

Feedback to IPART on its Methodology for Assessment of Council Fit for the Future Proposals

May 2015



Centroc's Mission is to be recognised as the lead organisation advocating on agreed regional positions and priorities for Central NSW whilst providing a forum for facilitating regional co-operation and sharing of knowledge, expertise and resources; effectively nurturing sustainable investment and infrastructure development.

www.centroc.com.au

25 May 2015

Reference bw:vp 051525
Enquiries: Ms J Bennett: 0428 690 935

Dr Peter J Boxall AO
Chairman
Methodology for Assessment of Council Fit for the Future Proposals
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop NSW 1240

Dear Dr Boxall,

Re: Methodology for Assessment of Council Fit for the Future Proposals

Central NSW Councils (Centroc) represents over 243,000 people covering an area of more than 72,500sq kms comprising the Local Government Areas of Bathurst, Blayney, Boorowa, Cabonne, Cowra, Forbes, Lachlan, Lithgow, Mid-Western, Oberon, Orange, Parkes, Upper Lachlan, Weddin, Young and Central Tablelands Water.

Centroc's vision is to be recognised as vital to the sustainable future of NSW and Australia.

Its mission is to be recognised as the lead organisation advocating on agreed regional positions and priorities for Central NSW whilst providing a forum for facilitating regional cooperation and sharing of knowledge, expertise and resources.



Centroc has two core objectives:

1. Regional Sustainability - Encourage and nurture suitable investment and infrastructure development throughout the region and support members in their action to seek from Governments financial assistance, legislative and/or policy changes and additional resources required by the Region.
2. Regional Cooperation and Resource Sharing – Contribute to measurable improvement in the operational efficiency and effectiveness of Member Councils through facilitation of the sharing of knowledge, expertise and resources and, where appropriate, the aggregation of demand and buying power.

Fit for the Future



Centroc has been selected as one of five regional pilot Joint Organisations to assist the NSW Government strengthen and reform local government.

The Centroc Board is made up of the 32 Mayors and General Managers of its member Councils who determine priority for the region. These priorities are then progressed via sponsoring Councils.

For more advice on Centroc programming and priorities, please go to our website

<http://www.centroc.com.au>

Please be aware that individual Councils will be making separate submissions which may vary in part or in whole with the advice following. Individual Councils will have particular circumstances with regard to the IPART *Methodology for Assessment of Council Fit for the Future Proposals* and this advice does not supersede that of member Councils. Rather IPART should consider the advice provided below alongside that of Centroc members.

The Centroc Board has given consideration to the questions as provided by IPART and provides the following responses.

- 1. How should the key elements of strategic capacity influence our assessment of scale and capacity? Are there any improvements we can make to how we propose to assess the scale and capacity criterion, consistent with OLG guidance material?**

Please find attached advice from Intentus reviewing the measures for:

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

The advice finds that that six of the seven measures are deficient, some to a significant extent. Please find the advice summarised in the table below where Attachment 1 provides more detail.

While the IPART measures are indicative, there is an opportunity to support Local Government in providing quality advice to the State regarding Council assets and operational sustainability. This region asks IPART to assist in shaping a reporting framework that is more reflective of the reality of Council assets, their management and other activities with a view to supporting Local Government funding programming for their communities. A significant concern for this region at the moment is the handling of depreciation, more advice in this regard is below and attached.

	Measure	Assessment
Sustainability Criterion	Operating Performance	<ul style="list-style-type: none"> Operating revenue over the assessment period is understated by the delayed FAGs instalments. The operating result applied in the numerator of this measure is significantly lower due to the depreciation expense and the outcome will see councils “fail” on this measure even where they are managing their finances and infrastructure efficiently.
	Own Source Revenue	<ul style="list-style-type: none"> Actual FAGs funding over the assessment period is understated. This measure is positively skewed for councils operating “non-core” activities such as saleyards, entertainment venues and aged care facilities that operate at a loss.
	Building & Asset Renewal Ratio	<ul style="list-style-type: none"> Use of the Note 4 & 9 depreciation expense is a manifestly inappropriate basis on which to measure whether renewals expenditure is sufficient. The three years of data considered in this measure are an insufficient period of time to obtain meaningful information on very long-lived infrastructure assets.
Infrastructure Criterion	Infrastructure Backlog Ratio	<ul style="list-style-type: none"> The source of this estimate - Special Schedule 7 is unaudited, subjective and information reported in that document is quite variable between councils. It is inappropriate that the denominator of this measure is written down value rather than gross book value. By mixing renewal cost in the numerator and replacement cost in the denominator, this measure becomes compromised and disadvantages all councils. Accordingly we are of the view that IPART should not rely upon this measure for making assessments or comparisons of councils.
	Asset Maintenance Ratio	<ul style="list-style-type: none"> Conceptually we are supportive of this measure, but in practice it is dependent upon the unaudited information in Special Schedule 7 so is susceptible to the variability and subjectivity previously referred to.
	Debt Service Ratio	<ul style="list-style-type: none"> When looked at in context provides useful information, but context is critical. The denominator (continuing operating revenue) incorrectly includes the revenue of “entrepreneurial activities” that in fact operate at a loss. It also unreasonably excludes the profits on (commercial) development of real estate.
Efficiency	Real Operating Expenditure	<ul style="list-style-type: none"> The measure positions a slow growth numerator (population) against operating expenditure which has historically been elevated annually through increased depreciation arising from the fair value regime. Where operating expenditure has increased, but the increase is fully funded, the measure would indicate declining performance when the opposite is true.

2. Which of the ‘Rural Council Characteristics’ are the most relevant, considering a council must satisfy a majority of the characteristics to be considered a rural council?

The Office of Local Government has advised that the Rural Council Model will no longer form part of structural reform:

The Independent Panel originally proposed a separate “Rural Council Model”, but consultation with the sector has shown that the needs of rural communities are so diverse, that a single legislated model, creating a new type of council, may not be the best solution. This is no longer being proposed.¹

Page 16 of the *Methodology for Assessment of Council Fit for the Future Proposals* describes Rural Councils as “largely autonomous working within regional Joint Organisations.”

At this stage, the fit between Rural Councils and Joint Organisations is far from clear and based on the work being undertaken by the Pilot JOs and the Office of Local Government, is not being trialled or contemplated by the Pilot JO at this time.

Some clarity from IPART regarding Rural Councils, their assessment and their fit with assessment including the proposed fit with Joint Organisations would be welcomed.

3. Are there any improvements we can make to how we propose to assess the sustainability, infrastructure management and efficiency criteria, consistent with OLG guidance? Are there issues that we need to consider when assessing councils’ proposals using the measures and benchmarks for these criteria?

Please see advice above at Question 1 where more detail is in Attachment 1.

4. How should councils engage with their communities when preparing FFTF proposals? Are there other factors we should consider to inform our assessment of council consultation? Please explain what these other factors are, and why they are important.

Centroc has no policy in this regard and refers the reader to individual Council submissions.

5. Should council performance against FFTF proposals be monitored? If so, are there any improvements we can make on the approach outlined for councils to monitor and report progress on their performance relative to their proposals?

Centroc has general policy regarding monitoring the performance of Councils for FFTF. Any monitoring process should have a purpose, be fit for purpose and be as lean as possible. For example, Special Schedule 7 is a long standing monitoring process that is subject to individual Council variability and can only provide broad brush advice. It is therefore recommended that the forward monitoring of the FFTF process:

- Be iterative and look for continuous improvement on its inputs, for example an audited Special Schedule 7;

¹ Advice from the OLG on the JO Forum under the thread “Rural Councils’ Model”

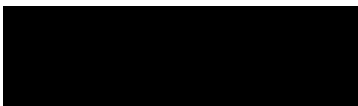
- Be fit for purpose including reviewing all existing criteria where the advice attached has some commentary in this regard;
- Be mindful of resource, be as lean as possible and use strategies such randomisation and a basket of advice to minimise the number of Councils having to report; and
- Be useful, that is, not just be collected but used to support Councils in delivering services to their communities.

We also invite stakeholders to comment on any other aspect of the proposed methodology.

The region has seen incremental improvement in asset management by members over the past 10 years, now supported by the Integrated Planning and Reporting. The FFTF process is fast tracking this process and IPART has an opportunity to provide considered advice to the State on a measured approach into the future. We ask that IPART provide advice to the State in this regard and would welcome any opportunity to expand on the commentary in this submission.

Please contact Executive Officer Jennifer Bennett on 0428 690 935 if you wish to discuss further.

Yours sincerely



Jennifer Bennett
Executive Officer
Central NSW Councils

Attachment: Advice from Intentus on the IPART Methodology for Assessment of Council Fit for the Future Proposals

22 May 2015

The Executive Officer
CENTROC
PO Box 333
FORBES NSW 2871

Dear Jenny

RE: REVIEW OF IPART ASSESSMENT CRITERIA

We have performed a review of the seven criteria and measures listed in Table 1.1 of IPART's document "Methodology for Assessment of Council Fit for the Future Proposals" issued in April 2015 for the purpose of considering and commenting upon the suitability of the measures and providing alternatives where they are found lacking. The procedures performed are detailed in the terms of the engagement issued and accepted by CENTROC on 19 May 2015.

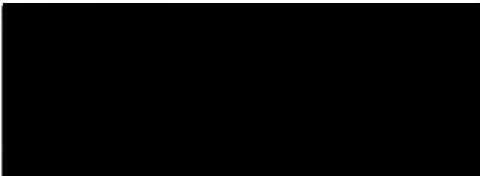
Because the review does not constitute either a reasonable assurance engagement (an audit) or limited assurance engagement in accordance with AUASB standards, no audit has been performed and accordingly, no assurance is expressed.

Restriction on Distribution and Use of Report

This report is intended solely for the use of CENTROC member councils and the Independent Pricing and 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 CENTROC 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 don't hesitate to contact me directly.

Yours faithfully
intentus


John O'Malley
Director

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REVIEW OF IPART
METHODOLOGY FOR
ASSESSMENT OF COUNCIL FIT FOR
THE FUTURE (FFTF) PROPOSALS



MAY 2015



REVIEW OF IPART FFTF METHODOLOGY



MAY 2015

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Executive Summary

On 27 April 2015 NSW Local Government was advised that the assessment of Fit for the Future (FFTF) proposals would be performed by the Independent Pricing & Regulatory Tribunal (IPART).

The methodology for assessing FFTF proposals was released for comment at the same time¹ and the criteria and measures outlined in Table 1.1 on page 5 of the document are the focus of this report.

Beyond the “scale and capacity” measures, IPART proposes to assess three elements containing seven selected ratios to assess responses. The elements are:

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

In summary, we find that six of the seven measures are deficient. Some to a significant extent:

	Measure	Assessment
Sustainability Criterion	Operating Performance	<ul style="list-style-type: none">• Operating revenue over the assessment period is understated by the delayed FAGs instalments.• The operating result applied in the numerator of this measure is significantly lower due to the depreciation expense and the outcome will see councils “fail” on this measure even where they are managing their finances and infrastructure efficiently.
	Own Source Revenue	<ul style="list-style-type: none">• Actual FAGs funding over the assessment period is understated.• This measure is positively skewed for councils operating “non-core” activities such as saleyards, entertainment venues and aged care facilities that operate at a loss.
	Building & Asset Renewal Ratio	<ul style="list-style-type: none">• Use of the Note 4 & 9 depreciation expense is a manifestly inappropriate basis on which to measure whether renewals expenditure is sufficient.• The three years of data considered in this measure are an insufficient period of time to obtain meaningful information on very long-lived infrastructure assets.
Infrastructure Criterion	Infrastructure Backlog Ratio	<ul style="list-style-type: none">• The source of this estimate - Special Schedule 7 is unaudited, subjective and information reported in that document is quite variable between councils.• It is inappropriate that the denominator of this measure is written down value rather than gross book value• By mixing renewal cost in the numerator and replacement cost in the denominator, this measure becomes compromised and disadvantages all councils.• Accordingly we are of the view that IPART should not rely upon this measure for making assessments or comparisons of councils.
	Asset Maintenance Ratio	<ul style="list-style-type: none">• Conceptually we are supportive of this measure, but in practice it is dependent upon the unaudited information in Special Schedule 7 so is susceptible to the variability and subjectivity previously referred to.
	Debt Service Ratio	<ul style="list-style-type: none">• When looked at in context provides useful information, but context is critical.• The denominator (continuing operating revenue) incorrectly includes the revenue of “entrepreneurial activities” that in fact operate at a loss. It also unreasonably excludes the profits on (commercial) development of real estate.
Efficiency	Real Operating Expenditure	<ul style="list-style-type: none">• The measure positions a slow growth numerator (population) against operating expenditure which has historically been elevated annually through increased depreciation arising from the fair value regime.• Where operating expenditure has increased, but the increase is fully funded, the measure would indicate declining performance when the opposite is true.

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

The deficiencies noted above are of genuine concern, so in the (likely) event that they are unchanged following the review of submissions on the assessment methodology, it is of some comfort that in Tables 3.3 and 3.5, IPART has shown their intent to apply “meet or improve” criteria to the measures, rather than a more rigid “meet the benchmark or fail” approach. IPART have also stated:

“We will base our assessment on the information provided in council proposals through the online portal using one of the templates OLG developed, and any additional relevant information.(our emphasis) This additional information may be provided by the council to support its proposal or may be otherwise gathered by, or provided to, us. Any proposal provided by the council should be supported by a sound argument with relevant documentation. We consider the ToR allows us to assess all information we consider relevant, and to make a judgement on the robustness of the argument, analysis and information used to support any position.”²

This was reiterated during the consultation held in Dubbo on 15 May where the Tribunal Chair confirmed that responses should include the specified financial measures but may also include alternative measures and where this is the case, the tribunal will assess those alternatives.

We recommend the CENTROC member councils should all consider supplementing their FFTF submissions with additional alternative measures where they are soundly argued. This is particularly the case for the sustainability measures containing accounting based depreciation and the infrastructure measures that are heavily reliant upon information drawn from Special Schedule 7.

² IPART Methodology for Assessment of Council Fit for the Future Proposals April 2015, Item 3.4.1, page 33

1. Sustainability Measures

1.1 Operating Performance Ratio

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

Issue 1: Excluded FAG income

The IPART actual assessment of operating performance is based on financial performance for the three financial years 2012, 2013 and 2014. Over those three years, NSW councils received only eleven quarterly Commonwealth Financial Assistance Grants (FAGs) payments instead of the twelve that would ordinarily have been received. In response to the 2008 GFC the Federal Government paid an extra quarterly instalment in an earlier year as an economic stimulus initiative.

Issue 2: Exclusion of real estate sales from continuing operating income

We also question the exclusion of the total amount of the net gain from the disposal of assets.

While excluding that revenue attributable to plant and equipment is a reasonable measure on the basis that trading-in or selling plant does not constitute operating revenue, the development and sale of real estate, when done on a commercial basis, is a regular, recurrent and profitable venture for some councils and in those circumstances we believe should be included.

We are of the view that the IPART assessment may understate councils' underlying performance for this indicator.

Issue 3: Depreciation impact

Our concerns regarding the measurement of infrastructure being depreciated and the reliability of this expense being applied to the assessment of sustainability are explored later in this paper.

We note that LG solutions performed modelling on the 2014 financial reports lodged by NSW Councils and found that a 10% variation in depreciation expense resulted in the number of councils reporting operating surpluses grow from 74 to 90, a 22% increase.³

Accordingly we are concerned that the operating result applied in 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.

³ LG Solutions "Debits & Credits" Newsletter February 2015, Part 5, page 24

1.2 Own Source Revenue Ratio

Measure	Formula	Benchmark
Own Source Revenue Ratio	$\frac{\text{Total continuing operating revenue (excl all grants and contributions)}}{\text{Total continuing operating revenue (incl capital grants and contributions)}}$	Greater than 60% average over 3 years

Issue 1: Exclusion of recurrent operating grants from continuing operating income

For many rural councils operating grants are a significant and essential source of recurrent revenue, often exceeding rate income. The Henry review of taxation in 2009 and the final report of the independent review panel in 2013⁴ both identified the need for the re-distribution of FAGs payments with a greater bias to rural councils. We note that IPART “will consider the impact of FAGs when assessing the sustainability criteria for rural councils, and in particular, the Own Source Revenue ratio.”⁵

We therefore recommend that CENTROC member councils report this measure both as defined above and again with FAGs included.

Issue 2: Bias to income rather than profit

By focussing only on the revenue measure rather than also considering the costs of “entrepreneurial activities” this measure is positively skewed for councils operating additional “non-core” activities such as saleyards, entertainment venues and aged care facilities. Often these activities run at a loss (sometimes significant) and are provided by councils more because of community expectation than for the generation of profit.

We believe it would be more appropriate to recognise the operating result (profit or loss) of those activities in the numerator than just the revenue.

Issue 3: Exclusion of real-estate sales from continuing operating income

As mentioned in 1.1 above, we believe that IPART’s flexible approach should also be applied in recognising that the development and sale of real estate is a regular and recurrent commercial venture for many councils, and therefore the profits from that activity should also be included in the Own Source Revenue ratio.

⁴ Final Report of the NSW Independent Local Government Review Panel - October 2013, page 46

⁵ IPART Methodology for Assessment of Council Fit for the Future Proposals April 2015, page 29

1.3 Building & Asset Renewal Ratio

Measure	Formula	Benchmark
Building & Asset Renewal Ratio	$\frac{\text{Asset renewals (building \& infrastructure)}}{\text{Depreciation, amortisation \& impairment (building \& infrastructure)}}$	Greater than 100% average over 3 years

Observation: This measure has been grouped under the “Sustainability” heading, but in our opinion would be more appropriately grouped under “Effective Infrastructure and Service Management”.

Issue 1: Use of accounting depreciation as the denominator

It is widely acknowledged across NSW local government that the annual depreciation expense⁶ 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 life⁷. 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”.⁸

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.***

⁶ Comrie – LGNSW Independent Review of FFTF Criteria (Comrie Supplementary) February 2015, Page 1

⁷ AASB 116 Paragraph 6

⁸ Local Government Code of Accounting Practice & Financial Reporting (Guidelines) Update 23 - March 2015, page A74

What is the Alternative?

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). While not all CENTROC members will have completed robust and reliable AMPs for all infrastructure categories, it is likely that they will have done so for roads.

Where that is the case, we are of the view that the AMP information detailing the required spend to maintain services would be a more appropriate denominator than depreciation expense.

Issue 2: Measurement period is too short

We believe the three years of actual data considered in this measure to be an insufficient period of time to obtain meaningful information on very long-lived infrastructure assets.

This is particularly so when expenditure can be “lumpy” and periodic. It would be appropriate to consider councils asset management plan which provides a long-term assessment of the asset activities and actions required to deliver services related to Civil Infrastructure. Many councils have applied the guidelines for the development of Asset Management Plans shown in the IPWEA International Infrastructure Management Manual (IIMM)⁹.

Where these guidelines have been applied, IPART would have a consistent basis for considering more appropriate measures of infrastructure maintenance.

⁹ IPWEA International Infrastructure Maintenance Manual 2006, Sec 2.5 pp 2.39 - 48

2. Effective Infrastructure and Service Management Measures

2.1 Infrastructure Backlog Ratio

Measure	Formula	Benchmark
Infrastructure Backlog Ratio	$\frac{\text{Estimated cost to bring assets to satisfactory condition}}{\text{Total (WDV) of infrastructure buildings, other structures, depreciable land \& improvement assets}}$	Less than 2%

Observation: We believe that the 2% target is setting the bar too high. Is it a realistic expectation that 98% of infrastructure assets should be at or above condition 2 on a 5 step scale?

Issue 1: Use of unaudited estimated cost to bring assets to satisfactory

The numerator for this indicator uses the estimated cost that would need to be incurred by a council to bring its infrastructure assets to a satisfactory condition. There are several deficiencies in this measure that are immediately apparent including:

- The definition of “satisfactory” is unique to each council and informed by their community consultation;
- The basis for estimating the costs to “bring to satisfactory” is itself an absurd notion. Councils when renewing assets will logically “bring to new” (condition 1) rather than “satisfactory” (condition 2) which the OLG mandates¹⁰;
- The intervention point at which an asset should be renewed is not defined; and
- The source of this estimate - Special Schedule 7 is unaudited, subjective and information reported in that document is quite variable between councils;

Issue 2: Use of Written Down Value for the Denominator

It is inappropriate that the denominator of this measure is Written Down Value (WDV) rather than Gross Book Value (GBV). The cost to bring to satisfactory should be expressed as a proportion of the restored state of the infrastructure rather than the depleted state. The difference in the result is shown in the example below:

	WDV as Denominator	GBV as Denominator
Cost to bring to satisfactory	7,221	7,221
WDV	322,512	-
GBV	-	431,572
Backlog	2.24%	1.67%
Result	FAIL	PASS

¹⁰ Local Government Code of Accounting Practice & Financial Reporting (Guidelines) Update 23 - March 2015, Special Schedules, page C21

Issue 3: Incompatibility between Numerator and Denominator

The numerator for this measure is informed by the OLG Code of Accounting Practice which advises “the estimated cost to bring assets to a satisfactory standard is the amount of money that is required to be spent on an asset to ensure that it is in a satisfactory standard. This should not include any planned enhancements.” So it can be reasonably inferred that if the council has an existing, but depleted, infrastructure asset, the cost would be only what needs to be spent to bring that asset back to satisfactory (condition 2 on the 5 step scale) i.e. it accepts that components of the expired asset can be renewed into its replacement.

The denominator on the other hand uses the Written down Value (WDV) of the specified infrastructure, drawn from Note 9 to the financial statements which as identified in 1.3 above, assumes that replacement of the asset with a modern equivalent on the basis that it is constructed from a zero base.

By mixing renewal cost in the numerator and replacement cost in the denominator, this measure becomes compromised and disadvantages all councils.

Accordingly we are of the view that IPART should not rely upon this measure for making assessments or comparisons of councils.

2.2 Asset Maintenance Ratio

Measure	Formula	Benchmark
Asset Maintenance Ratio	$\frac{\text{Actual Asset Maintenance}}{\text{Required Asset Maintenance}}$	Greater than 100% average over 3 years

Observation: Conceptually we are supportive of this measure as it succinctly measures whether councils are spending what they and the community considers necessary to maintain a satisfactory level of service. In practice, the measure is dependent upon the unaudited information in Special Schedule 7 so is susceptible to the variability, manipulation and subjectivity previously referred to. We also believe that the numerator should include maintenance and renewals expenditure.

2.3 Debt Service Ratio

Measure	Formula	Benchmark
Debt Service Ratio	$\frac{\text{Cost of debt service} \\ (\text{interest expense and principal repayments})}{\text{Total continuing operating revenue} \\ (\text{excluding capital grants and contributions})}$	Greater than 0% but less than or equal to 20% average over 3 years

Observation: Consistent with the recommendations of the review panel¹¹ it is clear that the intent of this measure is to encourage the use of debt as a source of funding for capital works. The measure, when looked at in context provides useful information, but context is critical. The ratio may spike when accelerated repayments are made, or when major (planned) capital works are commenced. Viewed in isolation the movements in the ratio can cause undue concern.

Issue 1: Inappropriate components of total continuing operating revenue denominator

Section 1.2 of this report identified that continuing operating revenue incorrectly includes the revenue of “entrepreneurial activities” that in fact operate at a loss. It also identified that the profits on (commercial) development of real estate are unreasonably excluded from continuing operating revenue.

We believe those adjustments should also apply to this measure.

¹¹ Final Report of the NSW Independent Local Government Review Panel - October 2013, Item 6.7 page 46

3. Efficiency Measures

3.1 Real Operating Expenditure

Measure	Formula	Benchmark
Real Operating Expenditure	$\frac{\text{Operating Expenditure}}{\text{Population}}$	A decrease in Real Operating Expenditure per capita over time

Issue 1: Application of a growing numerator to a comparatively static denominator

We understand the intent to identify a suitable measure of public sector efficiency, but find this indicator is not suited to the purpose.

In particular, for rural and regional areas population growth tends to be modest and in some cases in fact declines, but is positioned against the councils operating expenditure which has historically been elevated annually through increased depreciation that is a corollary of the requisite fair value regime.

Issue 2: Absence of recognition of revenue growth

The second deficiency of this measure is that where a councils operating expenditure has increased, but the increase is fully funded either by grants or own source revenue, the measure would indicate declining performance when the opposite is true.