PROPOSAL TO "DEMERGE" THE EXISTING SNOWY VALLEYS COUNCIL

Summary of Key Findings from Analysis by Deloitte on the Financial Implications

Local Government Boundaries Commission

OCTOBER 2020

1. BACKGROUND TO THIS DOCUMENT

In February 2020, the Minister for Local Government referred to the Boundaries Commission a proposal that would, in effect, “demerge” the Snowy Valleys local government area into the two areas that existed prior to the 2016 merger.

In examining any proposal for a change in local government boundaries, the *Local Government Act 1993* requires the Boundaries Commission to have regard to a number of specified “factors”. One of those factors (section 263(3)(a) of the Act) is -

> “the financial advantages or disadvantages (including the economies or diseconomies of scale) of any relevant proposal to the residents and ratepayers of the areas concerned”.

To assist in its consideration of this factor, the Commission engaged Deloitte Touche Tohmatsu to provide advice on the financial implications of the proposal. Details of the scope of the advice were set out in the Commission’s 16 July media release available at www.olg.nsw.gov.au/lgbc.

Deloitte’s report to the Commission has not yet been finished. However the Commission is releasing this summary of what it considers to be the key findings and observations from Deloitte’s work to date, in order that residents and ratepayers might have a better understanding of the financial advantages and disadvantages of the proposal ahead of the public inquiry sessions commencing 3 November and the close of written submissions on 13 November. The key findings and observations are based on Deloitte’s analysis of information obtained from the Snowy Valleys Council and other sources, discussions with Council staff and Deloitte’s own understanding of the issues involved.

The contents of this summary should not be seen as representing the Commission’s view on the financial advantages or disadvantages of the proposal. In having regard to this factor, the Commission will consider all sources of information, including written submissions from residents and ratepayers, oral presentations at the public inquiry sessions, the final Deloitte report, benchmarking data compiled by the Office of Local Government, etc.

2. SNOWY VALLEYS COUNCIL

Current Position

- Since the merger, Snowy Valleys Council’s (SVC) focus has been integrating the operations of the former Tumut and Tumbarumba councils, harmonising service levels and delivering a largescale program of infrastructure works enabled by one off merger and other capital grant funding.
- Operationally, the former councils are considered largely integrated under a single organisational structure, with harmonised systems, policies and processes in place. There has been little if any physical consolidation since the merger, with SVC retaining both Tumbarumba and Tumut service centres, depots and a service presence in smaller towns and villages.
- Post-merger activities that have impacted the SVC community include but are not limited to:
    - Approximately $16.5m investment in new community assets across the region including $10.7m in the former Tumbarumba shire and $5.8m in the former Tumut shire
    - Investment in renewal of road, sewer and aged building assets which has reduced the infrastructure backlog and improved the average condition of assets
    - Harmonisation of some service levels across the region (e.g. cultural programs, introduction of new waste programs) and standardising user fees and charges
    - Harmonisation of annual waste, sewer and water annual charges in FY19, which resulted in an increase in waste and sewer charges for all ratepayers and a reduction in water charges for Tumbarumba ratepayers

- Development of a Rates Harmonisation Strategy which, subject to community consultation, is expected to be implemented in FY22. The rates harmonisation is expected to result in a reduction in average rates for Tumut ratepayers and an increase in average rates for Tumbarumba ratepayers.

Overview of SVC's Financial Performance (FY17 to FY20)

- SVC has reported a cumulative operating surplus in the four-year period since the merger, including the benefit of one-off merger implementation and Stronger Communities grant funding to support the integration and investment in community infrastructure projects.
- Excluding capital grants, SVC has incurred a cumulative operating deficit over the same period. This indicates SVC's reliance on capital grants to maintain adequate investment in asset maintenance and renewal, which benchmarking indicates is consistent with many other Rural and Large Rural councils.
- Year on year, SVC's operating results have fluctuated due to:
  - The timing of receipt of recurring operating grants
  - One off grant funding and costs relating to the merger implementation, specific community initiatives and emergency response events including but not limited to the 2019/20 bushfires
  - Changes in accounting policy relating to the recognition of grant income.

Figure 1: Net Operating Result Summary (FY17 to FY20)

$m	FY17	FY18	FY19	FY20 DRAFT	4 Yr Total
Rates and annual charges	16.7	16.1	16.7	17.0	66.6
User fees and charges	21.1	16.0	15.1	15.2	67.4
Other revenue	2.5	2.7	2.8	3.4	11.5
Operating Grants	19.1	10.8	17.4	15.3	62.6
Capital Grants	12.1	6.1	4.8	11.7	34.7
Income	71.6	51.7	56.8	62.7	242.7
Employees	(18.6)	(18.4)	(18.2)	(20.6)	(75.8)
Materials	(20.2)	(14.8)	(15.9)	(18.4)	(69.3)
Depreciation	(12.3)	(10.5)	(11.6)	(11.7)	(46.2)
Other operating expenses	(6.4)	(5.4)	(5.4)	(6.0)	(23.2)
Non Operating Expenses					
Loss on disposal of assets	(2.3)	(1.1)	(2.5)	(2.0)	(7.9)
Asset impairments	(2.8)	(4.0)	0.0	0.0	(6.8)
Expenses	(62.5)	(54.3)	(53.6)	(58.7)	(229.1)
Net Operating Result	9.1	(2.7)	3.2	4.0	13.6
Net Operating Result before capital grants	(3.0)	(8.8)	(1.6)	(7.7)	(21.1)

Key Operating Ratios				
Operating Performance Ratio (%)	3.4%	-8.0%	1.8%	-11.1%
Own Source Revenue (%)	56.4%	66.8%	61.0%	56.9%

Notes:
- FY17 reflects a 13.5 month period from 13 May 2016 to 30 June 2017.
- FY20 accounts are draft only and are therefore subject to change.
- Operating Performance Ratio measures how well local councils contain expenses within revenue. The benchmark set by the Office of Local Government (OLG) for the ratio is greater than 0%.
- Own Source Revenue measures a council's fiscal flexibility and the degree to which it relies on external funding sources such as operating grants and contributions. The benchmark set by OLG for the ratio is greater than 60%.

SVC's Cost Base

- To date, SVC has not realised economies of scale or net savings as a result of the merger. However, this is not inconsistent with the pre-merger modelling which assumed minimal if any savings in the first four years due to integration activities and staffing protections in place under the Act. These staffing protections include:
  - no forced redundancy of non-senior staff for three years (expired June 2019)
  - Tumbarumba and Khancoban, as Rural Centres (with population < 5,000), to maintain the same level of staff as was employed immediately prior to the merger.
- In relation to SVC's organisational structure:
  - the current approved structure is 225 FTE which is approximately a 3 FTE (net) increase on pre-merger staffing levels. Gross savings realised in relation to redundant executive roles following the merger have been reinvested in service delivery and enhancing organisational capability, particularly in areas of governance, project and financial management.
  - excluding annual award increases, the average cost per employee has increased since the merger due to:
    - a wage harmonisation project completed in 2017 which aligned roles, grades and salary levels across the new council. This resulted in a net wage increase for some Tumbarumba roles in order to align with salary bands under the Act.
    - a higher degree of functional specialisation in the organisation, including the aforementioned investments in governance, project and financial management capability to meet the operational and regulatory reporting requirements of the larger council.
  - In November 2019, following expiry of the transitional staffing protections in June 2019, SVC undertook a restructure which is estimated to deliver c$0.4m net annual savings.
- In relation to other operating costs:
  - Materials and depreciation costs have increased in the period since the merger relating to: higher cost of service delivery harmonisation (including new waste programs) and higher indirect asset costs (including depreciation) as a result of investments in new infrastructure and asset renewal, partly funded by one-off merger and other capital grants.
- Since the merger, approximately $62m has been invested in capital projects, including new infrastructure, asset renewal and maintenance. As a result, SVC's Infrastructure Backlog Ratio has reduced to minimal levels (0.05% as at 30 June 2019) and the average quality rating for assets across the region has improved.

SVC's Long Term Financial Plan

- SVC's Long Term Financial Plan targets financial sustainability by 2030 which it defines as:
  - achieving an operating surplus before capital grants; and
  - maintaining adequate funding of asset renewal.
- In order to achieve financial sustainability by 2030, SVC is relying on:
  - operating and capital grants remaining at minimum average historic levels;
  - continuing RMS contract revenue, broadly in line with FY20 levels;
  - income growth from its private works business; and
  - a modest reduction in employee and materials and contracts expenses.

- SVC's Long Term Financial Plan to 2030 assumes no Special Rate Variations or material changes in service levels.
- The full year benefit of the November 2019 organisational restructure is forecast by SVC to be realised in FY21. Any further employee cost savings will rely on natural attrition and be subject to an assessment of resourcing needs at that time.
- Materials and contract savings are targeted from FY21 as a result of planned procurement process improvements leveraging economies of scale of the merged council and the Canberra Region Joint Organisation of which SVC is a member.
- SVC's ability to achieve financial performance improvement targets may be constrained by:
  - Geographic spread and community expectations in regards to service levels which limit asset and service consolidation opportunities
  - Minimum Rural Centre FTE requirements in place for the Tumbarumba Shire
  - Increasing cost of asset maintenance and renewal associated with new infrastructure projects
  - Community stakeholder alignment in relation to the merger, service levels and financial sustainability objectives.

3. DEMERGER CONSIDERATIONS

Demerger Costs

- A demerger of SVC into the former council areas of Tumbarumba and Tumut would result in additional costs being incurred which, in the absence of specific funding, would need to be borne by the community.
- One-off costs which are likely to be incurred include but are not limited to: project resources to support transition management and community engagement, ICT system implementation costs, financial and legal adviser costs and rebranding costs. As there has been minimal physical or asset consolidation following the merger, there are not expected to be material costs to re-establish or replace fixed assets.
- Based on available benchmarks, one-off demerger costs are estimated to be in the range of \$1.6m to \$2.3m for Tumut and \$2.1m to \$3.1m for Tumbarumba. The higher cost range for Tumbarumba reflects slightly higher assumed transition costs, as well as a potential need to invest in upgrading its quality systems and processes to attain required private works accreditation, if that is to form part of its future financial sustainability plan.
- There is also expected to be additional recurring costs connected with re-establishing Councillor and Executive Leadership team structures, effectively reversing the gross savings realised on merger. This recurring cost is estimated to be in the range of \$0.4m to \$0.7m per annum for each council.
- As these demerger costs will ultimately be funded by the community, they have been presented below on a per rateable assessment basis. The ratepayer impact is more pronounced in Tumbarumba than Tumut due to the higher assumed separation costs and relatively smaller ratepayer base sharing the costs.

Figure 2: Demerger cost estimates and ratepayer impacts

Indicative Demerger Cost Range	Tumut			Tumbarumba		
$m	Low	High	Mid	Low	High	Mid
One off separation costs	1.6	2.3	1.9	2.1	3.1	2.6
Recurring costs	0.4	0.7	0.5	0.4	0.7	0.5
Rateable Assessments (No)	6,346	6,346	6,346	2,466	2,466	2,466
$ / Rateable Assessment ($)						
One off separation costs	244	366	306	839	1,273	1,056
Recurring costs	55	110	84	142	284	215

Note: Rateable Assessment numbers are per SVC's FY21 Revenue Policy dated 16 July 2020

- The demerger costs as presented should be considered high level estimates and indicative only. The actual costs could be materially higher or somewhat lower depending on a number of factors including the ability of the councils to reach consensus on legal, financial and commercial separation matters (including the allocation of cash reserves) and the financial capacity of the new councils to fund such costs. Further investigation into key cost areas including ICT systems implementation and works division accreditation may also be warranted if a demerger proposal is to proceed further.

Financial Sustainability of New Councils vs “Base Case” (ie Continuing SVC)

- In order to assess councils’ financial viability under both a Base Case and demerged scenarios, Deloitte has undertaken high level modelling to identify the estimated ‘gap’ to achieving a breakeven operating result before capital grants (as an indicator of financial sustainability) in FY25 (year 5). The modelling is based on SVC’s FY20 draft financial result and Long Term Financial Plan assumptions, adjusted for known changes.
- The ‘gap’ to achieving a breakeven result in each scenario is presented on a per rateable assessment basis in the following table in order to illustrate the potential impact on ratepayers in a demerged scenario compared to the Base Case.

Figure 3: Gap to FY25 Operating Surplus before Capital Grants on a per Rateable Property Basis ($)

	F'cast Operating Result*	Rateable Assessments*	$/ assessment	% variance to Base Case
	$m	No.	$	%
Base Case	(5.9)	8,812	(664)	-
Demerged Tumut	(3.0)	6,346	(478)	-28%
Demerged Tumbarumba	(3.7)	2,466	(1,498)	125%

*Forecast Operating Result before Capital Grants in FY25 (year 5) based on high level scenario modelling

*Number of rateable assessments is per the FY21 Revenue Policy dated 16 July 2020

- The above analysis does not imply that the ‘gap’ can only be closed through rate increases – see later discussion.

4. BASE CASE OBSERVATIONS

The Base Case scenario indicates that in FY25, SVC is forecast to incur an operating deficit before capital grants of $5.9m which equates to approximately $664 per rateable assessment. It should be noted that SVC's own Long Term Financial Plan does not target a breakeven result or financial sustainability until 2030.

The scenario analysis indicates a demerger could impact Tumut and Tumbarumba ratepayers differently, with Tumbarumba's financial capacity relatively more constrained than Tumut.

5. TUMBARUMBA DEMERGED SCENARIO OBSERVATIONS

- The high level scenario analysis undertaken by Deloitte indicates that in FY25 (year 5), Tumbarumba's forecast operating deficit before capital grants is $3.7m which equates to approximately $1,498 per rateable assessment, 125% higher than the Base Case. This indicates that, in the absence of additional funding or major cost savings (which would impact service levels), Tumbarumba's ability to achieve financial sustainability in the next 5 years is likely to deteriorate in a demerged scenario.
- In addition, the modelling indicates Tumbarumba's cash reserves are at risk of being depleted in this period or at a minimum, Tumbarumba may need to significantly scale back planned capital works to maintain sufficient operating liquidity.
- The key factors influencing this outcome for Tumbarumba include:
  - Less relative access to third party income due to:
    - Forecast private works revenue being mostly attributed to a new Tumut Council, as the private works business is centred at Tumut. Tumbarumba may also need to invest in upgrading its quality systems and processes to attain the required accreditation if private works income is to form part of its financial sustainability plans
    - A declining trend in RMS contract revenue over the last 4 years, driven by RMS budget allocations and procurement changes, which Tumbarumba was heavily reliant on to support its financial performance pre-merger.
  - A higher level of discretionary community services provided in Tumbarumba including childcare and aged care services, which are not considered viable for commercial operators
  - Higher average staffing costs relative to the pre-merger position as a result of the wages harmonisation completed in 2017
  - A relative smaller population and ratepayer base that means the impact of any one-off items (including demerger costs) or other normal trading fluctuations are more pronounced.

6. TUMUT DEMERGED SCENARIO OBSERVATIONS

- The high level scenario analysis undertaken by Deloitte indicates that in FY25 (year 5), Tumut's forecast operating deficit before capital grants is $3.0m which equates to approximately $478 per rateable assessment, 28% lower than the Base Case. This indicates Tumut's ability to achieve financial sustainability in the next 5 years is likely to be enhanced in a demerger scenario.
- The key factors influencing this outcome include:
  - Revenue growth opportunities in the private works business which has historically been centred in Tumut

- A larger population and ratepayer base to absorb the impact of any one-off items (including demerger costs) and normal trading fluctuations.

7. PATHWAYS TO FINANCIAL SUSTAINABILITY

- For clarity, the analysis in Figure 3 does not represent and should not be interpreted as an intention by councils to increase rates by these amounts under the Base Case or a demerged scenario, but is rather a comparative indicator of the demerged councils' capacity to achieve financial sustainability in that year, relative to the Base Case.
- In all scenarios, there are a range of factors which would impact each council's ability to achieve financial sustainability in the medium term while continuing to deliver adequate community services and invest in asset renewal. In targeting financial sustainability, councils are likely to employ a combination of initiatives which may include:
  - Securing additional operating grants or other third party revenue streams
  - Special Rate Variations
  - Adjusting user fees and other annual charges. In the case of a new Tumbarumba Council, this may include restoring (increasing) water charges to pre-harmonised levels
  - Achieving cost savings through FTE reductions or implementing alternative operating or service delivery models such as outsourcing or shared service strategies with other councils. Demerged councils may have more flexibility to achieve cost saving in this regard, as the Rural Centre Minimum FTE requirements would no longer apply, however service levels would reasonably be impacted. It is also noted that in the case of Tumbarumba, the higher level of discretionary services provided in that community may also limit its capacity to achieve meaningful cost reduction or implement alternative service delivery models.
- The following sections illustrate the options that councils may implement to achieve a breakeven operating result (before capital grants). The tables show various combinations of (i) increases in rates and charges and (ii) additional external revenue and/or cost savings that would impact on the forecast operating result.

SVC Base Case Sustainability Pathway

- As an example, if SVC could achieve a $3-4m uplift in annual income from grants and third party contracts and/or cost savings relative to the forecast, a 10-15% average increase in rates and charges would be required to achieve a breakeven operating result before capital grants in that year. The required level of rate increases varies according to the level of incremental annual revenue and cost savings that can be achieved. SVC's capacity to achieve incremental income or savings over this period has not been tested.

		Increase in rates and charges				
	$m	0%	5%	10%	15%	20%
Additional external funding or cost savings	-	(5.9)	(4.9)	(4.0)	(3.1)	(2.2)
	1.0	(4.9)	(3.9)	(3.0)	(2.1)	(1.2)
	2.0	(3.9)	(2.9)	(2.0)	(1.1)	(0.2)
	3.0	(2.9)	(1.9)	(1.0)	(0.1)	0.8
	4.0	(1.9)	(0.9)	(0.0)	0.9	1.8
	5.0	(0.9)	0.1	1.0	1.9	2.8

Tumbarumba Sustainability Pathway

As an example, if Tumbarumba could achieve a $3m uplift in annual income from grants and third party contracts or in cost saving initiatives relative to the forecast, a 15-20% average increase in rates and charges would be required to achieve a breakeven operating result before capital grants in that year. Tumbarumba's capacity to achieve incremental income or savings has not been tested, however the constraints mentioned above relating to higher levels of discretionary services provided and access to private works revenue are relevant considerations.

		Increase in rates and charges				
	$m	0%	5%	10%	15%	20%
Additional external funding or cost savings	-	(3.7)	(3.4)	(3.2)	(2.9)	(2.6)
	1.0	(2.7)	(2.4)	(2.2)	(1.9)	(1.6)
	2.0	(1.7)	(1.4)	(1.2)	(0.9)	(0.6)
	3.0	(0.7)	(0.4)	(0.2)	0.1	0.4
	4.0	0.3	0.6	0.8	1.1	1.4
	5.0	1.3	1.6	1.8	2.1	2.4

Tumut Sustainability Pathway

As an example, if Tumut could achieve a $2m uplift in annual income from grants and third party contracts or in cost saving initiatives, a 5-10% average increase in rates and charges would be required to achieve a breakeven operating result before capital grants in that year. Tumut's capacity to achieve incremental income or savings over this period has not been tested.

		Increase in rates and charges				
	$m	0%	5%	10%	15%	20%
Additional external funding or cost savings	-	(3.0)	(2.4)	(1.7)	(1.1)	(0.4)
	1.0	(2.0)	(1.4)	(0.7)	(0.1)	0.6
	2.0	(1.0)	(0.4)	0.3	0.9	1.6
	3.0	(0.0)	0.6	1.3	1.9	2.6
	4.0	1.0	1.6	2.3	2.9	3.6
	5.0	2.0	2.6	3.3	3.9	4.6

Other Key Risks and Considerations

Under both the Base Case and demerged scenarios, a critical assumption and a key risk to financial sustainability is that operating grant funding will remain in line with average historical levels and continue to be indexed in line with the Consumer Price Index. There is no known imminent policy change that would materially reduce or increase the level of operating grant funding in the short term, however with funding allocations subject to annual review and government budgets subject to reprioritisation, this remains a risk. Equally, if either or both councils were able to secure additional operating grant funding or third party revenue, this would enhance the forecast positions.

The other key risk identified is that planned financial performance improvement initiatives are not achieved.

To demonstrate the potential impact of key risks, as well as upsides, on the forecast financial position, Deloitte has also modelled downside and upside scenarios. In all scenarios:

- The impact on Tumbarumba ratepayers in a demerger is higher than the Base Case
- The impact on Tumut ratepayers in a demerger is lower than the Base Case.

The allocation of cash reserves is also a critical consideration in a demerger scenario as it underpins the short term liquidity position for the new councils. For the purpose of this analysis, cash reserves have been allocated in proportion to the 2016 pre-merger cash position (Tumut 61.0%;

Tumbarumba 39.0%). However to determine an accurate allocation requires a detailed reconstruction of actual cash flows since the merger, and therefore this simplistic assumption may not be an appropriate indication of the actual position.

Potential Rate Implications

In relation to SVC's rate harmonisation strategy, SVC has released a Rate Options Overview reflecting the preferred option based on a community study in terms of 'benefits' and 'ability to pay' principles. The preferred option is expected to result in a $0.3m reduction in annual rate revenue from Tumut (-4%) with a corresponding increase in rate revenue from Tumbarumba (+10%) from FY22.

If rates are harmonised prior to the proposed demerger, the new councils may need to consider resetting or restoring historical rate structures to achieve required forecast rate revenue.

Annual charges have been harmonised effective from 1 July 2019. Overall, Tumut's residential and commercial ratepayers experienced an increase in charges. Tumbarumba's water charges decreased materially. A demerged Tumbarumba Council may need to consider reinstating those charges to pre harmonisation levels to support sustainability of the water fund.

	Unharmonised		Harmonised	Impact on resident	
	Tumut	Tumbarumba	SVC	Tumut	Tumbarumba
Waste	330.00	423.00	448.00	↑ 35.8%	↑ 5.9%
Sewer	698.00	674.00	710.00	↑ 1.7%	↑ 5.3%
Water	139.00	358.00	140.00	↑ 0.7%	↓ 60.9%