent research conducted by Brian Bell, General Manager of Lake Macquarie City Council which was mentioned above. The study indicated very clearly that there is no better performance by the amalgamated councils over the non-amalgamated councils on any of the 'Fit for the Future' performance indicators. The data also show there are no discernible economies of scale efficiencies in the bigger councils. These findings are reinforced by the diverse findings of several recent merger business cases conducted for councils.

[11] Commonwealth of Australia 2015, Local Government National Report 2012–13, p. 6

3. Response to Specific Inquiry Terms of Reference

a) The New South Wales Government's 'Fit for the Future' reform agenda

LGNSW has long recognised the need for change in the Local Government sector. Our organisation has been actively involved in the review process since 2011, and since September 2014 has taken a leadership role for the sector in the context of the NSW Government's FFTF package including by participating in Office of Local Government (OLG) and the IPART forums, running targeted workshops to assist councils preparing their FFTF proposals and contributing to the process through the MAG and other forums. Our priority is to ensure the needs of NSW communities are met through a strong and financially secure Local Government sector.

LGNSW does not oppose the "Fit for the Future" (FFTF) program and has taken a leadership role for the sector in the context of its roll out. On face value FFTF is a concerted council improvement program that is supported by resources and it also provides incentives to promote voluntary amalgamations. It is commendable that the NSW Government - unlike its counterparts in in other states – has taken Local Government along as a partner on the reform journey. It is equally true that many councils have benefitted from the FFTF process, in that it has necessitated greater scrutiny and understanding of financial factors.

Even if FFTF fails to deliver the NSW Government's amalgamation objectives, it will deliver improved council performance and sustainability. The apparent NSW Government 'agenda' for Local Government is a different matter. LGNSW is opposed to any agenda that involves forced amalgamations. The case for these has not been made.

b) The financial sustainability of the local government sector in New South Wales, including the measures used to benchmark local government as against the measures used to benchmark State and Federal Government in Australia

LGNSW has consistently argued the need to fix the current inadequacies in the revenue system in order to strengthen the long-term financial position of councils. Local Government recognises it needs to improve its financial sustainability, and many councils have been on a path of improvement for some time. However, as stated previously, with its limited taxation power (particularly in regional and rural areas where the rating base is small) Local Government does not have the capacity to raise sufficient funds on its own, therefore relying on intergovernmental transfers of tax revenues. It is like the State Government in this regard, which relies heavily on taxes collected by the Commonwealth. Restrictions on rating revenue such as rate pegging have exacerbated the council funding difficulties associated with a limited revenue base. These deficiencies were acknowledged by the ILGRP which concluded that "a number of significant changes are warranted in order to strengthen councils' revenue base within the overall framework of fiscal responsibility"[12].

Some of the recent rhetoric surrounding the perceived negative finances of councils has been exaggerated by a reliance on a set benchmarks that have been recognised as being flawed as a means of establishing whether a council is financially 'fit'. John Comrie, in his written comments on the Government's FFTF assessment criteria stated that: "It's not clear to me how a council's score for each of these indicators is applied to determine whether it is 'fit for the

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[12] ILGRP, *Revitalising Local Government – Final Report*, October 2013, p.38

future'. Providing that a council has reasonably reliable accounting records and long-term financial planning assumptions and is committed to and is forecasting ongoing achievement of modest operating surpluses (net of capital revenues) I would suggest (prima facie) that it is 'fit for the future'"[13].

With specific reference to the benchmarks, LGNSW holds that Local Government is a sphere of government with considerable autonomy, not an agency of the State Government. On this basis it is inappropriate that State Governments seek to micro manage Local Government by applying criteria and benchmarks that they do not apply to their own departments. State Governments would not accept such impositions being placed upon them by the Australian Government.

These types of performance measures are also considered unnecessary. Councils are democratically accountable to their communities. Poor performance will be punished at the ballot box.

c) The performance criteria and associated benchmark values used to assess local authorities in New South Wales

The FFTF criteria and benchmarks have been extensively commented on by LGNSW in submissions to the MAG, the IPART and through our membership of the FFTF Assessment Criteria and Benchmarks Working Group. (The Working Group included representatives of LGNSW and Local Government Professionals Australia (NSW) (LGPA) and was established at LGNSWs instigation.)

LGNSW has argued that there are significant weaknesses and deficiencies with the criteria and benchmarks. These conclusions were supported in independent reviews of both the TCorp Financial Sustainability Assessment Methodology[14] and the FFTF Financial Criteria and Benchmarks[15] conducted by recognised Local Government financial expert, John Comrie. (Refer Attachments A and B).

LGNSW also urged IPART to consider the advice that was developed by the Working Group and submitted to the MAG with the specific aim of informing the Independent Expert Assessment Panel. The Working Group's analysis of the implications of each of the benchmarks is provided in the table at Attachment C.

LGNSW recognises that experts will never agree on the ideal set of financial, asset management and efficiency criteria for analysing the comparative health of councils or other organisations. As that would be an interminable debate LGNSW put the focus on the application and interpretation of the criteria and benchmarks. LGNSW urged a holistic approach.

As noted previously, LGNSW welcomed the improved definition of the efficiency criterion and including FAGs in consideration of OSR for Rural Councils. LGNSW also called on the IPART

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[13] John Comrie, Independent Review of FFTF Criteria (Supplementary), February 2015 (Refer Attachment B)
[14] John Comrie, *Independent Review of TCorp's Report 'Financial Sustainability of the NSW Local Government Sector'*, October 2014 (Refer Attachment A)
[15] John Comrie, *Independent Review of FFTF Criteria (Supplementary)*, February 2015 (Refer Attachment B)

to extend consideration of FAGs to other council proposals where appropriate. LGNSW also welcomed the IPART's invitation for councils to include additional financial criteria in their proposal where relevant.

Local Water Utilities

There are a number of issues concerning scale and capacity and the benchmark criteria that relate exclusively to LWUs. The IPART states that its methodology would assess scale and capacity against the ILGRP objectives and performance against the benchmarks based on general fund data only, but would consider how the performance of the general fund is affected by the water utility business as part of this assessment.

- General fund performance

  How the water fund affects, and in the future could affect, the performance of the general fund is an important and relevant consideration which should be included in assessment of the benchmarks. The IPART notes that the activities of the LWU may affect the general fund, through dividend payments and through internal borrowings between the general and water funds. Dividends and internal borrowings can have a relevant impact on councils' financial sustainability indicators. LGNSW considers this definition to be too narrow as LWUs may influence the general fund in other ways (e.g. providing economies of scale that reduce purchasing costs).

- LWUs & scale and capacity assessment

  Even though the IPART acknowledges LGNSW's previous submissions which argued how the water supply and sewerage function can contribute to the strategic capacity of a council through economies of scale and scope, it is unclear from IPART's statement whether the water supply and sewerage function would also be included in the scale and capacity assessment. The IPART states that "… its methodology will assess scale and capacity…based on general fund data only…"[16]

  Councils' water supply and sewerage function is pertinent to many of the ILGRP's objectives with respect to scale and capacity. Water supply and sewerage services are a major part of most regional councils' operations often making up a quarter or more of councils' annual budget and employing a significant number of their workforce. Water supply and sewerage services enhance the robustness of councils' revenue base, their ability to undertake major projects, to employ a wider range of skilled staff, and to undertake strategic planning and foster knowledge, creativity and innovation, as well as the ability to achieve effective regional collaboration and be a capable partner for agencies of the NSW Government and the Australian Government.

  LGNSW therefore requested the IPART to clarify its methodology and to specifically include consideration of the water supply and sewerage function in the scale and capacity assessment and the impact of the LWU on the other criteria. This goes beyond merely considering "…how the performance of the general fund is affected by the water utility business."[17]

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[16] IPART, *Methodology for Assessment of Council Fit for the Future Proposals*, June 2015, p. 52
[17] Ibid.

Attachment 2 provides more detailed information as to how the water supply and sewerage function is relevant to the scale and capacity objectives.

d) The scale of local councils in New South Wales

The discussion around scale of councils is complicated by the range of relevant variables and criteria. Scale for councils may be defined in terms such terms as:

- population
- land area
- revenue or revenue raising capacity
- expenditure
- range of operations and services
- size of organisation

The variables are used in various combinations by different analysts and commentators, creating a high degree of inconsistency in definition. Volumes of analysis by experts, academics and practitioners over decades have failed to reach a consensus on what the optimal scale is for a city or Local Government Area. Furthermore, the research indicates that optimal scales vary for different activities and that broad-brush economies of scale prove to be elusive. The Australian Centre of Excellence for Local Government (ACELG) reported in May 2011 that:

> *An enduring theme is the perception that municipal consolidation will result in gains through economies of scale. Our review of the literature makes it clear there is insufficient robust research to support this proposition*[18]*.*

As councils are complex multifunctional organisations it is likely that the optimal scale will vary for different functions and activities. For example, there are unquestionable scale advantages in the procurement of materials and contract services and there are already mechanisms and arrangements in place that enable councils to access the economies of scale derived from group purchasing. The majority of Sydney councils and many rural and regional councils contract out their waste services on a group basis. This is a long established practice and has enabled councils to successfully exercise market power. Similarly, all NSW councils have access to group purchasing of a range of goods and services using group procurement through Local Government Procurement[19], access to State Government Contracts, through their ROCs or other arrangements. Councils do not need to amalgamate to access these advantages of scale.

On the other hand some services seem to be more effectively delivered to residents at smaller scales. These include services that require or benefit from direct contact with residents or where responsiveness is required.

To complicate this matter further, the ILGRP conflated the various definitions of scale with subjective, non-quantifiable elements of ‘strategic capacity’.

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[18] ACELG, *Consolidation in Local Government: A Fresh Look, Volume 1: Report*, May 2011, p. 39
[19] Local Government Procurement is a business arm of LGNSW (www.lgp.org.au/)

This has been a major source of confusion for councils throughout the FFTF process and the IPART Methodology for Assessment fails to deliver the required clarity. LGNSW and many councils through the reform process, and at the IPART's recent FFTF public forums, have questioned why scale and capacity are being assessed together when they are not mutually inclusive. LGNSW maintains the view that scale and capacity are two different criteria and should be assessed independently.

Strategic Capacity

IPART has advised that assessment will be made according to the 'Key elements of Strategic Capacity' presented by the ILGRP. These are reproduced in Box 3.1 of IPART's final assessment methodology[20] as follows:

- More robust revenue base and increased discretionary spending
- Scope to undertake new functions and major projects
- Ability to employ wider range of skilled staff
- Knowledge, creativity and innovation
- Advanced skills in strategic planning and policy development
- Effective regional collaboration
- Credibility for more effective advocacy
- Capable partner for State and Federal agencies
- Resources to cope with complex and unexpected change
- High quality political and managerial leadership.

These elements are clearly not quantifiable and have not been ranked or weighted. LGNSW called on IPART to provide clear concise guidance on how the elements listed in Box 3.1 would be objectively applied to measure the assessment of scale and capacity. However, the IPART failed to clarify the above elements of strategic capacity. It does not appear that these elements can be consistently applied, particularly as many of the elements are intangible. The assessment will inevitably come down to subjective judgement.

It was also unclear whether councils would be required to satisfy all the key elements of strategic capacity to some extent to be deemed fit, or whether they would need to satisfy a majority, or whether it would be satisfactory for councils to show competency in a few elements.

Population Size

As noted, the IPART introduced reference to minimum population size, but it also introduced reference to target council numbers. In both cases this means councils addressing "*an appropriate minimum population size" and "a target number of councils",* and the guidance was that councils should consider the outcomes in population size and council numbers in accordance with the ILGRP's preferred option for that council. Councils had been advised at OLG workshops, however, that there were no target council numbers or minimum population sizes. LGNSW argued that it was unfair to introduce them to the assessment process at that late stage.

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[20] IPART, Methodology for Assessment of Council Fit for the Future Proposals, June 2015, Box 3.1, p. 30

Basing minimum population and a target number of councils on the ILGRP preferred options raises numerous issues including consistency in application across the state and the relevance of the options in the first place. LGNSW is of the view that there is little or no empirical evidence to determine an optimal population size or number of councils. (This was corroborated by ACELG in 2011: "In general, research and debate about an optimum size (population) for local government areas have been inconclusive, and there remain strongly opposed views as to whether larger amalgamated councils enjoy significant economies of scale."[21]) LGNSW maintains that population minimums and a target number of councils should not feature in the assessment process.

The issues of inconsistency are readily apparent when looking at the range of population outcomes that would result from the full application of the ILGRP preferred options – council population sizes would range from less than 10,000 (e.g. Coonamble, popn:4970) to over 500,000 (e.g. Sydney Global City). This tells us that population size is not the primary issue.

LGNSW is pleased to see that IPART will be taking into account the social and community context when considering the scale and capacity criterion for council FFTF proposals. However it is unclear how these social and community factors will be assessed alongside the "Key elements of Strategic Capacity", nor what weighting or influence they will have on whether a council satisfies the scale and capacity criterion.

In addition to the strategic capacity elements and council's social and community context, IPART also stated that it will be considering "the proposal's consistency with the broader regional and state-wide objectives of the ILGRP's preferred option"[22]. These regional and state wide objectives are not always apparent and therefore sometimes need to be deduced. It is unclear how adherence to these state-wide objectives will be quantified and the degree of influence that this criterion will have on the overall scale and capacity assessment.

Metropolitan Planning Pretext

A justification for reducing the number of councils in the Sydney Metropolitan Area has been that it will help overcome perceived development obstacles. For example the 2015/16 NSW Budget Papers state "Further reforms to local government are critical to ensuring that these ambitious plans are met [housing targets]. Larger local government areas are likely to be better able to deliver on their housing targets"[23].

LGNSW refutes this gross oversimplification; however it is a view that has been effectively prosecuted by the property development sector and appears to be very widely accepted within the NSW Government.

As flawed as it is, LGNSW maintains that this rationale has been made redundant by the establishment of the Greater Sydney Commission (GSC). The Government's announcement of this proposed new regional planning model for metropolitan Sydney was made long after the delivery of the IPGRP's final report. The Government has placed a great deal of emphasis on the ILGRP preferred options, however the ILGRP's conclusions and options did not factor in the

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[21] ACELG, *Consolidation in Local Government: A Fresh Look, Volume 1: Report*, May 2011, p. 14
[22] IPART, Methodology for Assessment of Council Fit for the Future Proposals, June 2015, p. 33
[23] NSW 2015/16 Budget Statement, p. 3-6.

prospect that councils in the metropolitan area will be operating under a yet-to-be established GSC model.

LGNSW understands that the GSC and subordinate sub-regional planning bodies will now be responsible for delivering the metropolitan strategy for the Sydney region and ensuring councils deliver on their planning targets, supported by infrastructure delivery by state agencies. While the exact roles and responsibilities of the GSC are still not fully articulated, this represents a “step-change”[24] in the sub-regional approach for the delivery of the metropolitan plan for Sydney, and therefore cannot be ignored in any consideration of the structural reform of Local Government.
There is no longer a “need”- if there ever was – to amalgamate councils to improve planning performance.

Local Water Utilities

As discussed previously (refer to section 3c)), LGNSW has argued and continues to argue that LWUs contribute to the strategic capacity of councils. LGNSW urged the IPART to clarify how LWUs will be considered in the scale and capacity assessment. While a little further clarification has been subsequently provided, it is still inadequate

e) The role of the Independent Pricing and Regulatory Tribunal (IPART) in reviewing the future of local government in New South Wales, assisted by a South Australian commercial consultant

LGNSW had advocated[25] that the proposed Independent Expert Assessment Panel not be the IPART, TCorp or OLG, or be comprised of representatives of IPART, TCorp or OLG. This was based on the perception that they are NSW Government entities. LGNSW also expressed the view that the overall panel composition must demonstrate a capacity to provide a balanced assessment, not only of financial criteria, but of other equally important factors that embody social and community values.

LGNSW therefore recommended at least one panel member to be a community governance expert.There was also a desire to ensure that there was extensive Local Government expertise and experience represented on the panel, the type of expertise and experience that can only be derived from having been a successful Mayor or General Manager. While LGNSW welcomes the inclusion of John Comrie on the panel because of his extensive expertise and background in Local Government, he alone does not satisfy what the sector was looking for as he is but one of a Tribunal of four. LGNSW recommended Mr Comrie to the Minister.

Local Government has also raised concern about the very recent recruitment of Analysts and Senior Analysts on a temporary basis to assist the IPART with the FFTF assessment process. Due to the complexity and volume of council submissions and the short timeframe which IPART has to assess these submissions, increased staff resources are required. However councils have concerns that in the recruitment of these analysts, the essential eligibility requirements do not include Local Government knowledge and experience.

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[24] NSW Department of Planning and Environment, *A Plan for Growing Sydney*, Dec 2014, p. 18
[25] LGNSW, *Submission on the Independent Expert Assessment Panel for FFTF Proposals*, February 2015

Through submissions to the Ministerial Advisory Group, LGNSW has consistently called for those involved in the Independent Expert Assessment Panel to have Local Government experience.

LGNSW has also been critical of the NSW Government failure to consult with MAG members on the appointment of IPART as the Independent Assessment Panel.

f) The appropriateness of the deadline for 'Fit for the Future' proposals

LGNSW has previously indicated concerns about the ambitious FFTF schedule. The apparent haste of the process has raised several important questions about the integrity of the process and the quality of outcomes for communities in NSW. There are several aspects of this concern.

Methodology and Assessment Process

Firstly, LGNSW considers there has been an unrealistic timeframe set for the establishment and deliberations of the Expert Advisory Panel. This is largely because the much-anticipated announcement of the panel was behind schedule, and the proposed assessment methodology was not released until the end of April. There is a widespread view that the schedules have been too tight to allow adequate time for:

- IPART to revise the methodology before releasing it as a final;
- Councils to amend proposals in light of the revised methodology; and
- IPART to assess proposals.

IPART and John Comrie were announced as the Panel on the morning of 27 April 2015. That afternoon a draft methodology was released, so it is clear that the appointment had been in train for some time, and the whole chain of events has been the cause of some cynicism about the independence of the process. Compounding hat IPART had just 21 working days between the close of comments on the draft methodology and the release of the final even though 174 submissions were made.

LGNSW was also concerned to ensure that councils were given a reasonable amount of time, once the final methodology was released, to consider their options and finalise their proposals. However its release in June 2015 left councils just fifteen working days to complete their submissions that are instrumental in determining their future existence.

Further constraining the timeframe was the additional complication that many councils were unable to begin weighing up their FFTF options until the release of the full set of FFTF templates in late January 2015 (i.e. following the release of the Rural Council Template). The result was that many councils had little time to fully review and consider their options and develop their proposals. Working to this tight timeframe, a number of councils, particularly those engaged in potential merger discussions with their neighbours, reported significant challenges in reaching the point of finalising their decisions and having time to adequately consult with their communities before submissions were due. This uncertainty has not only affected the potentially 'rural' councils, but the impact spread to neighbouring councils, which may not meet rural council criteria themselves, but may have been waiting on neighbouring rural councils before weighing up their merger options.

Tight timeframes have most likely compromised the opportunity for some councils to fully consider and negotiate a merger option with their neighbours. Where councils were voluntarily working towards a merger, the potential to rush the complex analysis, community engagement and negotiation processes to meet the 30 June deadline has cost some councils the opportunity of achieving a favourable outcome from the process. LGNSW is aware of at least one example where the council involved was only in a position to consider and debate the merger business case and make a final decision as late as 29 June.

LGNSW also remains concerned about the timeframe for IPART's deliberations in its role of assessing councils' FFTF submissions. IPART is required to receive these critically important and complex proposals, consider public submissions, potentially meet with councils to obtain further information, make a judgement on each against complex criteria, and then advise the Government by 16 October whether or not individual councils are 'fit for the future'. With IPART having received 144 FFTF submissions[26], it will have far less than one day per council to make its assessments. This unrealistic and improbable timeframe compromises the rigour that should be applied to each individual assessment and potentially undermines the authenticity of the FFTF assessment process. Councils have committed significant resources to complete these substantial packages of information, and every council has a right to expect that its proposal will be subject to an in-depth, comprehensive and expert review.

In light of these concerns, LGNSW called for the deadline for reporting back to the Government to be extended to give a more realistic period to enable a full and comprehensive assessment of each FFTF proposal. IPART has acknowledged the tight timeframes during its public forums in May. LGNSW recommends an extension of the submission and assessment deadlines until at least end of November 2015 to enable it to comprehensively and rigorously review each and every proposal.

Implementation Phase

The second issue about timing concerns the implementation phase. The Government took some eleven months to respond with its FFTF package following the release of the ILGRP's Final Report in October 2013, and now aims to compress these complex assessment and implementation processes into an ambitious schedule to meet a September 2016 deadline.

With IPART reporting in October 2015, and uncertainty about how long the Government might take to respond, the implementation phase will at best be only ten months, although in practical terms, with the inevitable delays that occur with the Christmas and summer holiday period, this is likely to be reduced to less than 9 months. Amalgamations are complex, and this unrealistic timeframe is entirely inadequate to systematically and effectively undertake a massive structural change. It will severely hamper the achievement of a quality outcome for councils and their communities. If the Government is serious about encouraging more voluntary amalgamations, it should extend the implementation timeframes.

g) Costs and benefits of amalgamations for local residents and businesses

There does not appear to be any conclusive empirical evidence on the relative costs and benefits of amalgamations generally. Several councils have had merger business cases

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[26] IPART, Media Release: *All Requested NSW Councils Lodge Fit for the Future Proposals*, 1 July 2015

conducted and these have generated diverse results. It appears that different amalgamations result in different net outcomes positive or negative and are the result of a multitude of factors. These factors include the:

- condition of the councils amalgamating
- level of community support for the amalgamation
- quality and strength of management and leadership
- level of resources available to assist councils with the amalgamation process
- external factors influenced or controlled by State or Federal Governments

h) Evidence of the impact of forced mergers on council rates drawing from the recent Queensland experience and other forced amalgamation episodes

The Queensland amalgamations referred to took place in 2008. Total Queensland council rate revenue grew by 27.4% in the period 2001-08 to 2010-11. By comparison, NSW council rate revenue grew by only 13.4% in the same period. . According to the *Local Government National Report 2012-2013*, Victorian council rates averaged $692 per capita compared to $499 in NSW - a difference of nearly 40%. This is despite amalgamations in 1994 that reduced the number of Victorian councils from 210 to 78.

i) Evidence of the impact of forced mergers on local infrastructure investment and maintenance

There does not appear to be any comprehensive aggregate data that allow a generalised quantitative conclusion to this question. However, with or without amalgamations, the benchmarks being applied under FFTF will compel councils to achieve a minimum level of infrastructure investment maintenance expenditure. The relevant benchmarks are:

- Building and asset renewal ratio - >100% average over 3 years
- Infrastructure backlog ratio - < 2%
- Asset maintenance ratio - > 100% average over 3 years.

j) Evidence of the impact of forced mergers on municipal employment, including aggregate redundancy costs

The first point to make is that irrespective of whether an amalgamation is forced or voluntary there is no evidence to suggest that the impact upon municipal employment would or could be different.

Generally speaking mergers and amalgamations elicit concerns about the economic, social and employment consequences upon local communities. The justification of those concerns was tested by Jeff Tate in a report provided to the Independent Local Government Review Panel in January 2013.

Entitled *Assessing processes and outcomes of the 2004 Local Government boundary changes in NSW*, the Tate Report provided a comparison of 2002/2003 pre-amalgamation employment levels against the 2010/2011 post-amalgamation employment levels. Tate concluded that

"…there has actually been an overall increase of 11.7% in staff numbers in those areas" [27]. In the table below, the Tate comparison has been supplemented with data from the *Comparative Information on NSW Local Government Councils* for 2013/2014[28]. The more recent comparison demonstrates an increase of 12.08% in staff numbers for areas that were impacted by the 2003/2004 amalgamations. (Refer to table below).

Previous Councils	EFT employees 2002/2003	New Councils	EFT employees 2010/2011	% change	EFT employees 2013/14	% change
Glen Innes	76	Glenn Innes-Severn	132		130	
Severn	48					
Subtotal	124		132	6.45%	130	4.84%
Cooma- Monaro	120	Cooma-Monaro	149		160	
Crookwell	62	Goulburn-Mulwaree	256		252	
Gunning	34	Palerang	110		119	
Goulbourn	187	Queanbeyan	278		271	
Mulwaree	74	Tumut	142		141	
Queanbeyan	263	Upper Lachlan	132		133	
Tumut	112	Yass Valley	132		136	
Tallaganda	55					
Yarrolumla	56					
Yass	104					
Subtotal	1067		1199	12.37%	1212	13.59%
Copmanhurst	39	Clarence Valley	495		538	
Grafton	140					
Maclean	131					
Pristine Waters	75					
Subtotal	385		495	28.57%	538	39.74%
Barraba	42	Gwydir	158		165	
Bingara	50	Liverpool Plains	131		120	
Manilla	47	Tamworth Regional	517		520	
Murrurundi	43	Upper Hunter	202		193	
Nundle	24					
Parry	86					
Quirindi	82					
Scone	95					
Tamworth	305					
Yallaroi	78					
Subtotal	852		1008	18.31%	998	17.14%
Albury	434	Albury	466		453	
Corowa	82	Corowa	106		112	
Culcairn	41	Greater Hume	149		122	

[27] Jeff Tate, *Assessing processes and outcomes of the 2004 Local Government boundary changes in NSW*, June 2013, p. 17
[28] OLG, *Comparative Information on NSW Local Government Councils for 2013/2014*

Holbrook	42					
Hume	68					
Subtotal	667		721	8.10%	687	3.00%
Bathurst	287	Bathurst	350		353	
Coolah	72	Lithgow	189		187	
Coonabarabran	100	Mid-Western	275		288	
Evans	44	Oberon	80		78	
Lithgow	179	Warrumbungle	192		185	
Merriwa	62					
Mudgee	188					
Oberon	68					
Rylstone	59					
Subtotal	1059		1086	2.55%	1091	3.02%
TOTAL	**4154**		**4641**	**11.72%**	**4656**	**12.08%**

By way of explanation, Tate claims that results are not surprising as "…typically savings are put back into providing new or improved services"[29].

Employment Protection Provisions

- The employment protections contained within the *Local Government Act 1993 (NSW)* (the Act) can be summarised as follows:
- Employees of a council affected by a proposal cannot be forcibly made redundant during a proposal period – section 354C of the Act.
- Employees who have transferred as the result of an amalgamation cannot be forcibly made redundant for a period of three years after the amalgamation – section 354F of the Act.
- Employees who have transferred as the result of an amalgamation continue on the same terms and conditions of employment as applied to them at their previous Council – section 354D.
- Where an amalgamation has occurred in a centre of population of 5000 or less people (a rural centre), amalgamated council must ensure that the staff numbers employed at the rural centre are maintained at not less than the pre-merger level, so far as reasonably practicable.

k) The known and or likely costs and benefits of amalgamations for local communities

There are certainly significant costs associated with amalgamations. Many of those that relate to council operations are readily identifiable. These include the initial transitional costs associated with:

- integration of information technology
- harmonising rates, fees, charges, planning instruments, service and regulatory functions

[29] Jeff Tate, *Assessing processes and outcomes of the 2004 Local Government boundary changes in NSW*, June 2013, p. 17

- staff and premises relocation and displacement
- integration of employees and managements
- redundancy costs for senior management
- community consultation and information
- branding and identity of the new council

These costs alone will exceed the incentives offered for amalgamation under the Fit for the Future (FFTF) program. This is evidenced in the research commissioned by many councils to support their FFTF submissions, which concludes that the costs of amalgamation could be many times more than the NSW Government is offering councils to merge. For example, a report on the merger business case for Dungog and Maitland Councils indicated transition costs would be $6.5 million while FFTF assistance funding would only be $5 million.

The likely benefits of amalgamation are less certain, and not as easy to measure objectively. Furthermore, with the substantial transitional costs, any benefits are unlikely to be realised in the short term, only the medium to long term.

l) The role of co-operative models for local government including the 'Fit for the Futures' own Joint Organisations, Strategic Alliances, Regional Organisations of Councils, and other shared service models, such as the Common Service Model

Even though Local Government has already been very successful in implementing co-operative models, there is widespread agreement that Local Government will need to strengthen its capacity and position as a sphere of government. There is no single 'right' approach to improvement and reform, but enhanced regional collaboration – both amongst councils and between Local and State Governments – has a key role to play. In regard to Joint Organisations (JOs), it will be critical that benefits flow to Local Government and communities, not just to the State Government in the form of having fewer Local Government entities to deal with.

A paper prepared by LGNSW[30] discusses various aspects of regional collaboration and shared services, drawing on a series of extracts from a number of recent reports and research articles. The paper is available on the LGNSW website and the following excerpts from this paper are relevant for consideration here:

- *Advocates of regional cooperation argue that a well-established regional organisation undertaking a range of shared services, joint planning and special projects can achieve significant cost savings and service improvements, develop additional 'strategic capacity', and at the same time retain the benefits of smaller councils – in particular a high level of local political representation and responsiveness to community needs. During the 'noughties', and especially following the forced council amalgamations of 2004, the NSW Government gave strong 'in principle' support for regional cooperation, resource sharing and shared service delivery amongst councils (NSW Department of Local Government 2007). Advisory material was produced and various forums held. Often-quoted examples of 'good practice' include the Riverina East Regional Organisation of Councils (REROC), the Hunter Councils group, the Lower Macquarie Water Utilities Alliance, and the Wellington-Blayney-Cabonne (WBC) 'strategic*

[30] LGNSW, *Regional Collaboration and Shared Services – Background Paper*, April 2015

alliance'. 'Binding alliances' of local water utilities were advocated in the 'Armstrong-Gellatly' report of 2009 as an alternative to regional water corporations: their key feature was that infrastructure assets and local workforces would be retained by individual councils. Similarly, the WBC alliance was established specifically as an alternative to amalgamations, and is strongly focused on resource sharing.
A number of regional alliances work across state borders, notably the South East ROC which includes the ACT as an active member; Tweed Council's participation in South East Queensland regional arrangements; and a number of council groupings that cross the Murray River[31].

- *The functions of JOs will be explored through the Pilot process but at this stage 'core' functions appear limited to regional strategic planning and prioritisation, intergovernmental collaboration and regional advocacy. Regional service delivery (i.e. shared services) has been considered optional and the future relationship of County Councils, water utility alliances and regional roads groups will need to be negotiated with the new Joint Organisations*[32].

- *Regional collaboration can take a number of different forms and in most cases a combination of mechanisms will be required (e.g. shared services delivery amongst councils plus new approaches to regional strategic planning plus closer working relationships between councils and State agencies). This means that clear, agreed objectives are an essential starting point: the primary purpose of regional collaboration will differ from place to place and arrangements need to be tailored accordingly. Different approaches may 'succeed' or 'fail' depending on the circumstances of the case.*
  Two key messages seem very clear:
  - *Loose and purely voluntary (opt-in/opt-out) regional collaboration is less likely to deliver solid, long-term gains.*
  - *Developing and maintaining effective arrangements for a substantial package of shared services is a very demanding task that requires high-level skills in leadership and management, coupled with continuing trust and good will amongst the partner organisations. Again, this has proved to be a rare combination.*

  What is needed now is a willingness to take a hard look at potential opportunities arising from the introduction of JOs, current and past practice in NSW; compare results with those achieved elsewhere; learn from experience; and develop new models that will be 'fit for the future'[33].

m) How forced amalgamation will affect the specific needs of regional and rural councils and communities, especially in terms of its impact on local economies

It is unclear how forced amalgamation would ultimately affect the specific needs of rural and regional communities, especially in terms of impacts on local economies. As previously noted, success depends on a multitude of factors.

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[31] LGNSW, *Regional Collaboration and Shared Services – Background Paper*, April 2015, p.3
[32] LGNSW, *Regional Collaboration and Shared Services – Background Paper*, April 2015, p.16
[33] *ibid*.

Rural councils have genuine concerns that forced amalgamations will lead to the loss of services and jobs in their communities. This could occur through rationalisation or relocation of positions.

Their concerns do not end there; they fear the well-known snowballing effect of the loss of jobs and services on fragile rural economies. Councils are frequently the largest single employer in rural areas. Further, to a greater degree than metropolitan areas, councils are the hub of rural communities, helping provide community cohesion and identity. It is not surprising therefore that in a recent piece of a social research on community attitudes to local government, ACELG found that "respondents living in rural and remote areas are generally more concerned about the consequences of amalgamation on local representation, cost of rates and services and their sense of belonging to the local area"[34].

These concerns would need to be addressed in any amalgamation. However reports on the longer term results of such amalgamations in 2004 indicate that many rural councils have probably benefited in many respects from amalgamation with a larger and better resourced regional council.

n) Protecting and delivering democratic structures for Local Government that ensure it remains close to the people it serves

Councils are close to their communities and have a unique insight into local and community needs. Councils determine service provision according to local needs and the requirements of state and territory local government legislation. The larger a council becomes in population size or area the more remote it is likely to become from communities in terms of accessibility and participation. This is particularly so where elected representation is not proportionately increased. This is sometimes referred to as 'democratic deficit'.

In the above-mentioned research, ACELG found that "The impact of amalgamation that respondents are most concerned about is on how their interests are represented by councillors. Over half (52%) think that representation of their interests will get worse or much worse."[35] In terms of democratic involvement of people in their local areas, this study also found that:

> *"There is strong support for very participatory styles of democratic engagement by government with its citizens. Australians want to be involved by government in making decisions about what services are delivered in their local area. Nearly all (93 per cent) want to be personally involved with over half (51 per cent) reporting they strongly agree that government should involve them in decision-making."*[36]

The ILGRP recommended that sub council 'Community Boards' or otherwise named Precinct or Neighbourhood Committees be set up "to provide representation and some service delivery at suburb or district level within very large metropolitan councils, including following amalgamation – perhaps as a transitional measure in the latter case".[37] LGNSW would recommend that councils in this situation consider this option.

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[34] ACELG, *Why Local Government Matters*, June 2015, p. iii
[35] ACELG, *Why Local Government Matters*, June 2015, p. 134
[36] [36] ACELG, *Why Local Government Matters*, June 2015, p. 27
[37] ILGRP, *Revitalising Local Government – Final Report*, October 2013, p.93

o) The impact of the 'Fit for the Future' benchmarks and the subsequent IPART performance criteria on councils' current and future rate increases or levels

There is an expectation that achievement of the benchmarks for the criteria will place upwards pressure on rates in council areas that are currently below benchmark levels in the short to medium term while these councils work towards achieving the benchmarks. Improving the Operating Performance Ratio while reducing Infrastructure Backlogs and increasing Building and Infrastructure Maintenance expenditure will inevitably create pressures to increase revenue. This will not be met solely by cost cutting or potential cost savings.

Observation of the outcomes of past amalgamations provides no substantial evidence that rates will decline, rather it strongly indicates that they will increase. Once the required settings are achieved it could be expected that increases will taper off or normalise.

It should also be noted that future rate increases will not be solely driven by amalgamations or the FFTF process. There are a multitude of influencing factors including NSW and Australian Government policies and practices, for example, cost shifting and the FAGs freeze.

p) Any other related matter

'Orphan' councils

Several councils that were given the ILGRP's preferred option to merge have a willingness to do so but have not been able to find a neighbouring council which would agree to amalgamate, thus leaving them 'orphaned' in this process. Unless it fulfils the Rural Council characteristics, the council had no other option but to submit a Template 2 proposal.

It is unclear how IPART proposes to treat the assessment of these councils. LGNSW holds a firm view that those councils which sought to engage in merger discussions with their neighbours, but have had to default to submitting a Template 2 proposal, should not be disadvantaged by being given an "unfit" rating. These councils that wished to submit a merger proposal but could not find an agreeable amalgamation partner should not be denied the opportunity and benefits of being 'fit for the future' such as cheaper loans etc.

Provisions for de-amalgamating councils

If forced amalgamations do proceed in NSW, de-amalgamation cannot be entirely dismissed, as demonstrated by the experience of de-amalgamations of several councils in Queensland following forced mergers less than five years before. Should the NSW Government force councils to amalgamate, it will be necessary to ensure there are legal provisions to facilitate de-amalgamation where it is in the interests of, or the will of, the communities involved.

The Innovation Fund - Funding for Small Rural and Regional Councils

The $4 million FFTF Innovation Fund provides welcome additional money for rural and regional councils but will not be enough to support all the councils that really need it. The sum was allocated when the Government had plans to impose a 'one size fits all' rural council model but these plans were abandoned and the allocation of funding needs to catch up with the current expectation that these councils will be on a long term improvement journey towards sustainability. In reality the funding only provides a fraction of the support required.

Attachments

Attachment A:
Independent Review of TCorp's Report 'Financial Sustainability of the NSW Local Government Sector' by John Comrie – October 2014

Attachment B:
Independent Review of FFTF Criteria (Supplementary) by John Comrie – February 2015

Attachment C:
FFTF Assessment Criteria & Benchmarks –Guidance & Advice to Expert Panel by FFTF Assessment Criteria and Benchmarks Working Group

Attachment A

Review of TCorp's Report *'Financial Sustainability of the NSW Local Government Sector'*

Final Report 3 October 2014

John Comrie
JAC Comrie Pty Ltd

Contents

1. Introduction

The New South Wales Treasury Corporation (TCorp) April 2013 report, *'Financial Sustainability of the New South Wales Local Government Sector',* (TCorp report), was informed by its detailed assessment of each council's own published financial reports.[1] Based on its analysis, TCorp gave at that time approximately 75% of councils a moderate or better financial sustainability rating and 25% a weak or worse rating.[2] It also looked at councils' forward financial projections and concluded that without a change in their financial strategies the financial sustainability outlook rating was positive for only 3% of councils, neutral for 49% and negative for the remainder.[3] It suggested that if nothing changed 48% of councils could have a weak or worse rating within 3 years.[4] TCorp also emphasised that the local government sector had been reporting that it had significant asset renewal backlog needs.

Many councils expressed concern at the rating TCorp attached to their financial sustainability. Local Government New South Wales, (LGNSW), recently engaged Mr John Comrie to undertake a review of the TCorp report and in particular to provide an evaluation of the basis by which TCorp assessed the financial sustainability ratings and outlooks of NSW councils.[5]

2. Basis of TCorp's Ratings of Councils

TCorp developed the following definition of financial sustainability in local government:

> *A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure agreed with its community.*

TCorp based its assessments on the audited financial statements and other publicly available financial information prepared by councils. It looked not only at 2011/12 financial reports but those for the previous three years too (and attached a greater weighting to

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[1] The TCorp report and those it prepared for each individual council are available at http://www.olg.nsw.gov.au/strengthening-local-government/local-government-reform/TCORP-financial-assessments

[2] See TCorp Report Table 1.

[3] See TCorp Report Table 2.

[4] TCorp's analysis focussed primarily on councils' 'General fund'. It did not explicitly consider financial matters relating to councils' 'water' or 'sewerage' funds (bit did have regard to any significant matters) and neither does this report.

[5] John Comrie operates a consultancy, JAC Comrie Pty Ltd, specialising in local government financial sustainability matters. He conducts training courses and has written much of the guidance material on this and related topics for the South Australian Local Government Association, the Institute of Public Works Engineering Australasia (IPWEA) and the Australian Centre of Excellence for Local Government (ACELG). Further details regarding his experience are available at www.jaccomrie.gov.au.

more recent financial information). It also examined councils' forward financial projections reported in their adopted long-term financial plans. It thus focussed on trend data and its assessments were therefore not materially affected by abnormal one-off events. It also spent time with each council discussing the council's data (and made adjustments in its analyses for any errors or omissions that may have been detected). It also invited each council to review its draft assessment and associated report before finalising its work.

TCorp's assessment of each council's financial sustainability outlook and rating was based on scores that were generated for 10 indicators the results for which were calculated from each council's data. Some indicators were given a higher weighting than others. A value was attached to the score a generated for each indicator based on whether it met TCorp's benchmark score and if not how close it was to the benchmark.

A rating was then attached to each council's overall weighted score in the range; Very Strong, Strong, Sound, Moderate, Weak, Very Weak and Distressed. A Moderate rating was considered to be the minimum acceptable level to be assessed as financially sustainable. To achieve a 'Moderate' rating a council effectively needed to achieve performance at levels at or near the benchmark target scores for each of TCorp's 10 indicators.[6] TCorp also generated an 'Outlook' rating (Positive, Neutral or Negative) for each council based on its forward projections and an assessment of the assumptions and availability and reliability of data that underpinned those projections. TCorp's definitions for its various financial sustainability rating categories and outlook classifications are included in Appendix I.

TCorp noted (p.36) '*that for many Councils, there is still much work to be done in upgrading their IP&R* (Integrated Planning and Reporting) *documentation and their 10 year LTFP* (long-term financial plan)*. As this occurs, it may be that some of the Negative Outlooks would be removed'.* It also highlighted in various parts of its report that work was ongoing by councils to improve the reliability of accounting data such as depreciation estimates and forecasts of renewal needs. There is still considerable work to do in this regard but if the same review was undertaken today with available updated information then some and possibly many councils would be likely to receive more favourable results. Updated information for others though could generate less favourable ratings and outlooks.

[6] It should not be assumed that a rating above 'moderate' should necessarily be aspired to. Depending on the needs and circumstances of a council and its community a 'moderate' rating may be perfectly acceptable. In fact a 'very strong' rating could indicate a council is generating or is forecast to generate more revenue relative to the range and level of services provided than is absolutely necessary.

These 10 financial sustainability indicators applied by TCorp in its analyses were grouped in four categories. Details of the categories, their weighting in the overall rating and each indicator are listed below.

Financial flexibility (35%)

i). *operating ratio (17.5%)*

ii). *own source operating revenue ratio (17.5%)*

Liquidity (20%)

iii). *cash expense ratio (10%)*

iv). *unrestricted current ratio (10%)*

Debt servicing (10%)

v). *debt service cover ratio (7.5%)*

vi). *interest cover ratio (2.5%)*

Asset renewal and capital works (35%)

vii). *infrastructure backlog ratio (10%)*

viii). *asset maintenance ratio (7.5%)*

ix). *building and infrastructure renewals ratio (7.5%)*

x). *capital expenditure ratio (10%)*

Given that more weighting was assigned to some indicators than others in assessing overall performance, a council's rating depended more on how well it scored for some particular indicators compared with others. Further details regarding the basis of calculating the indicator score and the benchmark score for each indicator are provided in Section 3 and in more detail in Appendix II.

3. Assessment of TCorp Methodology

I am very comfortable with TCorp's definition of what financial sustainability should be interpreted to mean in a local government context and of its approach of focussing on recent financial data (including forward financial projections) produced by councils and giving consideration to the availability of evidence to support the reliability of that information. I am also supportive of its general conclusions regarding the financial sustainability of the NSW local government sector and especially its associated recommendations. This is so even though I am not convinced that all indicators it has applied and the basis of their calculation or the weighting they have been assigned in its analysis are optimal for this purpose.

My reservations regarding aspects of the TCorp methodology stems primarily from the fact that TCorp has scored councils using indicators that in some instances are more appropriate for financial assessment of entities operating in the business world. I accept that it is important that councils operate efficiently and in many respects in a business-like manner. However I do not see local government as an industry but as a sphere of government and believe that indicators used to assess the financial sustainability of councils should be more consistent with those applied to assess state governments' financial circumstances and capacity. I agree that particular attention also needs to be given to the asset management responsibilities and capacities of councils also but am not convinced that the methodology applied by TCorp is optimal in the circumstances.

It is important that tools and measures that are used to assess the financial circumstances and capacity of an entity have regard to its operating environment and in particular the reliability of its future income streams and the nature of service level responsibilities. Governments for example typically have more reliable income streams than individuals and private sector businesses. They have taxing and charging powers and such revenue can be increased subject to political and longer-term economic considerations. They also have at least some discretion over the range and level of services provided and are generally able to borrow more (and more cost-effectively) than corporates because there is less risk for lenders of not being repaid.

Local governments in NSW have some (but not full) control over their revenues and service level outlays. It is also noteworthy that they have more control over their net financial inflows and outlays than the state and federal governments.[7] Local governments' costs are heavily influenced by the provision and ongoing maintenance and renewal of long-lived assets (typically infrastructure and to a lesser extent buildings). Their outlay needs associated with provision of service from such assets can vary significantly between periods. This may be so even if service provision and population and properties served remain relatively constant over time, e.g. because there will be peaks and troughs in asset renewal needs between periods.

My views regarding TCorp's indicators are outlined below. The reasons why I am nevertheless comfortable with its general findings and recommended ways forward are documented in Section 4 of this report.

[7] Councils on average generate far more own source revenue than state governments. The income and outlays of both the state and federal governments are also far more sensitive to changes in economic conditions than is the case for local governments.

i). Operating Ratio

This ratio measured the annual cost of as council's current ongoing service provision (i.e. its operating expenses) relative to operating revenue (excluding capital grants and contributions). A council's score for this ratio measured relative to TCorp's benchmark of 'Better than negative 4%' was given a weighting of 17.5% in its overall assessment.

I am a strong advocate for this indicator and argue that generally speaking a council should base its capital expenditure, service level and revenue raising decisions on achieving a modest (say typically up to 10%) underlying (i.e. net of material abnormal revenues and expenses) operating surplus ratio (net of capital revenue, i.e. revenue required to be spent on acquisition of assets) on an ongoing basis (including in its long-term financial plan forward projections). If this can be achieved then a council's service levels would always be sustainable and it would have the capacity to renew and replace assets as required (even if that necessitated raising additional debt at times and repaying it in subsequent periods). I emphasise several times in this report the importance of a council ensuring its service levels are affordable over time. By affordable I mean that a council can maintain achievement of an appropriate operating surplus target.

Given the above I would argue for the operating ratio to be given a much higher weighting in an assessment of councils' financial sustainability that the 17.5% allocated in TCorp's assessments (say at least 50%). I would also argue for a higher benchmark than 'Better than negative 4%' (say usually to at least a breakeven result). During discussions with TCorp representatives they pointed out that if it had used a higher weighting for this ratio more councils would have received more adverse overall assessments. TCorp for example notes that in 2012 only one third of councils (50) reported an operating surplus but that 52% had an operating result of better than negative 4%.[8]

An arguable weakness of this indicator is that depreciation represents a very large proportion of the total operating expenses of councils on average. The reported level of a council's depreciation expenses can therefore have a big bearing on its operating result and can be difficult to reliably estimate. This estimate is nevertheless far too important to disregard. Councils' services are asset intensive. Recognition of the cost of asset consumption is a critical component of assessment of councils' financial and service level sustainability. The key therefore is to ensure that auditors and management teams pay careful consideration to the basis of their councils' annual estimates of depreciation expenses and that councils generally aim for modest (but not excessive) underlying annual operating surpluses over the medium term. Such a strategy (rather than a breakeven result) would help offset the risk that past estimates of annual asset depreciation may have been understated.

[8] See TCorp p.7 and p.40.

ii). Own Source Operating Revenue Ratio

This ratio measures the extent of a council's reliance on external funding sources. It is calculated by expressing a council's rates, utilities and charges revenue for a period as a ratio of its total operating revenue (inclusive of capital grants and contributions) for the same period.

I see merit in this type of indicator but would argue for refinements. First of all I suggest that consideration should be given to including financial assistance grants revenue in the numerator (or at least having an additional indicator that included such that was given equal weighting with this one). Such revenue is in the main a reliable source of revenue for local governments (despite the Commonwealth's decision to hold the quantum constant in nominal values over the three years following 2013/14). For many rural councils with small populations financial assistance grants are a major source of revenue that they should comfortably rely on in planning affordability of future proposed works and services. (I would not make the same arguments in relation to Roads to Recovery or other grants which unlike FAGs would not require legislative change for their availability to be discontinued or annual quantum reduced). The basis of distribution of the available FAGs pool is such that councils with greatest needs for FAGs receive a higher share.

Secondly I question the inclusion rather than exclusion of capital revenues in the denominator. Such revenues can be both significant relative to other operating revenue and lumpy over time. I'd claim the circumstances of two councils that had the same score for this indicator but where one had significant capital revenues and the other didn't were not identical. This is notwithstanding the fact that receipt of capital revenues will generally consequentially lead to higher operating costs for a council in future. (A large share of capital revenues is from developer contributions and development will lead to future higher operating revenues too.)

TCorp suggests that this measure is an indicator of a council's 'fiscal flexibility'. I accept it is an indicator of to what extent it has influence over its annual revenue quantum and that such information has some value in this regard. Given the nature of councils' operating environment and service delivery responsibilities I'm not convinced though that significant 'financial flexibility' is a critical consideration.

A council's score for this indicator measured against TCorp's benchmark of 60% was given a weighting of 17.5% in determining its overall assessment. I believe this indicator (modified as discussed above or not) should not be attached as great a weighting in assessing financial sustainability as the Operating Ratio.

iii). Cash Expense Cover Ratio

This ratio, the score for which was given a weighting of 10%, measured a council's cash and cash equivalents at year end relative to its average monthly outlays for the year. It thus was an indicator of the number of months a council could continue paying for its immediate expenses without additional cash inflow.

The score for such an indicator can be an important consideration for a private sector entity (or others interested in its performance and capacity). Uncertainty may exist for such entities regarding future revenue streams and capacity to borrow at short-notice to meet cashflow needs. By comparison most local governments' future revenue inflows are relatively reliable and future expenditure outflows reasonably predictable. Most would also be able to borrow at short notice if unforeseen circumstances arose (and could establish such facilities as a safeguard in advance of any such financing needs).

There is an opportunity cost from holding cash and cash equivalents (including term-deposits) in excess of immediate cashflow needs. My ACELG Working Paper on the role and use of debt argues that councils should adopt treasury management practices that generally reasonably minimise their cash holdings to reduce net interest costs and interest rate risk exposure (e.g. by repaying debt (and ensuring a significant share of their debt is structured in a way so that this can occur) and by deferring an otherwise need to raise debt).

NSW councils current treasury management practices are far from optimal but are generally consistent with guidance instructions that have traditionally been in place. In the circumstances I can understand why TCorp made use of the Cash Expense Cover Ratio indicator in its analyses. I would not though recommend its use in future and would instead encourage assessment of performance relative to treasury management approaches applicable to the circumstances of the local government environment.

iv). Unrestricted Current Ratio

Councils' score for this ratio relative to TCorp's benchmark of 'greater than 1.5' attracted a weighting of 10% in a council's overall assessment. It was calculated by comparing a council's current assets (net of monies with external restrictions on their use) with its current liabilities (net of specific purpose liabilities).

The current ratio is a commonly used liquidity ratio applied in the private sector to assess an entity's ability to meet short term obligations as they fall due. TCorp made refinements to the usual basis of calculating that indicator to take account of the fact that councils often hold significant monies that can only be applied for specific purposes and cannot be used to meet other outlay needs. Regardless of these adjustments, and as highlighted in iii) above, I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

TCorp's benchmark for this indicator favours councils holding a large (i.e. a conservative level) of unrestricted current assets. I would argue many councils would be better served in future by targeting a considerably lower unrestricted current ratio score than the TCorp benchmark. This could in many instances reduce both a council's net interest costs and interest rate risk exposure. Before implementing such a strategy a council should establish sound treasury management policy frameworks relative to their circumstances and ensure that they have complementary levels of knowledge and understanding by responsible staff.

v). Debt Service Cover Ratio (DSCR)

This ratio was given a weighting of 7.5% in each council's overall assessment. It measured a council's operating result before interest and depreciation (effectively approximately net operating cash inflow) relative to repayments of debt (principal amounts) and interest costs on debt.

This ratio is commonly used in the private sector to assess the capacity of a borrower to take on and repay borrowings. The fact that local governments' service responsibilities are very asset intensive and that their ongoing revenue streams are typically more reliable and expenditure needs reasonably predictable means it will often be appropriate for councils to carry large stocks of borrowings (In order to finance asset acquisition and then equitably fund associated costs over time from taxes and charges on service recipients). As such a council could possibly appropriately have a higher level of debt (and a lower debt service cover ratio score) than what may be warranted for entities in various private sector industries.

TCorp applied a benchmark of 'greater than 2 times' in assessing councils' performance for this indicator. All other things being equal this meant that a council that repaid debt more quickly (as I would advocate it should if it had cashflow capacity available) would receive a lower score than one that repaid it less quickly. This is because the former council would incur higher principal repayments (albeit over a lesser number of periods) and the denominator in its scoring for the indicator would therefore be larger.

My preference would be for councils to base service level decisions on long-run affordability and generally borrow only when cashflow needs warrant and for borrowings to be structured in ways that allow repayment arrangements to minimise net interest costs and interest rate risk exposure. Structuring loan repayment arrangements to achieve a higher DSCR score could in fact add to a council's net interest costs and interest rate exposure risks.

vi). Interest Cover Ratio

This ratio, the score for which was given a weighting of only 2.5%, is intended to provide an indication of the extent to which a council can service its interest bearing debt and take on additional borrowings. Its calculation was based on a council's operating result before interest and depreciation for a period relative to interest costs from borrowings for the same period.

TCorp indicated in discussions that its benchmark of 'Greater than 4.0x' for assessing councils' performance is commonly applied in the private sector. For reasons highlighted elsewhere (see e.g. item v) above in this section) I question the merit of applying liquidity and debt servicing indicators to financial assessments in the local government sector given the differences in operating circumstances.

The circumstances of some councils are that they could and should appropriately carry more net debt (e.g. often those that need to meet infrastructure upgrade costs associated with growth) compared with others. Such councils may therefore be warranted in having a lower interest cover ratio result than others.

vii). Infrastructure Backlog Ratio

This ratio identified a council's reported asset renewal backlog relative to the total reported value of its depreciable buildings and infrastructure. A council's score for this indicator was given a weighting of 10% in calculating its overall assessment.

In calculating a council's score, TCorp based the council's asset renewal backlog on its reported Special Schedule 7 forecast of the estimated cost to bring assets it was responsible for up to a satisfactory condition. The basis of information reported in that document is quite variable between councils. Special Schedule 7 is unaudited and interpretations as to what is needed and what constitutes satisfactory condition are necessarily subjective. Answers to this question will depend on the willingness of service recipients to pay (and also whether there is a perception of the possibility of grants from others to fund such expenditure) and consideration by a council of its community's other needs and priorities.

My report for the Independent Panel last year highlighted concerns with the basis of the reporting requirements of Special Schedule 7 and reliability of reported data. TCorp in its report also highlighted concerns with the reliability of data and consistency between councils as to the basis of reported backlogs. I also suggested in my report for the Independent Panel that many councils have considerable capacity to address reported asset management backlog needs by taking on additional debt but appear unwilling to do so suggesting either a lack of confidence in reported 'needs' (and/or an unwarranted fear of debt).[9]

I appreciate that there is considerable ongoing work being undertaken by councils to refine the reliability and basis of their asset renewal backlogs. Some councils have reported very significant revisions of their estimates post the finalisation of the TCorp report. Even with these refinements it will always remain problematic to compare one council's reported backlog quantum with that of another or to add all councils' figures and arrive at an

[9] See in particular Sections 3.3 and 3.4 of 'Roadmap to Financial Sustainability for Local Governments in NSW'.

estimated renewal backlog for the sector. The point at which an asset should be renewed is not definitive. It will depend to a large degree on the circumstances and subjective preferences of individual councils.

Rather than focus on the content of Special Schedule 7 in evaluating asset management needs a better approach would be to consider the content of councils' asset management plans (I acknowledge that the reliability of data therein is often still being refined). Such plans should be of course consistent with a council's long-term financial plan and therefore the achievement of their financial targets (thus forcing councils to wrestle with and make judgement calls in preparation of these documents regarding trade-off choices between service level preferences and service recipients' willingness and capacity to pay).

viii). Asset Maintenance Ratio

This ratio, the score for which was given a weighting of 7.5% in each council's overall assessment, measured actual asset maintenance expenditure relative to the asset maintenance expenditure for the period that the council deemed was warranted in its Special Schedule 7 report.

In theory I have no argument with the indicator or its assigned weighting. Councils need to make service level (and therefore asset maintenance level) decisions that are consistent with likely long-run revenue availability (which will to varying degrees depend on a council's capacity and willingness to generate own source revenue). A ratio of less than one may mean:

a) Available revenue is less than is needed to accommodate justified maintenance levels for a given preferred level of service. If so (and assuming this is the projected ongoing scenario) then a council needs to act to either generate more revenue or accept a lower level of service (and lower associated maintenance costs); and/or,

b) Available revenue is adequate to accommodate justified maintenance levels for a given preferred level of service but the council has chosen (implicitly or explicitly) to spend a lower amount on maintenance. That is, whether it realises it or not it has effectively decided that it prefers to utilise available funds in other ways – if so reported warranted maintenance expenditure is not in fact consistent with a council's preferences.

A council always needs to ensure that actual and future planned maintenance levels are consistent with warranted maintenance levels. It can do this by ensuring its asset management plans are based on preferred and affordable service levels and annual expenditure budgets are generally consistent with asset management plans.

Some people sometimes claim that it would be cost-effective but unaffordable to spend more on maintenance. This makes no sense. A council may be financially challenged but if it would really save money over time by spending more on maintenance now it should do so –

even if it needed to borrow additional money. In reality what they often mean is that a council's existing budget decision-making process has not delivered asset maintenance funding levels consistent with what such individuals prefer.

It is clear that there is a high degree of variability in the Special Schedule 7 reported needs of councils. This is likely to be so even for councils in similar circumstances. This often reflects differences in viewpoints of 'needs' between councils. Reported 'needs' should be based on long-run affordable service levels and if they are not then it is hard to make any conclusions regarding relative asset maintenance performance of councils. Differences in scores generated between councils for the asset maintenance ratio indicator will reflect this variability in the basis of reported Special Schedule 7 maintenance 'needs'.

ix). Building and Infrastructure Renewals Ratio

This ratio measured asset renewal expenditure relative to the recorded annual depreciation expense for the same classes of assets (i.e. buildings and infrastructure). Each council's score was given a weighting of 7.5% in its overall assessment.

Intuitively it seems reasonable to assume that this ratio score should be about 100% as that would mean that infrastructure asset renewal expenditure over any particular period of one or more years was approximately offsetting the decline associated with age and use in the service potential of existing assets. In practice though there may be good grounds why a ratio of substantially more or less than 100% is more appropriate.

The weighted average life of local governments' stock of depreciable assets is typically very long (often 40 years or more). Annual average asset renewal needs for classes of assets like stormwater drainage, road pavements and buildings are unlikely to be constant over time. They are likely to be periods of peaks and troughs. Rather than spend an amount on asset renewal each period consistent with annual depreciation, a council would be better advised to undertake asset renewal in accordance with levels and timing outlined in a soundly based asset management plan.

An indicator comparing asset renewal with depreciation can prove a useful guide of performance for individual classes of assets that have a significant stock of items and that have relatively short lives (e.g. plant and sheeted roads) or for councils that do not have material levels of long-lived assets (e.g. rural councils with large sheeted road networks).

South Australian councils were required to report asset renewal relative to depreciation for several years but results proved generally an inconclusive indicator of warranted performance. Now that SA councils have had several years' experience with asset management planning they are instead required to report (in their budgets, financial statements and long-term financial plans) asset renewal expenditure levels relative to asset management plan identified renewal needs for the same period.

x). Capital Expenditure Ratio

This ratio measured a council's annual capital expenditure relative to its annual depreciation for the same period. Each council's score was given a weighting of 10% in its overall assessment.

TCorp suggested that the indicator measures the extent to which a council is expanding its asset base (and used as a benchmark a score of 'greater than 1.1'). I accept that low ongoing scores for this indicator may indicate an under-investment in service providing capital works but such a conclusion will not always be valid. A higher score is likely to be far more warranted and appropriate for some councils (e.g. possibly those that are rapidly growing) than others (e.g. possibly those with a relatively stable or declining population and an asset stock in generally good condition and with a long weighted average useful life).

The fact that the numerator doesn't distinguish between expenditure on new additional assets and renewal of existing assets is also problematic. As highlighted previously expenditure on new assets has a much greater impact on long-run costs than renewal outlays. Furthermore warranted asset renewal can vary significantly between years, particularly for councils with a larger share of long-lived assets relative to classes with shorter useful lives.

Acquiring new additional depreciable assets adds to long-run operating costs. A council that has financial sustainability challenges will quite possibly be adding to those challenges rather than helping to address them by spending on new capital works. It seems potentially anomalous therefore to assume a higher score for such an indicator suggests greater financial sustainability.

In the private sector a firm will of course only invest in additional capital works if it helps it improve its long-term financial performance. The indicator therefore is likely to have more applicability in that context. Local governments have multiple objectives. Acquiring new assets may help meet some strategic social objectives but also adversely impact on financial ones. Their financial objectives are not about maximising long-run profits but instead more about efficiently providing affordable services and equitably generating revenue to pay for them.

4. General Discussion regarding financial sustainability indicators

I have expressed in Section 3 concerns and reservations regarding either the suitability, basis of measurement, weighting and/or benchmark targets (to varying degrees) for each of the indicators applied by TCorp in its assessment of the financial sustainability of NSW councils. Despite this I am comfortable with its overall findings regarding the sector. Its assessment of the reported circumstances is broadly consistent with the one I have formed from various work I have undertaken in recent years.[10] Simplistically this congruence of our assessments can be reconciled as follows:

a) I would give much greater weighting to the underlying operating result of councils which would drag down the overall assessment ratings,

b) I would assign less weight to reported asset management needs and performance and anticipate that this would improve the collective assessed ratings of councils, and

c) I would also assign less weight to liquidity and debt servicing considerations. The impact on overall assessments of this is less clear and would vary between councils.

Even though my assessment for the collective grouping of councils would I anticipate be similar to TCorp's our assessment of individual councils may well be different. Given that I would place more emphasis on some factors and less on others it is likely that I would rate some councils more highly and others less so.

I also believe that many councils (but certainly not all) could potentially be in a better position than the data TCorp necessarily used in its assessments suggests (or certainly can become so over time). It is still relatively early days in terms of councils developing and working with asset management and long-term financial plans and in refining estimates of asset renewal needs and warranted and affordable service levels. My experience (from leading various related training courses throughout NSW) suggests that there is still considerable inconsistency within and across councils regarding the recording and interpretation of asset management and financial data. Progress is being made though in improving data and its interpretation and appropriate responses. Intuitively for example I think it is more likely that councils on average have in the past been overstating rather than understating estimates of annual depreciation and asset renewal backlogs. (It is not uncommon for councils to have in service assets that they have already fully depreciated).

I agree with TCorp that most councils will need to improve their financial performance over time. I am also though of the view that most NSW councils with appropriate guidance and encouragement will be able, with incremental changes in policy settings, to make significant improvement in their financial sustainability over the medium term relative to the assessments and outlooks determined by TCorp in 2013.

In all Australian jurisdictions councils are now required, or at least strongly encouraged, to disclose results for specified financial sustainability indicators in their annual financial statements and long-term financial plans. There is reasonable (but not uniform) consistency in promotion of some particular indicators (and even for these there are some slight

[10] In particular work for the Independent Panel and ACELG listed in the references.

differences in their basis of calculation) but most states also encourage publication of others not widely applied elsewhere.

ACELG and IPWEA's Practice Note 6, Long-term Financial Planning (which I authored) encourages attention on just three indicators in order to maintain a clear and simple focus in strategic financial decision-making.[11] The three indicators are the :

i). Operating Surplus Ratio (same as the (Operating ratio described at item viii) of Section 3),

ii). Asset Renewal Funding Ratio (actual renewal expenditure relative to asset management plan identified needed renewal outlays for the same period),

iii). Net Financial Liabilities Ratio (debt and other financial liabilities less financial assets all expressed as a ratio of operating revenue (exclusive of capital revenue)).

Practice Note 6 suggests that the key to financial sustainability is ensuring a council sets own source operating revenues and service levels such that it will maintain a small operating surplus (including in its future projections) whilst also addressing asset renewal needs as required. In order to achieve these targets it may be necessary for many councils to carry more debt than they have traditionally been comfortable with so doing. My ACELG Debt Paper argues that if councils have reliable financial data and commit to strategies that help them achieve satisfactory targets for their operating surplus ratio and asset renewal funding ratio then they should not fear making greater use of debt.

There has been in-principle interest between jurisdictions in agreeing on a standard set of core financial sustainability related indicators for all local governments across Australia to report against. No significant objections have been raised to the proposal but local priorities in individual jurisdictions have meant that it has not yet been actively pursued to finalisation. The three ACELG and IPWEA recommended indicators are suitable prime financial sustainability indicators for application by NSW councils (or at least can become so over time). Having regard to the current level of reliability of some financial and asset management information and traditional guidance, understandings and practices I acknowledge that there is still some way to go before these indicators would be sufficient by themselves for sound financial sustainable strategy setting by all councils.

From discussions I had with TCorp I believe it may have refined its thinking regarding appropriate financial sustainability indicators and targets as a result of the work it did in preparing its 2013 report and in considering applications by councils for subsidised borrowings through the NSW Government's Local Infrastructure Renewal Scheme.

The NSW Government has recently announced a 'Fit For the Future' reform program. The assessment of councils as being 'fit for the future' will include their performance against six

[11] See Section 7.3 of 'Long-term Financial Planning, Practice Note 6'.

financial sustainability indicators.[12] Those indicators and their benchmarks are set out below:

a) Operating Performance Ratio with a performance benchmark of breakeven or greater over 3 years,

b) Own Source Revenue Ratio (benchmark performance of greater than 60% over 3 years),

c) Building and Infrastructure Asset Renewal Ratio (benchmark performance of greater than 100% over 3 years),

d) Infrastructure Backlog Ratio (benchmark performance of less than 2%),

e) Asset Maintenance Ratio (benchmark performance of greater than 1.0),

f) Debt Service Ratio (benchmark performance greater than 0 and less than 20% of operating revenue excluding capital grants and contributions).

It is not clear at this time how those indicators will be measured. The September 2014 IPART Report indicates that the basis of calculation of the first five may be as per items i), ii), ix), vii) and viii) respectively of Section 3 of this report. The proposed 'debt service ratio' indicator is not the same as item v) (debt service cover ratio) in Section 3. It is based on loan repayments (principal and interest for a period as a percentage of operating revenue).[13] Whether these 6 indicators will be weighted to generate an overall financial sustainability score and if so how is also not known at this time.

It would also appear that indicators iii), (cash expense ratio), iv) (unrestricted current ratio), vi) (interest cover ratio and x) (capital expenditure ratio) (as described in Section 3) will not be applied in 'fit for the future' assessments.

5. TCorp's overall findings and recommendations

As highlighted previously, despite some misgivings regarding TCorp's financial sustainability indicators I am supportive of its report's key findings and recommendations. I have listed below (generally in paraphrased form) some that I think are particularly noteworthy and or wished to comment on. (My comments below are generally restricted to adding to rather than repeating comments made earlier in this report.)

[12] See 'Fit for the Future, A Roadmap for Stronger, Smarter Councils' available at http://www.fitforthefuture.nsw.gov.au/sites/fftf/files/Fit-for-the-Future-A-roadmap-for-Stronger-Smarter-Councils.pdf

[13] I am not a fan of this indicator. Principal repayments are not an accrual accounting expense. I discuss my concerns regarding this indicator more fully in my ACELG Debt Paper (Comrie 2014) where this indicator is described as 'debt servicing ratio' (see e.g. p.22).

i). TCorp provided some recommendations to assist councils in improving their financial sustainability (see p.6 and p.38) These included:

   a) Sourcing additional revenue, e.g. through a Special Rating Variation,

   b) Using debt funding to assist in reducing the Infrastructure Backlog (TCorp noted (p.55 & p.59) that some councils have no debt and significant capacity to repay additional debt, yet report that they have Infrastructure Backlogs),

   c) Devising programs and strategies to contain rising costs and improve efficiencies,

   d) Refining the content of asset management and long-term financial plans and better ensure their consistency (and I would add reviewing service levels upon which they are based, including the timing of provision of new additional capital works, or the upgrade of existing assets to a higher level of service),

   e) Increasing spending on maintenance and infrastructure renewal.

ii). It emphasised the importance of councils aiming to achieve at least breakeven operating positions and developing pricing paths that help them achieve this over the medium term,

iii). TCorp highlighted that debt is underutilised and there are opportunities for it to be structured in a more cost effective manner (p.63 & p65),

iv). It also emphasised that liquidity levels are in some cases overly conservative (p.61) and that treasury management policies need to be reviewed to improve council management of liquidity (p.66). I would add that such policies would also help improve councils' use of debt. TCorp also suggested that there should be a review to consider improved use of restricted funds. In my view greater 'internal borrowing' between funds by councils if carefully managed could generate very significant overall savings and reductions in councils' interest rate risk exposure,

v). TCorp noted that reported infrastructure backlogs are not audited and require further refinement,

vi). It stressed that the provision of capital grants to build new additional assets or upgrade existing assets to higher levels of service can adversely impact on financial sustainability (p.63). I would argue that councils need to consider the impact on their overall financial sustainability and capacity to maintain existing service levels before seeking capital grants to add to their stock of assets and increase service levels,

vii). TCorp identified (see p.48) that the recognition and treatment of depreciation remains a contentious issue amongst some councils and that depreciation rates, expenses and methodologies vary widely. It suggested that further work may be warranted to provide guidance to refine such estimates. I support these findings. Asset consumption (depreciation) is a very significant component of the cost of service delivery in local government. It is as a legitimate a cost as any other a council may incur. The fact that it doesn't automatically result in a cash outlay is irrelevant. Councils should be basing their revenue raising and service level decisions on accrual accounting rather than cash accounting information. In order to be financially sustainable depreciation expenses generally need to be fully offset with revenue,[14]

viii). TCorp suggested that a review should be conducted to ensure a consistent approach to the future auditing of all councils' annual accounts. There is currently in my view some very inconsistent advice and direction being given by auditors and other external advisors to councils regarding appropriate accounting treatments for valuing and depreciating infrastructure assets. Increased guidance or sector-wide oversight is certainly worth consideration,

ix). TCorp suggested a need to enhance the capacity of councillors and their management staff as regards financial management. In my view good progress has generally been made in transitioning from a traditional short-run cash accounting mindset in decision-making but I don't disagree with TCorp's suggestion. It also recommended that increased community consultation will be needed to help improve understanding of and inform decisions regarding service level and revenue raising trade-offs. I agree with this. It will be essential for residents and ratepayers to feel that they've been listened to in order for financial sustainability improving reforms to be accepted and effectively implemented.

6. Case Studies

LGNSW asked that liaison take place with a small group of 3 councils in the preparation of this report and suggested Bourke, Greater Taree and Penrith. All 3 willingly agreed to assist and provided valuable input to help form and refine the content of this report. Brief comments regarding each council follow.

i). Bourke

Bourke was assigned a 'Weak' financial sustainability rating by TCorp in its 2013 assessment and a 'Negative' outlook.

[14] An exception for example may be where a council is satisfied that it would not be justifiable to replace significant depreciable assets in future. In such cases an adjusted lower operating result target may possibly be appropriate.

It scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Own source operating revenue ratio
c) Capital expenditure ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

At the time of TCorp's review Bourke reported a significant asset renewal backlog relative to its total value of infrastructure assets and annual operating income and a forecast gradual reduction in its operating deficit over time. TCorp concluded based on available reported data that Bourke was unsustainable in the medium to long term.

What TCorp effectively meant was that Bourke's service levels appeared to be unsustainable beyond the medium term based on reported information. This scenario was predicted because Bourke's service generating assets (predominantly roads) were being reported as being consumed at a rate in excess of which they were being renewed. TCorp recognised that rural councils serving large land areas with small population bases and large road networks face greater challenges than other councils in achieving and maintaining financial sustainability.[15] TCorp suggested that Bourke needed to review its service levels to ensure that they were set based on what was optimally sustainable on an ongoing basis.

I have no disagreement with TCorp's assessment based on then available information.

TCorp's findings have proved to be a driver for Bourke to look closely at the factors that gave rise to its rating score and what it may be able to do to better meet ongoing challenges. It appreciates that the rating is not an assessment of 'how well it is doing in the circumstances' and recognises it faces more operating environment challenges than many other councils. It also now has an increased appreciation of the value of asset management and long-term financial planning and the importance of ensuring accounting data reliably reflects the value and rate of consumption of infrastructure assets.

Bourke is currently reviewing depreciation rates, expenditure capitalisation policies and asset management needs. Based on evidence to date Bourke recognises that it's previously forecast asset renewal needs and road asset useful lives were more 'aspirational' than reflective of current actual service levels. Work is ongoing but it is reasonably confident that it can maintain current service levels on an ongoing basis and that they are acceptable to its community.

[15] I have argued in my ACELG 'In our Hands' and Independent Panel 'Roadmap to Financial Sustainability' reports that whilst such councils often can and must do more to help themselves they also need additional external financial support. I have suggested that consideration should be given to providing a larger share of the existing pool of Commonwealth Financial Assistance Grants to such councils if an increase in the overall pool of available grants is not able to be secured.

ii). Greater Taree

TCorp awarded Greater Taree City Council a 'Very Weak' financial sustainability rating and a 'Negative' outlook.

Greater Taree scored adversely against TCorp's benchmarks for the following:

a) Operating ratio
b) Capital expenditure ratio
c) Asset maintenance ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

TCorp highlighted that in particular Greater Taree had reported a very high infrastructure renewal backlog (about 25% of the replacement cost of its stock of infrastructure assets) and had forecast large ongoing operating deficits. It also indicated that Greater Taree believed that its reported asset renewal backlog was conservative and could not realistically be reduced without additional funding.

TCorp concluded that Greater Taree was currently in a satisfactory financial position but that '*clearly Council has insufficient financial resources to meet its future capital expenditure requirements or to address its infrastructure backlog'*.[16] I would agree with that assessment if a reasonable degree of confidence could have been attached to the council's then estimates of its annual depreciation expense and outstanding asset renewal needs.

In my September 2013 'Roadmap' report for the Independent Panel I highlighted that depreciation represented about double the share of Greater Taree's total operating expenses relative to the average for all NSW councils even though the council's asset stocks were not above the average proportion (compared with income) of other councils. I indicated then that the council had initiated work to review the basis of its assumptions regarding asset useful lives, depreciation rates and asset maintenance and renewal needs. In fact considerable work had already been commenced by the council well before the TCorp review to resolve the issues of asset renewal needs and service level affordability. TCorp's assessments were not a surprise to the council.

Greater Taree's work to refine its projections and determine appropriate responses is continuing and has been assisted by the introduction in NSW of the local government Integrated Planning and Reporting framework. It is noteworthy that for the year ending 30 June 2013 Council's depreciation expense was $26 million compared with $32 million for the previous two years. Council is anticipating a further reduction of about $4 million in its recorded depreciation expense for 2013/14. Council is currently preparing for a

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[16] P.33 of TCorp's Greater Taree City Council Financial Assessment and Benchmarking Report of Oct 2012.

conversation with its community regarding affordable service levels and asset renewal expenditure.

TCorp also was critical of Greater Taree for preparing its long-term financial plan in real rather than nominal values. This surprised the council because it had relied on the ACELG/IPWEA Practice Note advice recommending use of real values (the document suggests such an approach in order to aid inter-period comparisons). Providing a council adjusts individual classes of financial inputs (e.g. employee costs or rate revenue) for real movements in prices (i.e. relative to the expected general inflation rate) then a long-term financial plan will generate the same outcomes and indicator scores regardless of whether real or nominal input values are used.

iii). Penrith

Penrith scored a 'Weak' financial sustainability rating from TCorp in its 2013 assessment and a 'Neutral' outlook.

It scored adversely against TCorp's benchmarks (generally for most years) for the following:

a) Operating ratio
b) Cash expense ratio
c) Interest cover ratio
d) Infrastructure backlog ratio
e) Building and infrastructure renewal ratio

It is noteworthy that Penrith has well above benchmark levels of own source revenue. This suggests to me that it has considerable control over its own financial destiny. Even if depreciation expenses remained at the levels reported when TCorp undertook its assessment I would claim that Penrith has good capacity to improve its financial performance in future, e.g. by holding service levels reasonably constant and increasing its own rates and charges at an incrementally higher rate than costs over time. I would also argue that it has capacity to borrow considerably more if this was necessary to address justified asset renewal needs.

In the course of my work associated with the preparation of this report Penrith advised that it undertook a comprehensive review of its depreciation methodology post its TCorp assessment. This resulted in its depreciation expense falling from $39M to $19M in 2012/13. I am not in a position to comment on whether this estimate will prove to be a reliable long-run base but simply note that such a change would have had a very material impact on Penrith's score for several of the indicators TCorp applied in its assessment.

Penrith also advised that it felt that the basis of calculation of TCorp's cash expense ratio indicator was excessively restrictive. It is its understanding that TCorp used 'cash at bank' as the numerator for this liquidity ratio and did not allow inclusion of short-dated term deposits that Council had and was able to access with 24 hours' notice. Penrith changed its treasury management practices in order for such monies to be counted in the numerator in 2013. It also understands that from 2014 onwards term deposits will be allowed to be included in the numerator under the coding classifications applied for reporting purposes by the Office of Local Government.

As regards the unrestricted current ratio indicator, Penrith advised that it considers TCorp's benchmark is excessive and although it could easily meet the benchmark it instead conducts its treasury management affairs to achieve a lower target score that saves it money. I concur with its approach.

Penrith believes its reported asset renewal backlog is relatively small and is comfortable with its current and future planned levels of asset renewal expenditure. (This illustrates the point I've made elsewhere regarding the care needed in interpreting reported backlog levels. In some cases they reflect 'what in a perfect world would be nice to do but not now if we had to pay for it'.)

The experiences and responses of the three case study councils highlight the points that I've made earlier throughout this report that councils are still coming to grips with ensuring that their accrual accounting asset related information and their asset management data is consistent and reflective of current service levels and that this information is then used for critical decision-making. This is not surprising and consistent with experiences in other states. Councils Australia-wide traditionally focussed on short-run cash accounting information and it is only in recent years with the emphasis on accrual accounting and the requirement to regularly revalue assets and prepare asset management and long-term financial plans that the shortcomings of the traditional approach are becoming more widely recognised.

7. Conclusions and Summary

TCorp was entitled to rely on the data it used in its analysis but this data prepared by councils is not as robust as it could be. In particular councils are still refining their estimates as regards future asset renewal needs and ensuring that asset useful life and depreciation accounting estimates are closely correlated with actual practice and preferred, affordable service levels.

TCorp's ratings of councils has caused many of them to reflect on their accounting practices and implicit and explicit service levels, including estimates of warranted asset renewal needs. This in itself has made TCorp's work worthwhile. Elected councils, their management teams and communities and others that councils are accountable to should, indeed need to, be able to depend on the reliability of financial information produced by councils to make strategic decisions and judge performance. It is quite likely that if the TCorp review was repeated today with the same methodology but with updated financial data, that some, and possibly many, councils would be likely to receive more favourable ratings and outlooks. Others though could receive less favourable results. There would though at least be a better appreciation by such councils of the reasons for the assessments and what the implications may be and what further actions may be warranted.

I am supportive of TCorp's general findings regarding the sector's financial sustainability and particularly its recommendations to help strengthen councils' financial performance and capacity. This is despite the fact that that I would advocate some differences in the range of financial sustainability indicators applied and in their computational basis and weighting. Such changes would result in some councils getting better and others a less favourable rating.

In my opinion some of TCorp's indicators are more appropriate for assessment of the financial worthiness of private sector entities (and in particular their worthiness to take on more debt) than for a sphere of government. Local governments generally have more reliable revenue streams, discretion regarding expenditure and stable and predictable operating environment than is typically the case for entities in the commercial business world.

I would encourage in particular a prime focus on the current and projected operating result (net of capital revenues) of councils in assessing their financial sustainability. Secondly I would also caution against assessment of asset management performance that involved comparison of asset renewal levels with depreciation. Asset renewal needs can vary significantly over time and may justifiably in any period be at levels higher or lower than depreciation. Thirdly councils generally need to make greater use of debt if they are to cost-effectively manage their service level responsibilities and equitably charge beneficiaries of these services over time. Not only should councils make greater use of debt (subject to having sound financial plans, strategies and policies in place) but they could also benefit substantially from changes in their treasury management practices. As such I would give less regard to liquidity considerations than TCorp has in its assessments.

Acknowledgement

I acknowledge and thank TCorp and the three case study councils, Bourke, Greater Taree and Penrith for the very valuable assistance provided by their representatives in the preparation of this report. All were not only willing to assist but genuinely interested in hearing and understanding other perspectives on the issues discussed.

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APPENDIX I

The TCorp ratings and their definitions are listed below. (This information has been sourced from Appendix 1 of the TCorp report.)

FINANCIAL SUSTAINABILITY RATING

Very Strong

- A local government with a very strong capacity to meet its financial commitments in the short, medium and long term.
- It has a record of reporting operating surpluses.
- It is highly likely to be able to manage unforseen financial shocks and any adverse changes in its business without revenue and/or expense adjustments.
- Its capacity to manage core business risks is very strong.

Strong

- A local government with a strong capacity to meet its financial commitments in the short, medium and long term.
- It generally has a record of operating surpluses and may occasionally report minor operating deficits. It is able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor revenue and/or expense adjustments.
- The expense adjustments are likely to result in only minor changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is strong.

Sound

- A local government with an adequate capacity to meet its financial commitments in the short, medium and long term.
- While it is likely that it may have a record of minor to moderate operating deficits, the local government is expected to regularly report operating surpluses. It is likely able to address its operating deficits, manage major unforseen financial shocks and any adverse changes in its business with minor or moderate revenue and/or expense adjustments.
- The expense adjustments are likely to result in some changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is sound.

Moderate

- A local government with an adequate capacity to meet its financial commitments in the short to medium term and an acceptable capacity in the long term.
- While it has some record of reporting minor to moderate operating deficits the local government may also have recently reported a significant operating deficit.
- It is likely able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, with moderate revenue and/or expense adjustments. The expense adjustments are likely to result in a number of changes to the range of and/or quality of services offered.
- Its capacity to manage core business risks is moderate.

Weak

- A local government with an acceptable capacity to meet its financial commitments in the short to medium term and a limited capacity in the long term.
- It has a record of reporting moderate to significant operating deficits with a recent operating deficit being significant. It is unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business, without the need for significant revenue and/or expense adjustments.
- The expense adjustments would result in significant changes to the range of and/or quality of services offered.
- It may experience difficulty in managing core business risks.

Very Weak

- A local government with a limited capacity to meet its financial commitments in the short to medium term and a very limited capacity long term.
- It has a record of reporting significant operating deficits. It is highly unlikely to be able to address its operating deficits, manage unforseen financial shocks and any adverse changes in its business without the need for structural reform and major revenue and/or expense adjustments.
- The expense adjustments are likely to result in significant changes to the range of and/or quality of services offered and it may need the assistance from higher levels of government.
- It has difficulty in managing its core business risks.

Distressed

- A local government with a very limited capacity to meet its short term financial commitments and no capacity to meet its medium to long term financial commitments.
- It has a record of reporting significant operating deficits.
- To be able to address its operating deficits, meet its medium and long term obligations, manage unforseen financial shocks and any adverse changes in its business, major revenue and expense adjustments and structural reform will be required.
- The local government is unlikely to have the capacity to manage core business risks and may need assistance from higher levels of government.

FINANCIAL SUSTAINABILITY RATING OUTLOOK

Positive

As a result of a foreseeable event or circumstance occurring, there is the potential for enhancement in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

Neutral

There are no known foreseeable events that would have a direct impact on the financial sustainability of the local government. It may be possible for a rating upgrade or downgrade to occur from a neutral outlook, if warranted by an event or circumstance.

Negative

As a result of a foreseeable event or circumstance occurring, there is the potential for deterioration in the local government's capacity to meet its financial commitments (short and/or long term) and resulting change in its rating. However, it does not necessarily indicate that a rating change may be forthcoming.

The TCorp indicators, their basis of calculation and the weightings attached to each in arriving at a council's overall financial sustainability rating is set out below. (This information has been sourced from Appendix 2 of the TCorp report.)

i). Operating Ratio

Benchmark = Better than negative 4%

Ratio = Operating revenue excluding capital grants and contributions – operating expenses /

Operating revenue excluding capital grants and contributions

This ratio measures a Council's achievement of containing operating expenditure within operating revenue. It is important to distinguish that this ratio is focussing on operating performance and hence capital grants and contributions are excluded.

Weighting: 17.5%

ii). Own Source Operating Revenue Ratio

Benchmark = Greater than 60%

Ratio = Rates, utilities and charges Total operating revenue (inclusive of capital grants and contributions)

This ratio measures fiscal flexibility. It is the degree of reliance on external funding sources such as operating grants and contributions. A Council's financial flexibility improves the higher the level of its own source revenue.

Weighting: 17.5%

iii). Cash Expense Cover Ratio

Benchmark = Greater than 3.0 months

*Ratio = Current year's cash and cash equivalents / ((Total expenses – depreciation – interest costs)*12)*

This liquidity ratio indicates the number of months a Council can continue paying for its immediate expenses without additional cash inflow.

Weighting: 10%

iv). Unrestricted Current Ratio

Benchmark = 1.5x

Ratio= Current assets less all external restrictions / Current liabilities less specific purpose liabilities

Restrictions placed on various funding sources (e.g. Section 94 developer contributions, RMS contributions) complicate the traditional current ratio used to assess liquidity of businesses as cash allocated to specific projects is restricted and cannot be used to meet a Council's other operating and borrowing costs. The Unrestricted Current Ratio is specific to local government and is designed to represent a Council's ability to meet short term obligations as they fall due.

Weighting: 10%

v). Debt Service Cover Ratio (DSCR)

Benchmark = Greater than 2.0x

Ratio =

Operating results before interest and depreciation (EBITDA) /.(Principal repayments from the statement of cash flows +borrowing interest costs (from the income statement))

This ratio measures the availability of operating cash to service debt including interest, principal and lease payments

Weighting: 7.5%

vi). Interest Cover Ratio

Benchmark = Greater than 4.0x

Ratio = Operating results before interest and depreciation (EBITDA) / Borrowing interest costs (from the income statement)

This ratio indicates the extent to which a Council can service its interest bearing debt and take on additional borrowings. It measures the burden of the current interest expense upon a Council's operating cash.

Weighting: 2.5%

vii). Infrastructure Backlog Ratio

Benchmark = Less than 0.02x

Ratio = Estimated cost to bring assets to a satisfactory condition (from Special Schedule 7) / Total infrastructure, building, other structures and depreciable land improvement assets (from Note 9a)

This ratio shows what proportion the backlog is against total value of a Council's infrastructure.

Weighting: 10%

viii). Asset Maintenance Ratio

Benchmark = Greater than 1.0x

Ratio = actual asset maintenance / required asset maintenance

This ratio compares actual versus required annual asset maintenance, as detailed in Special Schedule 7. A ratio of above 1.0x indicates that the Council is investing enough funds within the year to stop the Infrastructure Backlog from growing.

Weighting: 7.5%

ix). Building and Infrastructure Renewals Ratio

Benchmark = Greater than 1.0x

Ratio = Asset Renewals / Depreciation of building and infrastructure assets

This ratio compares the proportion spent on infrastructure asset renewals and the asset's deterioration measured by its accounting depreciation. Asset renewal represents the replacement or refurbishment of existing assets to an equivalent capacity or performance as opposed to the acquisition of new assets or the refurbishment of old assets that increase capacity or performance.

Weighting: 7.5%

x). Capital Expenditure Ratio

Benchmark = Greater than 1.1x

Ratio = Annual capital expenditure / Annual depreciation

This indicates the extent to which a Council is forecasting to expand its asset base with capital expenditure spent on both new assets, and replacement and renewal of existing assets.

Weighting: 10%

LOCAL GOVERNMENT NSW

FFTF – LGNSW Submission:
Independent Review of FFTF Criteria (Comrie Supplementary)

February 2015

NSW LOCAL GOVERNMENT FIT FOR THE FUTURE – COMMENTS ON ASSESSMENT CRITERIA

The State Government announced its Local Government 'Fit for the Future' (FFF) assessment criteria in about September 2014. At about the same time I completed a report for Local Government NSW (LGNSW) evaluating the criteria that the NSW Treasury Corporation (TCorp) had used in its 2013 report assessing the financial sustainability of NSW councils.[1] Some of the TCorp applied financial indicators that I had been critical of in my report have not been utilised in the FFF criteria.

Brief comments regarding each of the FFF criteria follow. Before discussing each of these criteria though it is important to highlight that there is a wide degree of variation regarding infrastructure asset accounting practices between NSW councils (and presumably therefore between auditors as to what or may not be acceptable). Some variations are warranted to account for differences in service levels and operating environments. Such factors far from fully explain all differences. There are for example differences regarding expensing or capitalising outlays, the basis for and outcomes of asset revaluation, componentisation of assets, depreciation rates and methodologies, assumed useful lives and residual values that may be hard to reconcile. Depreciation represents about 23% on average of councils' operating expenses. Differences in above described asset accounting practices can have a material impact on recoded depreciation, and hence therefore a council's reported operating result.

The above comment is not intended to suggest that reported past and projected accrual accounting based financial performance by the local government sector and individual councils is generally unreliable. Asset accounting practices and their consistency are improving. Care nevertheless needs to be taken in comparing councils' performance. My work both for the Independent Panel and more recently my report for LGNSW highlighted that some councils that have been given low financial sustainability rankings in the past (for example by TCorp) believed that their circumstances are not significantly different from some others that scored higher ratings.[2]

1. Operating Performance Ratio (Greater than or equal to breakeven average over 3 years)

   I support use of this indicator and suggested target. In fact I consider it to be by far the most important indicator. If a council can maintain a reasonable Operating Performance Ratio over time I would not be unduly concerned regarding its performance against

[1] The report was titled '*Review of TCorp's Report 'Financial Sustainability of the NSW Local Government Sector*'.
[2] My report for the NSW Independent LG Review Panel was '*Roadmap to Financial Sustainability for Local Governments in NSW*', 2013.

other appropriate financial indicators. For further discussion regarding this indicator see also my comments at item 3(i) of my 2014 report for LGNSW (Comrie 2014).

Note that the FFF assessment is based on financial performance for the years 2011/12, 2012/13 and 2013/14. During this 3 year period local governments received only 11 (rather than 12) quarterly Commonwealth Financial Assistance Grants (FAGs) payments (an extra quarterly payment was made in an earlier year as a Global Financial Crisis stimulus initiative). Thus the FFF assessment understates councils' 'under-lying' performance for this indicator. This impact would not be significant for many councils but may have been material for councils that depend on FAGs for a high share of operating revenue.

2. Own Source Revenue Ratio (Greater than 60% average over 3 years)

   I acknowledge that a higher proportion of own source revenue provides security and flexibility for a council. It is unrealistic though to expect many relatively disadvantaged councils in rural and regional areas to meet this criteria. In my earlier report I suggested that if this type of indicator was to be used I would favour including FAGs income in the numerator. Such income is relatively secure. (See Comrie 2014, item 3.(ii).)

   In my earlier report I also argued that I believed it would be more appropriate for the denominator to exclude rather than include capital revenue. Both the TCorp assessments and FFF criteria include capital revenue in the denominator.

3. Building and Infrastructure Asset Renewal Ratio (Greater than100% average over 3 years)

   I do not support use of this indicator. Renewal expenditure relative to depreciation may give a reasonable indicator of a council's asset renewal performance for classes of assets that have numerous items and relatively short lives (for example possibly plant and equipment, road resheeting and road resealing). Experience elsewhere has shown that it is a poor indicator where assets have long lives, (for example road pavements, stormwater drains, buildings etc). For many councils asset classes with longer lives represent a majority of the total value of their stock of physical assets. (See also Comrie 2014, item 3.(ix).)

   The assessment model acknowledges renewal expenditure needs can be lumpy and averages 3 years data to address this concern. In practice a much, much longer period than 3 years would be needed to generate meaningful results for this indicator.

South Australian councils are no longer required to report results for this indicator because results were found to be meaningless. The draft 2nd edition of the Institute of Public Works Engineering Australasia's (IPWEA's) Australian Infrastructure Financial Management Guidelines (AIFMG) (currently out for consultation) discourages use of this indicator.

4. Infrastructure Backlog Ratio (Less than 2%)

This indicator uses as its numerator the estimated cost that would need to be incurred to bring assets to a satisfactory condition. As highlighted in my earlier work for both LGNSW and the Independent Panel there is a high degree of subjectivity by and inconsistency of approach between councils in quantifying asset renewal backlogs. I would be very wary of making financial assessments of councils or comparisons between councils based on this data. (See Comrie 2014, item 3.(vii).)

5. Asset Maintenance Ratio (Greater than 100% average over 3 years)

This indicator also suffers from similar data reliability problems to 5. above. (See Comrie 2014, item 3.(viii).)

In addition I do not understand the rationale for the 'at least 100% target'. Surely a target of close to 100% would be more appropriate (for example 90% to 110% or even 80% to 120%). I can't see how spending a lot more than is considered warranted can be financially desirable.

6. Debt Service Ratio (Greater than 0% and less than or equal to 20% average over 3 years)

I think the evidence is overwhelming that the financial and asset management challenges of many councils in NSW and elsewhere are to a large degree because they are making too little use of debt (and indeed have been encouraged to do so by jurisdictional authorities).[3]

I have three prime concerns with this indicator. The first is that the suggested target favours less use of debt relative to more. My second concern is that it is fundamentally an indicator that is inconsistent with encouraging use of accrual accounting data for decision-making.[4] This is because the numerator includes both interest expenses and principal repayments and principal repayments are not an accrual accounting expense.

Thirdly, a focus on this indicator could also discourage councils from improved treasury management practices that have the potential to realise significant interest savings and reduce their interest rate risk exposure. It would be generally sensible for example for

[3] I discuss this issue and the other points I make it Item 6 in my 2014 paper, 'Debt is not a Dirty Word', prepared for and published by the Australian Centre of Excellence for Local Government, University of Technology, Sydney.

[4] The various financial sustainability inquiries conducted in NSW and elsewhere highlighted the need to move thinking away from cash accounting metrics and for decision-makers to embrace accrual accounting.

councils to apply cash on hand to reduce outstanding debt where possible but if they did so their score for this indicator would be adversely affected.

Most other states no longer encourage reporting and decision-making using similar indicators. IPWEA's AIFMG (1st edition and unchanged in draft 2nd edition) recommends use instead of the Net Financial Liabilities ratio and several jurisdictions require local governments to report against this indicator.

7. Real Operating Expenditure per capita.

   A decrease in real operating expenditure per capita over time could imply that efficiency is improving but it could also imply that service levels are falling. An increase in real operating expenditure per capita is in my view most likely to suggest service levels are rising. Providing that a council can also maintain a reasonable operating result then I'd imagine that is an outcome that would be preferred by a majority of its residents and ratepayers (particularly given that rate revenue can only increase beyond the rate cap if supported by the community).

   As communities' incomes per capita have risen over time (as they have in almost all local government areas) citizens and ratepayers presumably have preferred higher real levels of local government services (just as they have federal and state government services and private sector supplied goods and services too). Certainly it's safe to say local elected decision-makers are best placed to judge its community's preferences in this regard.

It's not clear to me how a council's score for each of these indicators is applied to determine whether it is 'fit for the future'. Providing that a council has reasonably reliable accounting records and long-term financial planning assumptions and is committed to and is forecasting ongoing achievement of modest operating surpluses (net of capital revenues) I would suggest (prima facia) that it is 'fit for the future'.

John Comrie

JAC Comrie Pty Ltd

2 February 2015

Attachment C

FFTF Assessment Criteria & Benchmarks –Guidance & Advice to Expert Panel by FFTF Assessment Criteria and Benchmarks Working Group

Measure, Definition and Benchmark	Strengths	Weaknesses	Implications/Considerations
Operating Performance Ratio (greater or equal to break-even average over 3 years) ***Total continuing operating revenue (exc. capital grants and contributions) less operating expenses*** ***Total continuing operating revenue (exc. capital grants and contributions)***	• High significance - Comrie suggests a greater weighting. • Generally accepted as an important ratio.	• Depreciation in the numerator has an impact ongoing. Data could be considered unreliable i.e. easily manipulated to affect desired result. • Important to note that this benchmark will not be achievable in the short to medium term by many councils. Objective should be to look for improvement over time.	• Although this is an important measure - care needs to be given to not over emphasise. • Need a balanced view – this measure is impacted by the results of other measures and need to be conscious that good performance is not being managed through under performance in other areas for example under funding asset maintenance.
Own Source Revenue Ratio (greater than 60% average over 3 years) ***Total continuing operating revenue less all grants and contributions*** ***Total continuing operating revenue inclusive of all grants and contributions***	• Risk Assessment Tool – measures financial autonomy & flexibility.	• Differences between rural and metro. councils : - source of aggravation for rural councils as many cannot realistically be expected to ever achieve the 60% benchmark. • Need to understand context that it represents a factor in the risk assessment of a council and reflects on a council's financial flexibility.	• The context of the council must be considered e.g. rural council – small rate base and lower ability to generate other own source revenue vs. Metro Council large rate base and ability to generate other own source through e.g. fees and charges. • Assumptions that metro councils are expected to exceed this benchmark whilst some rural councils may never reach the benchmark of 60% but instead continue to show improvement over time. • FAGs an important, ongoing, consistent revenue stream for councils, particularly rural councils and needs to be part of context considerations.
Building and Infrastructure Asset Renewal Ratio (greater than 100% average over 3 years) ***Asset renewals (building and infrastructure)*** ***Depreciation, amortisation and impairment (building and infrastructure)***	• Provides an indicator of asset management and sustainability.	• Depreciation in the numerator has an impact ongoing. Data is considered unreliable i.e. easily manipulated to affect desired result. • Building and Infrastructure Asset data is unreliable. Different interpretations, methodology and data quality means the indicator lacks comparability.	• How robust is the asset data for the council being assessed? • Potential for expert panel to access expert technical support to assess infrastructure measures. • Expert technical support a must for this and other asset indicators.
Infrastructure Backlog Ratio (less than 2%) ***Estimated cost to bring assets to a***			• How robust is the asset data for the council being assessed?

<u>satisfactory condition</u> ***Total (WDV) of infrastructure, buildings, other structures and depreciable land improvement assets***	As above.		• Difficult to use for comparing councils but for an individual council provides information regarding the size of the task facing a council in terms of being able to bring its infrastructure to an acceptable standard. • Expert panel to access expert technical support to assess infrastructure measures essential.
Asset Maintenance Ratio (greater than 100% average over 3 years) ***<u>Actual asset maintenance</u>*** ***Required asset maintenance***	As above.	• Asset data reliability issues. • Lack of comparability due to difference in definition/interpretation of asset maintenance vs. renewals.	• How robust is the asset data for the council being assessed? • Difficult to compare councils, but if a council is underspending in this area on a regular basis, this ratio is a potential warning sign that could lead to declining asset standards in future years. • Expert panel to access expert technical support to assess infrastructure measures essential.
Debt Service Ratio (greater than 0 and less than or equal to 20% average over 3 years) ***<u>Cost of debt service (interest expense & principal repayments)</u>*** ***Total continuing operating revenue (exc. capital grants and contributions)***	• Provides an indicator of intergenerational equity.	• Important to note that this is primarily a measure of inter-generational equity. • Need and capacity to utilise debt varies widely between councils.	• Debt interaction with infrastructure measures e.g. is debt being effectively used to reduce backlog? • Need to consider infrastructure needs of the individual council and community and ensure balance between current and future funding. • Expert technical support a must for this and other asset indicators. • The group thought this was important to consider but is less significant than the other major indicators.
A decrease in Real Operating Expenditure per capita over time	• Provides a proxy measure of efficiency.	• Proxy measure. • Methodology issue. • Decline in expenditure is not necessarily a sign of efficiency. • Decline in population is not a sign of inefficiency. • Lacks comparability. • Genera tendency for this to increase over time due to increasing roles and responsibilities and rising community demands.	• Need to understand the operating context of the council, especially as it relates to the community needs expressed through the IP&R process. Context is crucial. • Need to ensure performance is not driven by demographics • Efficiency is considered an important factor, but this is not considered to be a meaningful measure.