Dr Michael Keating,
AC

Chairman

IPART NSW
Revenue Framework for Local Government

Dear Dr Keating

**Submission to the Independent Pricing and Regulation Tribunal of New South Wales on the Revenue Framework for Local Government
Other Industries - Draft Report July 2009**

1. Summary

The efficient management of ratepayers' capital impacts on the financial sustainability of councils. I have examined this issue from the perspective of return on capital employed in respect to councils' core and non core business activities and a case study of Ballina Shire Council (BSC). I have also made recommendations aimed at the development of a framework to enable councils to achieve and maintain financial sustainability.

2. Introduction

I am a residential ratepayer in BSC. The purpose of my submission is to comment on the issue of financial sustainability and specifically capital sustainability of NSW councils.

Generally I support the approach of the Independent Pricing and Regulation Tribunal of New South Wales (IPART) in assessing financial sustainability. In respect to capital sustainability the IPART focus appears to be on the adequacy of capital. However the efficient management of capital also impacts on capital sustainability and therefore this is an issue for which Key Performance Indicators (KPIs) need to be determined.

3. Background

3.1 Core Business Activities

The core business of a council is the provision and maintenance of community infrastructure and services. For most councils capital allocation is focused solely on these activities. However infrastructure and services generally do not provide a financial return in terms of income and capital appreciation and therefore the return on capital employed cannot be accurately measured in traditional financial terms. Nevertheless a council's investment in community infrastructure and services does provide a social return on capital employed insofar as it provides the facilities to enable a community to function such as roads, street lightening, sporting and recreational amenities, waste removal etc. The quantifying and measuring of the social return on capital employed needs to be addressed in terms of assessing capital sustainability.

3.2 Non Core Business Activities

Some councils allocate ratepayers' capital (equity and long term debt) to non core business activities particularly commercial property investment. Under the accounting standards these assets are classified as investment properties in the council's financial statements. Whist councils are not permitted to invest in property pursuant to Section 625 of the Local Government Act 1993 and the Ministerial Investment Order they maintain that they gain authority to make these investments under Section 186(1) of the Local Government Act 1993. That section states that:

> *'a council may acquire land (including an interest in land) for the purpose of exercising any of its functions.'*

There appears to be an anomaly in the legislation which allows councils to undertake property acquisition and property development for investment purposes and which are outside the constraints of Section 625 of the Local Government Act 1993 and the Ministerial Investment Order. This anomaly poses an unacceptable risk of loss of ratepayers' funds and the situation needs to be reviewed by the Department of Local Government (DLG).

3.3 Non Core Business Activities Not Justified

Councils endeavour to justify commercial property investments by claiming that the revenue streams from the investments augment council income enabling them to enhance their core business, being the provision and maintenance of infrastructure and services. I question this assumption. Putting aside the technicalities of discounted cash flows, internal rates of return, commercial property capitalisation rates and net present value issues the free cash flows from property investments, including the end value in the event that the investment is sold, represents the return of the original capital outlay in real terms after allowing for the time value of money and the premium to cover the risk that the future cash flows may not be received in whole or part.

If the purpose of investing in non core activities is to improve the performance of the core infrastructure and services business then, for capital management purposes, the social return on capital employed in infrastructure and services should be considered alongside the financial return on capital employed from the investment in non core activities. The target return on capital employed in core and non core activities should be at least equal. If the social return on capital employed in the core business is considered to be less than the financial return on capital employed in non core activities then the efficiency of core infrastructure and service business should be improved. If the return on capital employed in core and non core activities is equal then the investment in non core activities will not improve the performance of the core infrastructure and services business and therefore there is no point in investing in non core activities.

Excessive investment of ratepayer's capital in non core activities, particularly financial assets such as investment properties may have a negative impact on a council's core business. It reduces the amount of capital that a council has available for investment in infrastructure and services. Consequently ratepayers are deprived of the infrastructure and services that their rates were intended to fund. A council may need to raise additional capital in the form of increased rates, fees, charges and borrowings to meet its infrastructure and services programs or alternatively the community may need to go without these facilities. This is not conducive to the achievement and maintenance of intergenerational ratepayer equity.

3.4 FiscalStar Comment

FiscalStar has addressed the issue of investment in financial assets and has commented in part as follows in its Editorial Opinion, 15 October 2007:

'From a ratepayer perspective, surplus holdings of financial assets at worst are evidence of rates and charges being too high or, at best, represent a management distraction and risk.

For these reasons, FiscalStar does not include a council's holdings of financial assets in its assessments. Rather than being a 'positive', at best holdings of financial assets are a 'neutral' consideration from the ratepayer perspective.

The most appropriate use by councils of capital – whether raised through borrowings or in the form of ratepayer-provided equity – is investment in non financial assets *such as infrastructure and buildings.'*

Councils rated by FiscalStar held around $13 billion in financial assets at 30 June 2006. These represent nearly 8% of total assets held by rated councils. There were significant differences between States, with South Australia and Victoria being at much more prudent levels (2.5% and 5% respectively) while the average for the other States approached 10%.

3.5 Capital Sustainability KPIs

There may be many millions of dollars tied up in excessive non core financial asset investments by NSW councils. In terms of capital sustainability KPIs need to be developed which benchmark the levels of non financial asset holdings by councils and drive the efficient management and allocation of ratepayers' capital. One such KPI should be a financial asset ratio similar to that developed by FiscalStar. That is for financial sustainability considerations financial assets should not exceed the range of 2.5% to 5% of total assets.

The definition of financial assets also needs to be addressed. In addition to investments and investment properties which are specifically identified in financial statements councils may also hold other property and real estate assets. These may have commercial, industrial or residential zonings, which have market values, and which are not required in the core business. These assets may be listed as fixed assets in the financial statements and not taken into account in the calculation of financial assets. Nevertheless they need to be brought to account. Councils need to consider divestment of these assets with the proceeds being reallocated to fund community infrastructure and services rather than increasing rates, fees and charges.

For the purpose of determining the capital sustainability KPI, financial assets should include current assets, plus non current investments, plus investment properties, plus surplus fixed assets comprising real estate and properties at market value, minus externally restricted cash and investments.

3.6 Expertise and Policies

There is a need for the NSW local government sector to improve its knowledge and understanding of contemporary capital management theory and practices in order to manage ratepayers' capital in an efficient and effective manner. It would be helpful if the DLG could arrange training courses for councilors and local government staff, require councils to implement capital management policies and issue policy guidelines to assist councils in this regard.

4. Case Study – Ballina Shire Council

The following case study of BSC highlights the issues relating to the efficient management of capital in terms of capital sustainability.

4.1 BSC Profile

BSC was classified as a Group 4 council – Regional Town/City (Comparative Information on NSW Local Government Councils 2007/08)

BSC is located on the far north coast of NSW approximately two hours from Brisbane. The shire has an area of 487 square kilometres. It is largely rural with the major centre servicing the shire being the town of Ballina which is located on the Richmond River. The region has a number of smaller villages and major townships at Alstonville, Lennox Head, Wollongbar and Wardell.

The population of Ballina Shire at the 2006 Census (ABS Census QuickStats) was 38,461. Most people live in the township of Ballina. There is a reasonably large population, over 7,000 persons, which live in the rural area of Ballina Shire. While the population of the Ballina Shire area is growing, the rate at which it is increasing has slowed.

Ballina Shire has a population age profile that is different to that of the NSW State profile. Specifically, the Shire has a larger percentage of persons aged over 55 years than the State average. This difference is more significant for the age group over 65, with the Shire's percentage being more than 6% higher than the State average. Conversely, the population below the age of 54 years is generally lower than the State average. The Shire's Indigenous population is slightly larger than the State average, being 2.7% of the Ballina Shire population. Only 9.7% of the population were born overseas, as compared to the State average of 22.2%.

The 2006 Census data identifies school education as the industry employing the largest number of persons aged over 15 years. This is followed by cafes, restaurants and takeaway food services, highlighting the tourism focus of the area. The main rural industries include sugar, macadamia nuts, coffee, avocado, dairy and beef. There is also a fishing industry. (Promoting Better Practice Report – October 2008)

4.2 BSC Financial Issues

BSC had an annual income of approximately $61.1 million with an approximate expenditure of $55.7 million (Annual Report 2007/08). BSC has had a deficit before capital items for the three financial years to 30 June 2008.

The Northern Star newspaper reported on 4 August 2009 that BSC's spending per capita on community services in 2007/8 was $19.42 compared to the NSW state average of $59 and $79.85 by the adjoining Byron Council.

According to FiscalStar for 2007/8 BSC had an infrastructure backlog of $21.46 million or 57% of operating revenue. However the infrastructure situation would appear to be much worse than revealed by the FiscalStar analysis. BSC management reported to the BSC Facilities Committee on 6 July 2009 that the potential demand on BSC for capital works funding including the infrastructure backlog (estimated at $20 million) was $100 million plus, of which $12 million is for commercial property development.

While the 2008 Promoting Better Practice Report described BSC financial as satisfactory, based on financial viability ratios, BSC has been rated financially unsustainable by FiscalStar for the 2006, 2007 and 2008 financial years. The primary driver of these unsustainable ratings appears to be the cumulative effect of under investment in infrastructure and over investment in financial assets over many years.

As at 30 June 2008 BSC had excess financial assets of $22 million to $37 million. Based of the FiscalStar definition BSC financial assets as at 30 June 2008 were $53.3 million including investment properties of $16.2 million and excluding externally restricted investments of $39 million. The financial assets ($53.3 million) comprised 8.5% of total assets of $628.1 million. This is well in excess of the FiscalStar benchmark range for financial assets of 2.5% to 5% of total assets.

The position however would appear to be considerably worse. Included in its fixed assets BSC has other real estate holdings such as subdivision land banks and an assortment of properties which are surplus to requirements. When these are taken into account the excess financial assets figures are increased.

4.3 BSC Rating Strategy

BSC maintains that its rates have been historically low compared to other Group 4 councils. BSC has been applying for special rate variations above the rate pegging limits to increase its rate base in relation to the Group 4 average. It applied for and was grated special rate variations for 2007, 2008 and 2009. The problem with the BSC strategy is that by basing its rate setting on what other councils are charging it is ignoring the financial fundamental of BSC and the relativity of the level of services and infrastructure which it is providing to the Ballina community.

BSC also applied for a special rate variation of 3.7% above the rate pegging limit for 2010. In June 2009 I made a submission to the DLG arguing that based on the financial fundamentals of BSC a special rate variation for 2010 was not justified. I recommended that BSC's application be declined, which it was. In his written response to my submission the Deputy Director - General (Local Government) Department of Premier and Cabinet, Ross Woodard, said in part:

> *'I have noted your concerns in regard to council's application for a special variation. After careful consideration, the Minister has declined council's request to increase its general income. Council has been encouraged to pursue projects within its current financial resources, reviewing expenditure priorities and initiating productivity measures.*

It would appear that based on the above BSC has serious issues regarding its rate setting strategies and its capital management in respect to the provision of a reasonable level of community services and infrastructure to the Ballina community.

4.4 BSC Flawed Financial Strategy

Since the mid 1970's BSC has been allocating ratepayers' capital to non core commercial activities. These have primarily comprised land subdivisions but in recent years BSC has also ventured into commercial property development. Generally BSC considers these projects in confidential sessions on the pretext of commercial confidentiality. The Ballina community is not consulted on individual projects and there is limited public reporting on the feasibility, viability and financial performance of these ventures. The information provided by BSC is inadequate to allow diligent public scrutiny.

BSC argues that the income from these ventures augments council's revenue and helps to fund infrastructure projects. BSC does not report on the return on capital employed on its commercial property ventures and I question whether it considers this issue when assessing the financial performance of the ventures. I also question whether the return on capital employed is commensurate with the risk taken given that the industry classification for commercial property development and investment is high risk.

BSC also claims that its commercial property ventures are funded from separate income streams or are self financing or self funding. I do not agree with this assertion. While for reporting purposes some council activities are addressed separately, councils are accounted for on a single entity basis where income from all sources is pooled and expenses are paid from pooled funds.

Ratepayers' annual contributions are continually replenishing the pool of funds to enable councils to meet ongoing expenses. Also borrowings to finance commercial ventures are not provided on a stand alone non recourse basis. Financiers have recourse to ratepayers' funds to secure their credit facilities. Ratepayers effectively underwrite all financial aspects of a councils' activities. Capital expenditure on commercial ventures is funded from ratepayers' funds and not from separate income streams of commercial ventures. These are important considerations from a capital management perspective.

4.5 BSC Unsatisfactory Financial Position

The unsatisfactory financial position of BSC is a result of its flawed and failed financial strategies. BSC is running operating deficits, it has a very low level of expenditure on services, it has a large infrastructure backlog, it has been rated financially unsustainable by FiscalStar, it has a large amount of ratepayers' capital tied up in high risk real estate related financial assets and it is planning the further allocation of millions of dollar of ratepayers' funds to speculative land subdivisions and commercial property developments .The financial asset investments are concentrated in Ballina Shire which is a sub prime real estate investment precinct. This poses an unacceptable risk of loss of ratepayers' funds. It would also appear that BSC financial strategies no longer have the support of the DLG or the Minister for Local Government as BSC's application for a special rate increase for 2010 has been declined.

4.6 Promoting Better Practice Report

The position of Ballina Shire ratepayers has not been helped by the DLG's October 2008 Promoting Better Practice Report on BSC. In respect to land development activities the report commented as follows:

> *'For some time Council has undertaken land development activities. A strategy plan will be prepared for the future development of Council's commercial activities. It is anticipated that these activities will provide Council with additional sources of revenue. The development of this strategy is encouraged to ensure that Council's activities in this area do not pose uncertain risk to Council's ongoing operations.'*

The DLG focus is on the generation of additional revenue without regard to or comment on the capital sourcing and funding issues to finance future developments. It gives no consideration to the adverse impact these activities have on the capacity of BSC to provide a reasonable level of services and infrastructure to the Ballina community. Also it does not identify that these activities will exacerbate BSC financially unsustainable position and result in a further deterioration of intergenerational ratepayer equity. The DLG needs to adopt a more professional approach to the financial analysis of and comentary on councils' non core business activities.

4.7 BSC Financial Sustainability Rehabilitation

BSC should be able to achieve financial sustainability without increasing the rates, fees and charges burden on the Ballina community. In this regard BSC should be looking to develop a medium term business plan to exit non core financial assets and use the proceeds to improve its operating deficit and infrastructure backlog. Once financial sustainability is achieved BSC should adopt prudent and responsible financial plans to ensure that financial sustainability is maintained going forward.

4.8 Role of the Private Sector in Ballina Shire

Given the size and location of Ballina Shire it has a good level of retail and commercial facilities and an acceptable supply of residential accommodation both in terms of existing dwellings and vacant building allotments. These have been provided primarily by the private sector which has historically demonstrated a willingness to invest in the Ballina Shire. Consequently there is no need for BSC to invest ratepayers' capital in these ventures. They are best left to the private sector which has the capital resources and the experience and expertise to undertake them.

It was reported in the Northern Star newspaper on 11 September 2008 that Homeworld Ballina, the developer of a $100 million bulky goods complex planned for West Ballina alleged that BSC used information from Homeworld's proposal to plan its own bulky goods development. I understand that this issue is now the subject of litigation between Homeworld and BSC.

The private sector has become concerned about BSC's involvement in commercial property developments primarily because of the conflict of interest which arises from BSC being both a developer and the regulator of commercial property projects. These concerns have the potential to adversely impact the supply of private capital needed to fund the future growth of Ballina Shire.

BSC owns the land banks to the two industrial estates currently under development in Ballina Shire. There are concerns within the Ballina community that the public land releases from these estates are inadequate to satisfy demand and this is inhibiting the economic development of Ballina Shire. The situation is exacerbated by BSC holding vacant industrial allotments to undertake its own developments which are to be leased to private businesses. Once again because of inadequate reporting it is not know whether BSC has achieved a return on capital employed which is commensurate to the risks taken in respect to its land development activities.

There is no need for BSC to be tying up ratepayers' capital in industrial land developments. This is another activity that should be left to the private sector. Again BSC should be formulating medium term business plans to exit its land development activities with the proceeds being reallocated to the capital funding of community infrastructure and services.

5. Supervision and Regulation

There is a need for greater supervision and regulation of councils' non core commercial activities in order to protect ratepayers' funds from risk of loss and to ensure the financial sustainability of councils. Generally local government management has little professional experience outside the local government sector. I question whether management has the expertise to successfully undertake commercial activities on a consistent basis particularly in the high risk sector of commercial property development and investment.

Traditionally the financial performance of councils has been assessed using viability financial ratios. The emphasis is changing to include financial sustainability. Based on the annual FiscalStar ratings and the KPIs proposed in the IPART draft report many councils are financially unsustainable. A contributing factor includes poor financial management. The attainment and maintenance of financial sustainability is likely to be one of the biggest challenges facing many NSW councils going forward. A lot of work will need to be done over coming years to rehabilitate financially unsustainable councils and in this regard I believe that the DLG has an important role to play.

The Australian Prudential Regulation Authority (APRA) which is the prudential regulator of the Australian Financial Services Industry is an example of the very valuable contribution government supervision can make to the performance of an industry. Under APRA supervision the financial services industry has been able to deliver high quality financial products and services to the Australian public whilst maintaining prudential standards. The Australian banking system which is supervised by APRA is regarded as one of the most financially sound in the world and has played an integral role in the Australian economy avoiding the worst of the global financial crisis. I believe that with proper supervision and regulation NSW could have a world class local government sector.

Once the DLG settles its financially sustainable KPI's it should take an active supervisory role in the rehabilitation of those councils which are rated financially unsustainable. In this regard it would be helpful if the DLG issued sustainability guidelines. Also financially unsustainable councils should be required to develop financial sustainability rehabilitation business plans. The plans should be reviewed by the DLG and improvements suggested as appropriate. The actual performance to plan should be reviewed as part of a council's quarterly financial report. Quarterly performance to plan should also be monitored by the DLG and remedial action suggested where appropriate.

6. Recommendations

The following is recommended:

1. IPART recommend to the DLG that it review the operation of Sections 625 and 186(1) of the Local Government Act 1993 and the Ministerial Investment Order with a view to removing the anomaly which permits councils to acquire land and undertake property development for investment purposes.

2. A suite of capital sustainability KPI's be included in the financial sustainability assessment of councils.

3. The capital sustainability KPI's include a financial asset ratio under which financial assets are not to exceed a given percentage of total assets.

4. For the purpose of determining the capital sustainability KPI financial assets include current assets, plus non current investments, plus investment properties, plus surplus fixed assets comprising real estate and properties at market value, minus externally restricted cash and investments.

5. Once the financial sustainability KPI's are determined the DLG issue financial sustainability guidelines.

6. Councils which are assessed as financially unsustainable be required to develop financial sustainability rehabilitation business plans.

7. The financial sustainability rehabilitation business plans be reviewed by the DLG and improvements suggested where appropriate.

8. Councils report on actual performance to sustainability rehabilitation business plan as part of their quarterly financial reviews.

9. The DLG develop a supervision regime to monitor the progress of councils' financial sustainability rehabilitation business plans.

10. Councils be required to develop a capital management policy.

11. The DLG develop and issue capital management policy guidelines.

Yours sincerely

V M (Vince) Kelly