D15/15705

25 May 2015

IPART
Chairman Dr Peter Boxall AO
PO Box K35
Haymarket Post Shop
NSW 1240

Dear Dr Boxall

IPART METHODOLGY – FIT FOR THE FUTURE

Orange City Council welcomes the opportunity to make submissions on the IPART methodology.

While in support in principle of local government reform Orange City Council is of the view that the process for assessment of Fit for the Future is missing a critical step.

Orange City Council is of the view that there is not sufficient diligent information to either support or exclude a merger. A more thorough analysis is required before Orange City Council could be properly informed on a decision to merge or not.

Orange City Council has a fiduciary duty to act in the best interests of its constituents. Council cannot fulfil that duty on the evidence detailed in the data revealed by the Fit for the Future process. By comparison the process does not meet the due diligence requirements of private or corporate sectors.

However these shortcomings could be significantly improved if a further assessment phase is added to the process.

If at the end of the IPART assessment process there is still a NSW Government view that mergers should proceed those identified as worthy of proceeding to the next step could be shortlisted for a further body of work.

This work would ensure the helicopter view undertaken by the Independent Local Government Review Panel, the Fit for the Future process and IPART shifts to a ground truthing exercise to address the limitations listed earlier.

IPART METHODOLGY – FIT FOR THE FUTURE Cont…

questions detailed in the methodology documentation.

Despite these concerns please find following Orange City Councils Responses to the IPART

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?

IPART notes the scale and capacity is the ability *"to engage effectively across community, industry and Government".*

Cabonne Council and Orange City Council commissioned Morrison Low through the Office of Local Government Merger Business Case Panel to undertake a merger business case.

While Orange City Council can comfortably meet this scale and capacity benchmark, Morrison Low noted that it is more likely that Orange will deliver scale and capacity to its neighbours and subsequently the resourcing issues relating to delivering scale and capacity could be transferred to another area.

Council notes that while a population number has been used for scale in Sydney it is ill-defined in regional NSW.

It is noted that in the IPART methodology document it states that if a standalone option is lodged it must demonstrate it is *"superior to the merger option".* At the Dubbo IPART consultation this was amended to *"as equal to"* or *"as good as".*

Chairman Dr Peter Boxall AO (as printed in the transcript on the IPART website) stated: "This shows that we evolve as we consult."

While there is uncertainty around the data collected as dictated by Fit for the Future (FFTF), Orange City Council can demonstrate it is standalone as a superior option.

Nonetheless the tempering of this benchmark, with greater definition is welcome.

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?

Not applicable.

IPART METHODOLGY – FIT FOR THE FUTURE Cont…

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?

Council has engaged its independent auditor Intentus to undertake an assessment of this element, which is attached.

There are significant concerns with the template criteria in the model particularly in relation to asset renewal ratios which are based on a high level model which does not consider full data or calibrated and detailed asset management systems. It is understood that this high level approach allows comparison between all Councils, including those which do not have full asset management systems.

In this regard some of the indicators ignore Orange City Council's detailed asset system and contemporary industry asset management techniques, particularly around intervention levels and residual asset values.

This approach has been canvassed with Council's Independent Auditor, Intentus, with the following observation:

"The infrastructure asset ratios are based upon the (unaudited) data in Special Schedule 7 that is generally accepted as being highly subjective and subject to significant fluctuation. And the depreciation expense reported from Note 9 which is based on financial reporting requirements that are inconsistent with the realities of asset management.

Primarily the requirement for Note 9 is that infrastructure is required to be valued on depreciated replacement cost i.e. as if the asset had to be built from nothing. 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?" The answers to the two questions are very different numbers."

It is noted that John Comrie in his FFTF – LGNSW Submission on the assessment criteria raised significant concerns around the model. His submission is attached.

In particular Orange City Council supports his concerns raised around the Building and Infrastructure Asset Renewal Ratio.

He stated:

"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

IPART METHODOLGY – FIT FOR THE FUTURE Cont…

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).)"

At the IPART consultation in Dubbo (as printed in the transcript on the IPART website) Dr Boxall AO, is quoted in the following:

"I think the point here is that we can make a judgment on the best data available."

The issue here is that while it is agreed it is the best available data as per the requirements and limitations of the Fit for the Future criteria it is not adequate to make such a critical decision on whether to merge or not.

In regards to population data the Office of Local Government has required the use of Planning NSW data while the IPART consultation paper only references the Australian Bureau of Statistics population data. This discrepancy will impact on the Real Operating Expenditure Per Capita measure of some councils. Council is of the view that the use of the ABS data for historical comparisons is appropriate, whereas the Planning NSW data should be utilised for future projections.

The IPART methodology paper correctly states that the performance of the water utility can be addressed in the template. While this is true water and sewer functions are excluded from the financial data in same template. It is assumed this path was taken to create some sort equalisation for these Council's that operate a water authority role (many in regional NSW) and those that don't (most in the metropolitan area).

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.

Orange City Council's consultation process is broadly consistent with that detailed in the IPART Methodology Consultation Paper in relation to a merger business case and there is a Council resolution to that effect.

Cabonne Council and Orange City Council commissioned Morrison Low through the Office of Local Government Merger Business Case Panel to undertake a merger business case.

IPART METHODOLGY – FIT FOR THE FUTURE Cont…

The IPART methodology documentation contained the following:

"In particular, OLG requires councils to provide evidence on community consultation regarding any proposed merger or new 'rural council' structures. In addition, evidence should be provided of council resolutions in support of merger proposals. OLG also suggested that councils exhibit proposals for mergers for at least 28 days as part of their community consultation."

There are significant limitations in this approach as it in part presumes a merger business case is the only option to consult on.

The development of the merger business case for Orange City Council and Cabonne Council does not get to a strong conclusion and is a limited assessment. Given this it is appropriate that Orange City Council also seeks community feedback on the standalone option, particularly if Cabonne Council subsequently declines to participate in a merger submission

Orange City Council consultation includes a community meeting, online forums and surveys and a 28 day exhibition period. Orange City Council has also taken feedback from Cabonne Council on the level of consultation in its LGA and the results.

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?

While Orange City Council is comfortable with further monitoring, there are already significant reporting requirements for local government.

If there is further work to be carried out Orange City Council is of the view that that body of work should proceed before there is decision to merge or not.

The need for further monitoring would be less relevant if there was more robust assessment prior to a final decision.

Yours faithfully

[redacted]

Garry Styles
GENERAL MANAGER

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

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[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

intentus
CHARTERED ACCOUNTANTS

Thorough, Attentive, Earnest

22 May 2015

The General Manager
Orange City Council
PO Box 35
ORANGE NSW 2800

Dear Garry,

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 deficient. The procedures performed are detailed in the terms of the engagement issued on 4 May 2015 and accepted by Orange City Council on 11 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 Orange City Council 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 Orange City Council 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

Per: [redacted]

John O'Malley
Director [redacted]

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

ORANGE

MAY 2015

intentus
CHARTERED ACCOUNTANTS

REVIEW OF IPART FFTF METHODOLOGY

intentus
CHARTERED ACCOUNTANTS

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) with Mr John Comrie appointed as a temporary tribunal member.

The assessment methodology for FFTF proposals were released 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 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	• Operating revenue for OCC over the assessment period is understated by $7,446,000.
Sustainability Criterion	Own Source Revenue	• Real Estate sales profits of $5,171,000 on revenue of $9,722,000 over the assessment period are excluded from the measure. • Conversely, revenue from loss making activities (Theatre & Function Centre) of $4,018,000 is included in the three-year assessment despite those activities incurring losses of $3,891,000 which are not included in the measure. • FAGs funding over the assessment period is understated by $2,275,000.
Sustainability Criterion	Building & Asset Renewal Ratio	• 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 actual data considered by this measure is an insufficient period of time to obtain meaningful information on very long-lived infrastructure assets.
Infrastructure Criterion	Infrastructure Backlog Ratio	• 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. • We are of the view that IPART should not rely upon this measure for making assessments or comparisons of councils.
Infrastructure Criterion	Asset Maintenance Ratio	• 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.
Infrastructure Criterion	Debt Service Ratio	• 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	• 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 that Orange City Council supplements their FFTF submissions with additional alternative measures accompanied by sound evidence that those alternatives are better tools in determining council fit for the future. This is particularly the case for the sustainability measures containing accounting based depreciation.

[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	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

OCC Outcome: ✓

	2011-12	2012-13	2013-14	Average over 3 years
Result	0.146	0.103	-0.055	0.065
Benchmark	0	0	0	0

Issue 1: Excluded FAG income

The IPART 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. For Orange City Council the missing payment amounted to $2,275,000.

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 part 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 is a regular and recurrent commercial venture for many councils.

For Orange City Council this activity generated profits of $5,171,000 over the three-year period of the review and in our opinion it would be appropriate to include those profits in the calculation.

We are of the view that the IPART assessment understates councils' underlying performance for this indicator. Despite meeting the benchmark overall and in two out the three years, we maintain that operating revenue for Orange City Council over the assessment period is understated by $7,446,000 even before contemplating the inclusion of operating (FAG) grants.

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 may 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	Total continuing operating revenue (excl all grants and contributions) / Total continuing operating revenue (incl capital grants and contributions)	Greater than 60% average over 3 years

OCC Outcome: ✓

	2011-12	2012-13	2013-14	Average over 3 years
Result	60.2%	69.6%	68.2%	65.9%
Benchmark	60%	60%	60%	60%

Issue 1: Exclusion of operating grant income from the numerator

The analysis undertaken by T-Corp in 2013[4] identified that operating grants and contributions comprise a significantly greater proportion of total revenue for non-metropolitan councils. Unlike discretionary grants, we consider FAGs funding to be a recurrent, reliable and in non-metropolitan settings, very significant source of revenue and it would therefore be appropriate to include in the numerator. Conversely, capital grants are less frequent, regular or reliable and due to their size can distort results markedly. We therefore believe they should be excluded from the denominator.

For Orange City over the assessment period the actual FAG grant revenue (excluded from own source revenue numerator) was $12,610,000 and General Fund capital grants (included in the denominator) were $33,502,000.

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.

By way of example, Orange City Council operates two such enterprises (Civic Theatre and Function Centre) that have over the three-year assessment period incurred losses of $3,891,000 on turnover of $4,018,000. The Own Source Revenue ratio as it currently stands, recognises the $4M revenue, but fails to also recognise that the overall result of the activity is a financial loss.

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

We note and concur with IPART's position that "we will consider the impact of FAGs when assessing the sustainability criteria for rural councils, and in particular, the Own Source Revenue ratio"[5].

As mentioned in 1.1 above, we believe that flexible approach should also be applied by 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.

For Orange City this activity generated profits of $5,171,000 on revenue of $9,722,000 over the three-year period of the review and in our opinion it would be appropriate to include those profits in the calculation.

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[4] Financial Sustainability of the New South Wales Local Government Sector, NSW Treasury, April 2013 ,page 52
[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	Asset renewals (building & infrastructure) / Depreciation, amortisation & impairment (building & infrastructure)	Greater than 100% average over 3 years

OCC Outcome: X

	2011-12	2012-13	2013-14	Average over 3 years
Result	21.5%	14.1%	6.9%	12.7%
Benchmark	100%	100%	100%	100%

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 expense[6] 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[7]. 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.***

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[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).

Orange City Council in particular has invested heavily in the development of detailed AMP's for all infrastructure assets and 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 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. In common with many councils, Orange City Council has 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	Estimated cost to bring assets to satisfactory condition / Total (WDV)of infrastructure buildings, other structures, depreciable land & improvement assets	Less than 2%

OCC Outcome: ✓

	2013-14	Average over 3 years
Result	1.07%	1.07%
Benchmark	2.00%	2.00%

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 mandates[10];
- 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.

Issue 3: Incompatibility between Numerator and Denominator

The numerator for this measure is from 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 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 WDV drawn from Note 9 to the financial statements which as identified in 1.3 above assumes replacement of the asset with a modern equivalent 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 of council's response.

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

2.2 Asset Maintenance Ratio

Measure	Formula	Benchmark
Asset Maintenance Ratio	Actual Asset Maintenance / Required Asset Maintenance	Greater than 100% average over 3 years

OCC Outcome: ✓

	2011-12	2012-13	2013-14	Average over 3 years
Result	57.5%	201.7%	137.4%	130.2%
Benchmark	100%	100%	100%	100%

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	Cost of debt service (interest expense and principal repayments) / Total continuing operating revenue (excluding capital grants and contributions)	Greater than 0% but less than or equal to 20% average over 3 years

OCC Outcome: ✓

	2011-12	2012-13	2013-14	Average over 3 years
Result	4.43%	5.32%	6.27%	5.34%
Benchmark 1 >0%	0%	0%	0%	0%
Benchmark 2 <20%	20%	20%	20%	20%

Observation: Consistent with the recommendations of the review panel[11] 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

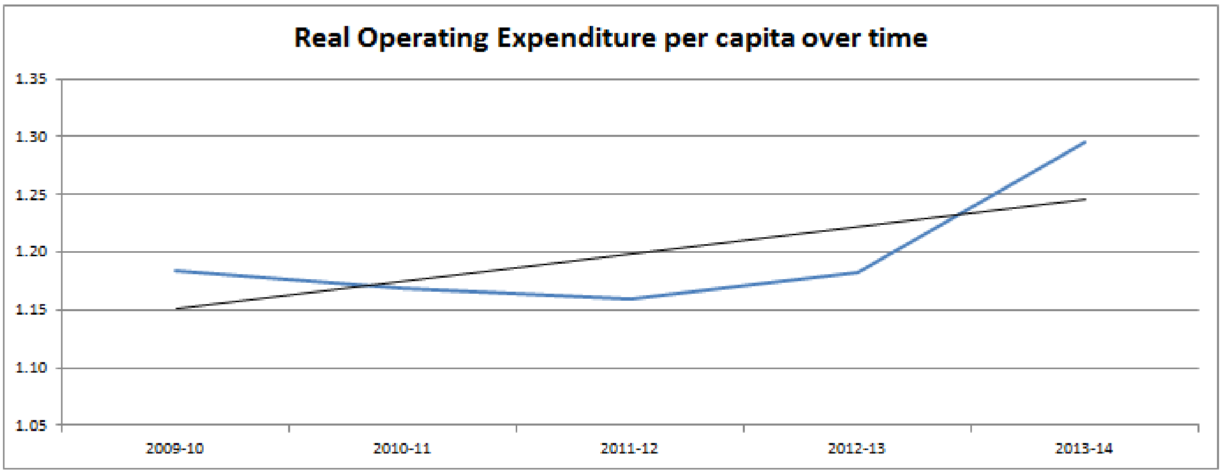
3. Efficiency Measures

3.1 Real Operating Expenditure

Measure	Formula	Benchmark
Real Operating Expenditure	Operating Expenditure / Population	A decrease in Real Operating Expenditure per capita over time

OCC Outcome: X

	2009-10	2010-11	2011-12	2012-13	2013-14
Result	1.18	1.17	1.16	1.18	1.29



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.