Discussion Paper Prepared by
Financial Advisory Panel
Newcastle City Council
May 2013

Report of the Financial Advisory Panel (FAP)

Introduction

FAP welcomes this opportunity to provide the Council with advice on ways it might redress its current financial predicament. It is very evident to us that the status quo is not sustainable, and as local residents and/or businesses, we share the Council's concern and determination to remedy the position.

In analysing and considering the financial position we have drawn a number of conclusions and made thirteen recommendations for corrective action.

In this draft report we examine, at a high level, the current financial predicament and challenges, and what levers Council has at its disposal to improve the position. Some of the recommendations have the potential to be quite controversial but most propose more detailed investigation and issue analysis. So it's not as though we're suggesting the Council "push the button" on anything until that work is done and fully considered.

We believe our recommendations provide a roadmap for dramatic improvement. What is especially evident is that systemic change is needed in the way Council functions. A collection of ad hoc revenue enhancement and cost-cutting initiatives, however meritorious they may be, will not remedy the more fundamental challenge of reforming the way Council goes about setting service levels and priorities, and then ensuring they are delivered with optimum efficiency as a matter of course.

Importantly, we believe Council needs a concise and coherent overarching narrative and strategy on reform. It needs to demonstrate the way this reform will deliver a more sustainable future fiscally, and, at the same time, meet community needs and expectations, and the Council's own vision for Newcastle.

Vision and business strategy - a crucial starting point

It is perhaps stating the obvious, but the financial objective this Council (or any Council) is to raise sufficient income to fund and sustain its day to day services (e.g. waste collection, regulation of land use and development) and assets (e.g. roads and parks), as its business strategy dictates.

The importance of first having a vision and business (service delivery) strategy cannot be overstated. That is, the provision of services and assets must reflect the elected Council's view of the contemporary needs and priorities of its community. Too often services and assets are provided by governments simply because they have always been (even if circumstances have moved on) or because it's what the bureaucracy prefers (public administration scholars call this "public choice theory" – it's worth looking up).

It follows that the starting point for the Council is to think deeply about the services and assets it currently provides and fully understand:

- Whether they are provided at a level below or above what they should be or whether in fact they need to be provided at all, having regard for Council's vision for Newcastle and financial planning.

- What these services are costing Council after deducting user fees and other external income sources. (This is, in effect, the level of Council subsidisation funded from general rate revenue, versus the assessed benefit of the service to the general community.)

Of course, this is not something local government has typically been good at, given the absence of methodology (e.g. zero based budgeting) and political will. Fading libraries, empty "pocket handkerchief" parks, childcare services where a thriving private market now exists, and unused community halls are just a few of the testaments to this.

It's unclear to FAP just how much time and attention the new and previous elected Council devoted to aligning resource allocation for services and assets with its stated strategic plan "Newcastle 2030" and five year corporate strategy. What is clear to us is that there isn't an obvious alignment.

So, as an example, while Newcastle 2030 is rich in content and specific strategies to deliver its vision for Newcastle, there is little direct mention of the role of libraries. Yet an adopted ten year capital works program has library upgrades costing $42.9 million – the largest of all the capital expenditure commitments. That's not to suggest such an investment isn't worthy, but that it doesn't appear to reflect the articulated vision and priorities of the Council, in what is an extensive and comprehensive document.

Recommendations

1. **Compile a simple inventory of all Council services including their costs and the general revenue funding requirement (i.e. costs less user fees, grants etc).**

2. **Review the inventory of services and capital works program having specific regard for the Newcastle 2030 plan, 5 year corporate strategy and more recent plans.**

3. **Develop an agreed process of assessment of services and business plan alignment to establish a clear basis for prioritisation.**

Financial overview

As depicted in Table 1 below, Council's fiscal challenge largely centres upon the following.

- Based upon the "Integrated Strategic Financial Analysis" or ISFA, Council is generating sufficient recurrent income (read cash-flow) of about $207 million to fund its day to day services and maintain assets which currently cost it about $195 million. That is, it has a surplus of about $12 million. Importantly however, maintaining assets only means basic maintenance and running repairs (e.g. tar patching roads, repairing playground equipment or painting a community hall).

- Even with recurrent grants and contributions in the order of $9 million, this $12 million surplus is insufficient to fund the calculated life cycle renewal of these assets. Council's recent financial analysis suggests the needed capital expenditure is in the order of $40-50 million per annum, to renew and keep these assets viable (e.g. major road and building reconstruction). It's this deficiency which is at the heart of Council's difficult plight and it becomes even more serious by FY22. See below:

Table 1	**FY13 $mill**	**FY22 $mill**
Recurrent income	207	278
Recurrent expenditure (ex deprec)	195	283
Surplus	12	(5)
Capital income	9	7
Funds available for capital renewal	21	2
Funds required for capital renewal	43	45
Deficit	**(22)**	**(43)**

Essentially, Council's ISFA anticipated this deficit to be funded by borrowings of $100 million between now and FY22, plus asset sales and reserves.

- Council has identified income to fund a third type of spending - what we call new or improved assets (e.g. a new or significantly enhanced road or building). This covers a wide range of assets forecast in the ISFA over the period FY13 -22.

	FY13 – FY22 $000
Hunter Street revitalisation	16,670
Coastal revitalisation	35,798
Swimming pool upgrade	29,826
Libraries upgrade	42,900
Provision of new cycleways	15,660
Newcastle Art Gallery expansion	21,000
Blackbutt Reserve upgrade	9,850
Implementation of parking strategy (on-street)	2,795

The proposed spending on new or improved assets is funded largely via the special rate variation (SRV), Section 94 contributions, special purpose Government grants, internal cash funded reserves, assets sales and debt. A large proportion of these monies are 'uncertain' as to realisation .i.e. they are not guaranteed.

	FY12 $000
Special Rates	51,220
MAPPs	9,778
Government Grants	20,365
Section 94	7,067
Asset Sales	66,415
Reserves	16,147
Loans	2,984

The reliance upon debt and asset sales to fill the void for this program, as for capital renewal works, is very disturbing to us. We discuss this further later in this document.

Council's senior management has done an excellent job in modelling the position, and the ISFA has been for FAP the "go to" document. Based upon this analysis, the Council basically runs out of cash somewhere between now and 2020.

The ISFA (Section 8) nominates a wide range of actions called "sustainability options" to improve Council's financial position which, if achieved, would see an improved scenario set out on page 137. We have compared the income and expenditure statement on page 30 of the ISFA with page 137 (see attached). So for example, we can see that under management's improvement plan, total operating expenses would in FY22 decline from $345 million to $316 million.

The ISFA is a good effort in setting out the financial difficulties and possibilities to improve the position. However, we have concerns about the improved position depicted by taking up the sustainability options as follows:

- The cutting of services in isolation of a more comprehensive review of all Council services currently being delivered and their associated benefits and net cost (as contemplated in recommendation 1), may be short sighted and difficult politically.

- There is very limited evidence to suggest many of the proposed operating savings or revenue enhancements are actually achievable. If they are, then why hasn't action been taken already? Additionally, it may well be that some areas deserve additional funding, and others can be made more 'efficient' than the savings levels proposed.

- Further special rate variations are proposed.

We restate our view that the ISFA lacks a concise and coherent high level strategy and narrative on how Council's financial difficulties might be overcome.

For example, the ISFA simply writes on page 105 that "savings can be achieved" through inter alia "efficiencies brought about by changed work practices" and "outsourcing – only where the costs of service is lower". This is hardly inspiring. We would expect, for example, a more definitive statement of intent to introduce competition to Council works and services with some targets. Competition or what is often termed "contestability" is, we believe, one of the most powerful steps Council can take to improve service level definition and cost effectiveness.

Recommendations

4. **Conduct a detailed review of the proposed sustainability options (set out in section 8 of the ISFA, and support those which have no immediate consequences for service levels and the general rate burden (e.g. energy savings and material cost reduction).**

5. **Consider other sustainability options which impact service levels and the rate burden, only as part of a more comprehensive review of Council services contemplated in Recommendation 1.**

Remedial options

Options for meeting this challenge are fairly clear cut but by no means easy.

Essentially, Council can:

- Increase rates to meet the deficiency in asset renewal spending and/or review and lower ambitions.
- Eliminate or cut recurrent services.
- Require users to fund a greater proportion of service costs.
- Increase external funding.
- Review its new or improved asset program.
- Reduce operating expenses.

In this section we look at each option and possibilities.

Increase rates to meet the deficiency in asset renewal spending.

Although it's a recommended sustainability option in the ISFA, we do not believe this is a necessary, nor responsible option, given there are so many other opportunities to redress the Council's financial position.

We would strongly recommend Council investigate, however, how the additional income expected to flow for the SRV may be reallocated to support more urgent asset renewal priorities, as distinct from the new and improved asset program contemplated in the original approval.

Something that also needs to be tested is the reliability of the calculated $40-50 million per annum asset renewal spending requirement. Whilst we're in no position to challenge the Percy Allen/GHD calculations, there is in our experience always a tendency to "gold plate" these demands. There's also a question of the actual costing of the identified works and the tendency to overestimate the costs of work "just in case". That said, spending something close to the level of asset depreciation (depreciation was $55 million last year) is, prima facie, not unreasonable.

The "catch up" logic behind the heavy spend on capital renewal in the early years of ISFA is understandable, but it is not clear to us why, in outer years, the level of required spending on renewal is even greater.

Recommendations

6. **Investigate how the additional income expected to flow from asset sales for the SRV-identified projects may be reallocated to support more urgent asset renewal priorities.**

7. **Review the capital renewal requirements, estimates of expenditure and programming.**

Eliminate or cut recurrent services

As already argued, we believe this option can only be contemplated as part of a more comprehensive review of services (recommendations 1 and 2).

But once this is done, it is more than reasonable for Council to consider eliminating or reducing services consistent with its vision, business strategy and priorities.

Increase user charges

We haven't the benefit of any comparisons with other Councils, but note that user charges represent just 49% of general rate income and, even under the ISFA improvement plan, would only account for 53% by FY17.

"User pays" in local government is one of those unsophisticated policy areas whereby a cocktail of history, regulatory requirements and politics have created much inconsistency. So for example, no one argues that user fees should fully cover the costs of waste management without any call on general rate revenue, but just about everyone would argue for a library or netball court to be funded from general rate revenue on the basis there is an implicit wider community benefit (or community social obligation - CSO).

An action point here is to develop a pricing and users pay strategy. This would start by making more explicit the level of subsidisation of Council services (as previously discussed in recommendation 1), and then making more rational decisions about user fees. It must be noted that somebody has to pay, and if it's not the users, it's the non-users via their general rates (e.g. local pensioners).

Implementation is always tough, but other Councils have made strong progress. There will always be strident user resistance to imposing user charges. Demonstrating the full cost of a service and the level of subsidisation implicit in its delivery is an essential starting point. Only with this transparency, can decisions be made about what is a reasonable level of user contribution and what is fair.

As touched upon above, there is of course nothing wrong with Council funding services from general rate income. It is, however, important to ensure that when it does, there's good reason, such as:

- Council simply isn't able to render a user fee e.g. a local street or park (unless we want toll gates and fences and turnstiles across the city). Economists call these "public goods" defined by the inability of Government to actually collect a fee and exclude non payers.

- The level of general rate funding is commensurate with the wider community benefit.

- The provision of the service is affordable in the context of the Council's overall financial position.

We also include here improving the financial performance of commercial activities which the ISFA puts some stock in, albeit again without sufficient detail as to how it can actually be done. So, for example, if it's so easy to increase Civic Theatre income by $250k by FY14, then why hasn't it happened already?

Recommendation

8. **Commission the development of a pricing and user pays strategy. This strategy should identify all council services, fully absorbed costs and the level of funding required from general rate revenue, allowing for the inability in some cases to collect a fee, and should identify clearly agreed community service obligations. Such obligations should be regularly reviewed and made transparent.**

Reduce debt servicing

Debt servicing cost will absorb about 3.5c of every rating dollar paid by ratepayers in FY13. Under the proposed rescue plan by FY22, it will absorb 4.4c.

There is, in our view, no rational commercial reason for having debt as part of a Council's capital structure. Unlike in the commercial "for profit" world, there is no tax advantage, no need to better match costs and revenues, and no wealth to be created from the spread of earnings versus the cost of debt.

The use of debt in local government is purely a matter of historical precedent, mostly born from Councils wanting to fund spending (often grandiose) they couldn't otherwise afford. We can only support debt for funding large "lumpy" investments that generate ongoing cashflows to service the debt, such as the creation of electricity and water infrastructure or an airport in the event that the market "fails" to meet a palpable community need (often a factor in the 19th century).

Council should in our view, look to retire its entire debt of $63 million. This could be achieved through asset sales already earmarked and the sale of its equity in Newcastle Airport at the appropriate time. A Council owning an airport in this day and age is odd, especially when by its own admission, the Council has so many competing, high priorities for the deployment of its capital.

But beyond paying off the debt, the proceeds of asset sales should not be used to fund any new and improved asset spending, unless the new assets similarly pay their own way or have well established potential to deliver external benefits to the community or city over a long period (e.g. Sydney Opera House). Otherwise, it's a case of selling off the farm to fund today's consumption. The potential utilisation of proceeds of asset sales should not become a diversion for Council to defer the potentially difficult decisions that need to be made to ensure all its services are delivered as efficiently as possible.

Recommendations

9. **Revise capital income intentions, especially the sale of surplus assets, to give priority to retiring all outstanding debt. It is essential to keep commercial imperative principles when selling capital assets in order to maximise benefits to all rate payers.**

10. **Fully investigate the sale of Council's equity in Newcastle Airport, at the appropriate time, as a central part of the debt retirement objective.**

Reduce operating expenses

FAP has no industry benchmarking at its disposal to make firm judgments about the opportunity to reduce recurrent operating expenses. It seems to us however, that the absence of "contestability" of Council services and major works (read competitive tendering) means the opportunity is very real and more than likely, enormous.

Reducing Council's operating expenses by just 10% would free up $18 million per annum in funds to spend on asset renewal. It would virtually solve the financial problem, especially if the debt servicing cost was also removed. It is also likely the actual cost of the capital renewal itself could be reduced through competition, further alleviating the problem.

Action here centres upon establishing a regime of contestability and focusing on workforce improvement.

Workforce improvement would better prepare the current day labour for contestability and should also trim corporate non-contestable services such as town planning. Executing a systematic process of workforce improvement and increased productivity is no easy task, but coupled with the discipline of contestability, no single initiative offers so great an opportunity.

As previously mentioned in this report, the other big benefit to be gained from establishing a contestable regime is the Council is forced to consider what it is actually "purchasing" as a body corporate on behalf of the community. That is, in order to put works and services to competitive tendering, Council must first research and specify what it actually wants in terms of outcomes. Under the status quo, outcomes are normally a function of the level of inputs and the decisions of the service deliverers.

As experience here in Australia and overseas has demonstrated, a shift towards creating a contestable regime within a Council is not without its challenges and pitfalls. Some general observations:

- Contestability cannot be positioned or promoted as an end in itself. Rather it is a mechanism for helping Council fund and achieve its vision and delivery of priority services for the City of Newcastle; a mechanism that assists resource allocation by forcing Council to more clearly specify service outcomes and relative priorities; a mechanism which ensures service outcomes are delivered at the best price possible for residents and business. It otherwise runs the risk of simply being driven by ideology.

- It is beyond the scope of this FAP to give a full account of the experience and pros and cons of competitive tendering in local government generally. Based upon experience in Victoria and New Zealand, there is however, little doubt it does drive efficiency, productivity and cost reduction, even if it's only the "threat" of contracting out to an external provider. Contestability is also a driver of innovation and technological advancement as provider firms strive for competitive advantage and new markets. Waste collection was largely won by the private sector in the 1980's and 1990's due to their new technologies.

- Generally, the community rightly or wrongly perceives local government as notoriously inefficient and, often, self-serving. By exposing services and works to competition Council can anticipate increased community confidence in the efficiency of its operations. Alternatively when work is won by external providers, the community will benefit through lower costs or better service. There is no reason why residents and businesses of Newcastle should have to pay more for a service (through rates or fees) than is absolutely necessary, once Council has specified the level and quality of the service required. Most wouldn't expect to pay a premium simply to keep Council's own operations in business and the workforce in employment (noting contractors employ people too).

- Council can no longer, with any confidence, warranty job security for its staff as a matter of policy. Council's modern day obligation to staff is to skill, organise and lead, making them more productive, engaged and competitive.

- Importantly, there is no reason why most of Council's own operations can't successfully compete with the private sector in most service areas. Evidence suggests the question of public or private ownership is not the key to industry performance or efficiency. Rather, it depends on whether or not competition is present, as well as on workplace flexibility, and the quality of management and staff. Competing for work is also a tremendous motivating force for staff which should, beyond a period of difficult transition, provide staff with a greater sense of purpose, credibility and job security.

In order to introduce a contestable regime, much planning and thought needs to be devoted to how Council's operations are best structured, and the implementation timeframe. We believe in particular there is a strong case for Council restructuring its management and organisation on the basis of a "purchaser/provider" separation.

Since it first moved away from a management structure based on the more traditional technical functions of Council (e.g. engineering, health and building surveying etc), Council has experienced a series of iterations based on the particular fashion of the time or General Managers' preferences. Having considered a number of models, we believe the most appropriate to Council's circumstances would see a four part divisional structure premised upon:

- Strategic planning (including land use), high level policy, finance and corporate governance.

- Development control and regulation.

- Service specification (including community assets) and commissioning – “Purchasing”.

- Service delivery (in competition with the private sector) – “Providing”.

Naturally any shift towards a ‘purchaser and provider’ structure and environment of contestability needs to be carefully planned with a timeframe that allows Council’s ‘purchaser’ side to properly define service requirements and the ‘provider’ side to ready itself for competition.

Another significant opportunity for Council and one also contemplated in the ISFA is the rationalisation of Council’s asset base. The sale of surplus assets not only delivers income to retire debt, but reduces ongoing maintenance costs.

Recommendation

11. Develop a contestability policy and program including ways the Council might be best structured to accommodate contestability, the timing of inviting the private sector to compete for services and work currently undertaken by Councils own workforce, and measures to improve the competitiveness of the Councils workforce.

External funding

Again we are not familiar enough with the workings of Council to opine on how well the Council does relative to others in attracting Federal and State Government grants. Sufficient to say, it can be high payback for the effort invested. It does however come with a warning. It is vital to ensure that all grants that are applied for relate to projects that fit with Council’s priorities in terms of maintenance and new asset creation. A grant may become a burden if it requires Council funding that is unplanned and unfunded.

Council’s reliance on Section 94 contribution reserves also seems low at $15.3 million and, based upon ISFA, fund just a little over $7 million in works over the next 10 years. This appears to be in conflict with a local government area heavily focused upon growth and cementing its place as a major regional centre.

Recommendations

12. Investigate further S94 contributions to fund more urgent and needed asset renewal or new and improved assets.

13. Investigate the business case for establishing a specialist Government grant funding capability within Council, ensuring all grants sought align with the Council's prioritised service delivery strategy.

Conclusion

Council is unlikely to need any further expert internal or external advice to convince itself of the dangers of its current financial trajectory. Urgently required is a convincing narrative and strategy supported by an action plan to chart a new course of financial rectitude.

It is for the Council to construct the narrative, but this is essentially a story about how the status quo is not sustainable, and without corrective action, Council ultimately goes broke and/or services and assets in the city crumble. Thoughtful, responsible and tough decisions need to be made sooner rather than later, and Council needs a new mindset and methodology as to how it decides what services are to be delivered, how they can be delivered more cost effectively, and who pays for them.

FAP has in mind five guiding strategic principles:

i. Council will minimise further additional special rate variations during its current term by focussing on refining service levels and improving efficiencies.

ii. Council will seek to eliminate its current debt through asset rationalisation and avoid burdening future generations with borrowings to fund current wants.

iii. All current Council services will be the subject of a dispassionate assessment guided by the Council's vision for Newcastle and its understanding of contemporary needs and priorities.

iv. Where practical, Council will ensure that service users make a fair and reasonable contribution towards the costs of the service, while acknowledging that implicit in many services, is a broad community service obligation that requires funding from general rate revenue.

v. Allowing the private sector to compete for service delivery will improve efficiency, will demand of Council clearer definition of service levels and outcomes, and will provide the sense of urgency amongst Council's existing management and workforce to improve productivity.

In this report we've made a series of recommendations designed to give effect to these five strategic principles. Naturally, we are more than happy to meet again with the Council and elaborate on our thinking. We are also strongly of the view that most of the reform we recommend relies upon the leadership of the General Manager and finding a permanent General Manager is arguably the Council's most immediate and important priority. For the material changes required to be made to be successful, they must be 'owned' by both the General Manager and the Councillors.

We take this opportunity to thank Council staff and Councillors for their honest and open assistance with our review.

Mark Fitzgibbon Bob Cameron Philip Gardner Jeff Eather

Summary of Documents Reviewed by the FAP

The City of Newcastle Annual Financial Statements 2010/11
The City of Newcastle Annual Financial Statements 2011/12
The City of Newcastle Quarterly Performance Review – September 2012
The City of Newcastle Quarterly Performance Review – December 2012
The City of Newcastle – Newcastle 2030 – 2012/13 Operational Plan
The City of Newcastle – Preliminary Draft Integrated Strategic Plan (ISPP) – 10 Years – 2012/13 – 2021/22
The Newcastle Report – Issues of Sustainability – Professor Percy Allan – February 2007
Review of Newcastle City Council Historical Financial Performance and Proposed Budget for 2012/13 and Beyond – The Callaghan Institute – April 2012