intentus
CHARTERED ACCOUNTANTS

Thorough, Attentive, Earnest

JUN12'15 08:04:17 RCVD

4 June 2015

Acting General Manager
Campbelltown City Council
PO Box 57
CAMPBELLTOWN NSW 2560

Dear Lindy,

RE: REVIEW OF OPERATING PERFORMANCE RATIO AS PART OF IPART ASSESSMENT CRITERIA

We have performed a review Campbelltown City Council's Financial Indicators prepared by Council for its "Fit for the Future" (FFTF) proposal, in order to make comment on Council's Operating Performance Ratio and any deficiencies we believe exist in the numerator and denominator used to calculate this ratio. The procedures performed are detailed in the terms of the engagement issued by us on 21 May 2015 and accepted by Campbelltown City Council on 25 May 2015.

Because the review does not constitute either a reasonable assurance (an audit) or limited assurance engagement in accordance with AUASB standards, no audit or review has been performed and accordingly, no assurance is expressed.

Restriction on Distribution and Use of Report

This report is intended solely for the use of Campbelltown City Council and the Independent Pricing & Regulatory Tribunal (IPART) for the purpose set out above. Distribution of this report is restricted to those parties since others, unaware of the reasons for the procedures, may misinterpret the results. Accordingly, we expressly disclaim and do not accept any responsibility or liability to any party other than Campbelltown City Council or IPART for any consequences of reliance on this report for any purpose.

Should you require any further information in relation to the specifics of the work we have performed, please do not hesitate to contact me directly.

Yours faithfully
intentus

Per:

[redacted]

Leanne Smith
Partner

CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

COVER OF EXCELLENCE

PO Box 69, Orange NSW 2800
14 Sale St, Orange NSW 2800
Ph: 02 6362 5100

PO Box 9013, Bathurst West NSW 2795
291 Stewart Street, Bathurst NSW 2795
Ph: 02 6333 7611

Liability limited by a scheme approved under Professional Standards Legislation

REVIEW OF COUNCIL'S OPERATING PERFORMANCE RATIO AND IPART METHODOLOGY FOR THIS RATIO FOR COUNCIL'S FIT FOR THE FUTURE (FFTF) PROPOSAL

MAY 2015

Background

On 27 April 2015 NSW Local Government was advised that the independent assessment of their Fit for the Future (FFTF) proposals would be performed by the Independent Pricing & Regulatory Tribunal (IPART) with Mr John Comrie appointed as a temporary tribunal member.

The IPART methodology for assessing FFTF proposals was released for comment at the same time[1] and the criteria and measures outlined in Table 1.1 on page 5 of the methodology document are the focus of this report.

Beyond the "scale and capacity" measures, IPART proposes to use three criterion containing seven selected ratios to assess responses. Those criterion are:

1. Sustainability;
2. Effective infrastructure and service management; and
3. Efficiency

We have been requested by Council to specifically comment on what we believe are the inherent limitations of the Operating Performance Ratio, and in particular, how the calculation of this ratio may impact on the result achieved for this indicator by Campbelltown City Council.

[1] http://www.ipart.nsw.gov.au/files/1c534975-5aca-4769-82c5-a48700c182c6/Consultation_Paper_-_Methodology_for_Assessment_of_Council_Fit_for_the_Future_Proposals_-_April_2015.pdf

Operating Performance Ratio

Measure	Formula	Benchmark
Operating Performance Ratio	Net continuing operating result (excl capital grants and contributions) / Total continuing operating revenue (excl capital grants and contributions)	Greater or equal to break-even average over 3 years

Depreciation impact

The numerator in this ratio includes all expenditure incurred by Council, including depreciation expense.

Our concerns regarding the measurement of infrastructure being depreciated and the reliability of this expense being applied to the assessment of sustainability are outlined below under the sub-heading "*Use of accounting depreciation*".

Our main concern is that the that the net continuing operating result calculated for the numerator of this measure is significantly lower due to the depreciation expense and that the resulting outcome will see councils "fail" on this measure even where they may be managing their finances and infrastructure efficiently.

We recognise and accept that IPART faces a difficult task in fairly assessing the performance of councils in effectively managing and replacing their infrastructure as it ages.

The same challenge was faced by T-Corp in their 2013 infrastructure assessment and will continue to be the case until all councils have sufficiently progressed their asset management planning and suitably prescriptive criteria are applied to the renewals, maintenance and capital expenditure definitions. Our observation following their review was that T-Corp staff openly acknowledged that many councils could potentially be in a better position than the data T-Corp was required to use in its assessments suggested. So it is pleasing to see that IPART is performing their assessment on a "meet or improve" basis rather than meet alone.

The distinction between the Accounting Standards driven financial reporting measurement of depreciation and the asset management required spend to continue providing service is stark.

Essentially, the financial reporting requirement for Note 9 is that infrastructure is valued on depreciated replacement cost i.e. as if the asset had to be built today from a zero base. The depreciation charge is then based upon that valuation.

This is inconsistent with the asset management information which takes the realistic premise "we have the existing asset in its current condition, what do we need to spend in order to keep it in that condition (or better) into the future?" Not surprisingly the answer to that question is typically far less than the depreciation expense.

Since integrated planning and reporting was introduced, most councils have progressively been improving their long-term infrastructure management. One of the products of this process has been the development of detailed Asset Management Plans (AMPs).

Campbelltown City Council has developed detailed Asset Management Plans and these are the basis on which Council determines funding for its asset renewals and maintenance. For the reasons outlined below, we believe this is a more appropriate denominator than depreciation expense.

Use of accounting depreciation

It is widely acknowledged across NSW local government that the annual depreciation expense[2] and infrastructure spending whether replacement, renewal or maintenance, can vary significantly in their measurement and interpretation. This is also true for individual council assessments of level-of-service and satisfactory condition.

Depreciation expense as reported in the financial statements in Notes 4(d) and 9(a) represents the systematic allocation of the depreciable amount of an asset over its useful life[3]. The depreciable amount for local government in NSW has been determined by means of the Code of Accounting Practice and Circulars issued by the Office of Local Government that have limited the options available under Australian Accounting Standards.

Accordingly, where there is no market-based evidence of fair value, councils need to estimate fair value using the depreciated replacement cost approach. Depreciated replacement cost "is the current replacement cost of an asset less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset".[4]

What does that really mean?

- It means that councils are valuing the infrastructure assets on the (flawed) basis that they are building them today from a zero base.

- It means that assets that were built and funded by the State Government and then "gifted" to local government (e.g. regional roads) are now owned and depreciated by local government. Yet on the other hand, there is no recognition in this measure that capital funding of infrastructure by the higher tiers of government has always been and must continue to be a major contributor to its construction cost.

- It means that although there are modern engineering technologies that can restore existing assets to "as new" condition at considerably less expense than the replacement cost, councils must nonetheless depreciate the (higher) replacement cost.

- In summary ***it means that the Note 4 & 9 depreciation expense is a manifestly inappropriate basis on which to measure whether renewals expenditure is sufficient.***

[2] Comrie – LGNSW Independent Review of FFTF Criteria (Comrie Supplementary) February 2015, Page 1
[3] AASB 116 Paragraph 6
[4] Local Government Code of Accounting Practice & Financial Reporting (Guidelines) Update 23 - March 2015, page A74

Impact on Campbelltown City Council

In practical terms, a review of Campbelltown City Council's financial statements shows that depreciation expense for infrastructure assets for the year ended 30 June 2009 (before the impact on depreciation expense of the revaluation of these assets) totalled $10,292,000. Depreciation expense for Council's infrastructure assets for the year ended 30 June 2011 (the first full year in which the revaluations impacted on depreciation expense) was $20,695,000. Whilst Council did have additions throughout this period, the main reason for the large increase between 2009 and 2011 was simply that the revaluation of these assets increased their depreciable value and consequently, the annual depreciation expense reported by Council.

Council's depreciation expense in subsequent years has remained relatively consistent with the 2010 figure, with the financial statements for the year ended 30 June 2014 reporting that depreciation expense for Council's infrastructure assets totalled $18,398,000.

Over this same period, Council's infrastructure backlog (estimated cost to bring to a satisfactory standard as reported in Special Schedule 7) has fallen from $53,553,000 at 30 June 2009 to $33,753,000 at 30 June 2014. This is an improvement of $19,800,000 over this period.

Council's estimated annual maintenance was $16,256,000 for the year ended 30 June 2010, $15,797,000 for the year ended 30 June 2012 and $16,243,000 for the year ended 30 June 2014, indicating a relatively stable, ongoing cost required to maintain Council's infrastructure assets at a satisfactory standard.

Actual maintenance as reported in Special Schedule 7 for the year ended 30 June 2014 was $13,933,000. This maintenance expenditure is substantially included in Council's operating expenditure for the year (predominantly in materials and contracts) and as such, the inclusion of both this and depreciation expense on these assets in calculating Council's net operating result for the purposes of the operating performance ratio is essentially double-counting the cost of maintaining these assets.

For example, for the year ended 30 June 2014, Council's actual maintenance expense for infrastructure assets was $13,933,000 and depreciation expense on these assets was $18,398,000. As such, expenditure totalling $32,331,000 has been included in the calculation of numerator of this ratio to allow for the maintenance and renewal of Council's infrastructure assets. This is compared to an estimated required annual maintenance cost of $16,243,000 and a total cost to bring these assets to a satisfactory standard of $33,753,000.

Also of note is that Council's liquidity has continued to improve over this same period. At 30 June 2009, Council held internally restricted and unrestricted cash and investments of $38,430,000, with the internal restrictions including a total amount set aside for asset replacement and renewal of $7,299,000. At 30 June 2014, Council held combined internally restricted and unrestricted cash and investments of $69,182,000, which included a total of $22,894,000 which was set aside for asset replacement and renewal.

We believe that this strong liquidity position, combined with the reduction in the reported infrastructure backlog, is an indicator of Council's ability to renew and maintain its assets in accordance with its Asset Management Plans, rather than as determined by its annual depreciation expense.