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Dr Peter Boxall AO  
Chairman  
Independent Pricing and Regulatory Tribunal of New South Wales  
PO Box K35  
Haymarket Post Shop  
NSW 1240

Dear Sir,

### **Methodology for Assessment of Council Fit for the Future Proposals**

The Independent Pricing and Regulatory Tribunal of New South Wales (IPART) has published a consultation paper setting out its proposed methodology in assessing local government Fit for the Future (FFTF) proposals. IPART has invited written comment on the document.

New South Wales Treasury Corporation (TCorp) provides the following comments which focus on Question 3 from section 1.6.1 of IPART's methodology document.

*Question 3: Are there any improvements 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?*

TCorp has been working on the assessment of local government sustainability since 2011, and our methodology has focused on:

- Developing a series of ten benchmarks to assess various aspects of financial sustainability with those benchmarks used as a package to assess performance.
- Performance against each of the TCorp benchmarks are considered within a range around each benchmark, not just considering the benchmark level itself. TCorp does not make the assessment on the basis of 'Pass/Fail' for individual benchmarks.
- Trends in performance are an important signal to consider council performance.
- As there is a significant level of interaction between the benchmarks, there are situations where a council's performance in some areas may deteriorate in the short to medium term in order to achieve an overall level of improvement over the medium to long term. An example would be where a council needs to increase its maintenance and/or renewals expenditure to improve asset condition, which has a negative impact on operating performance.

TCorp's understanding is that the IPART methodology has several 'Pass/Fail' or 'Must meet' areas:

- Operating performance.
- Own source revenue.
- Debt Service.
- Efficiency.

TCorp has been in attendance at nearly twenty FFTF workshops with council representatives between October 2014 and February 2015 to discuss various aspects of the FFTF program,

including the benchmarks. At these workshops the TCorp and OLG representatives have advised the council representatives present, that we do not view the achievement of the benchmarks on the basis of 'Pass or Fail'.

By promoting a 'Must meet' methodology, IPART's methodology paper can be viewed as not consistent with the 'guidance material' provided to councils and their representatives.

We also note that IPART is proposing to use two categories of councils, being 'All councils (except rural councils)' and 'Rural councils'. From our work in the sector we consider that there are three categories of councils, being Metropolitan, Regional and Rural. Each of these council categories have some distinct features and considering their performance in these categories, would in our view, be appropriate. The three council categories are also consistent with the categorisation used in the Sansom Report.

In respect of some of the specific benchmarks and the assessment methodology proposed we make the following comments,

### **Operating Performance**

Table 3.3 (page 30) states that all councils (except rural councils) 'Must' meet the benchmark of break-even (average over three years) by 2019/20 and rural councils should 'plan' to meet it within 10 years (i.e. by 2024/25).

As councils are not expected to report significant profits in any year, under the calculation, non rural councils will effectively have to be at or near break-even by 2017/18. This is a very short period of time for councils to improve their operating performance. This is on the basis that to get a break-even average in 2019/20, financial results for the following years are used:

2017/18  
2018/19  
2019/20

Whilst the principle of using an averaging process over three years allows for the smoothing of results, the current requirement that most councils 'Must' meet the breakeven benchmark by 2019/20 is not consistent with what has been previously advised to councils.

This issue will most adversely impact on regional councils and we believe that consideration should be given to extending the time period for compliance with the benchmark. This however should be on the understanding that councils are demonstrating an improving financial operating performance. Materiality of the size of any losses reported from year to year are also relevant. Failure to achieve a benchmark by a small margin should be considered in the overall context of a council meeting the FFTF criteria.

Metropolitan councils (in general) currently achieve greater levels of operating performance than either regional or rural councils. By having a third category of 'Regional' could allow IPART to address the issues raised above and allow Regional Councils some additional time to achieve the Operating Performance ratio, say an additional 2 or 3 years. To be classified as FFTF such



councils would still need to demonstrate a strong commitment and plan to achieve a break-even operating performance, but in an additional period of time.

### **Own Source Revenue (OSR)**

TCorp's view of sustainability is that OSR is an important risk factor in considering the sustainability of a council in that it illustrates the financial ability of a council to adjust its finances to deal with change and unexpected events.

Many rural or regional councils will struggle to or may never achieve a 60% OSR. Under TCorp's methodology that is not a Fail, but just one of 10 factors considered in terms of their ability to be sustainable. In our view this does not in itself, make them unsustainable.

Section 3.3.1 states that IPART 'will consider the impact of FAGs when assessing the sustainability criteria for rural councils'. It is not clear to TCorp what these comments mean. Further, if IPART is considering including FAG's in the calculation for rural (or any other council), that could be viewed as compromising the benchmark as it creates a special definition of sustainability for those rural councils.

Further, recent Federal Government decisions in respect of freezing the indexation of FAG's shows there are risks associated with FAG's and that they should not be considered as OSR.

Page 30 (although not table 3.3) also states that rural councils must demonstrate that they 'will meet and maintain the benchmark within 10 years'. Given the current levels of OSR for most rural councils, this position is unlikely to be achieved. TCorp's view is that achievement of the OSR benchmark should not be a Pass/Fail, but is considered as part of the overall assessment of the sustainability of a council.

### **Debt Service Ratio (DSR)**

Debt can be an important funding source for all businesses to procure long term capital assets and TCorp supports IPART's promotion of the idea of intergenerational equity. IPART's methodology promotes debt as one of the most important sustainability factors, in that compliance with the debt benchmark is one of the four 'Must' meet benchmarks. TCorp's work on local councils used two different debt benchmarks, being Debt Service Cover Ratio and Interest Cover Ratio. These ratios focus on the capacity of councils to meet debt repayments. TCorp's methodology used a weighting for these two benchmarks as a total of 10% as we regarded them as important, but not as critical as some other factors in terms of sustainability.

Whilst it is generally recognised that the council sector is under-gearred having the DSR as a 'Must meet' is in our view an aspirational goal, not a core driver of a council being sustainable.

It is relevant to note that based on the work that TCorp has undertaken since 2011, some of the councils that TCorp assessed as amongst the strongest financially sustainable councils in NSW (for example, City of Sydney and Hills, have no existing or current need for debt, significant capital expenditure programs, and very low Infrastructure Backlogs). Under the IPART methodology these councils would not meet the DSR criteria.



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TCorp would have concerns that some such councils may consider borrowing a nominal amount, say \$100,000, to say they meet the criteria, but this would not be a wise use of debt.

There are many more complex issues (including sector education to explain the benefits of debt when used correctly) to be considered to determine if councils are using debt wisely, but having debt or not having debt shouldn't, in TCorp's view, be one of the 4 key financial determinants of being Fit for the Future.

### **Building and Infrastructure Asset Renewal Ratio (BIARR)**


It has been stated that all Councils have to meet or improve this ratio within 5 years however this statement lacks relativity. While there is a benchmark to aim for, the wording suggests that at a minimum a Council should show improvement: but it could improve from 0.50 times to 0.55 times and potentially 'pass' this ratio.

Therefore we would argue that some form of relativity or materiality is included in this assessment.

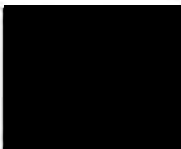
### **Asset Maintenance**

Similar to the BIARR this ratio lacks relativity and materiality given that Councils' should be allocating sufficient funds to maintain their asset base therefore a small improvement would not be sufficient. TCorp's preferred approach would be to quantify a minimum improvement (i.e. to 0.90 times minimum) as the benchmark.

Again, the three year average should be '100% average over 3 years' and not 'greater than 100% average over 3 years' or a range.

Should you require any further information, please don't hesitate to contact me on 

Yours sincerely,



Kevin Pugh  
Head of Local Government Services