lgbc

Local Government Boundaries Commission

PROPOSAL TO "DEMERGE" THE EXISTING COOTAMUNDRA GUNDAGAI REGIONAL COUNCIL

Boundaries Commission Summary of the Key Findings from Deloitte's Analysis to Date of the Financial Implications

NOVEMBER 2020

1. BACKGROUND

In February 2020, the Minister for Local Government referred to the Boundaries Commission a proposal that would, in effect, "demerge" the Cootamundra Gundagai Regional Council (CGRC) into the two local government 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.

2. THIS DOCUMENT

Deloitte's report to the Commission is not yet 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, so 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 25 November and the close of written submissions on 4 December. The key findings and observations are based on Deloitte's analysis of information obtained from the Cootamundra Gundagai Regional 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 examining the section 263(3)(a) factor and the demerger proposal in general, 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.

3. COOTAMUNDRA GUNDAGAI REGIONAL COUNCIL

Current Position

- Since the 2016 merger of the former Cootamundra and Gundagai Councils into the CGRC, there has been some level of organisational integration including ICT systems and some back-office functions. However CGRC still effectively operates with a team in Cootamundra and a team in Gundagai and maintains the pre-merger footprint of service centres, depots and assets primarily due to geographical constraints.
- Since the merger, CGRC has delivered a range of community projects enabled by merger grant funding, as well as c.$41m in infrastructure investment across both Cootamundra and Gundagai.
- CGRC has addressed the need for sustainability of the Water Fund and Sewer Fund via increases in fees and charges to offset increasing maintenance costs and to partially fund major upgrade works in the Cootamundra water supply and Gundagai sewer supply networks.
- CGRC's current priority and focus is on immediate budget repair and short-term liquidity challenges in the General Fund. While prevented from pursuing a Special Rate Variation (SRV) due to the rate path freeze under the Act, CGRC has recently harmonised rates and is pursuing a SRV from FY22. CGRC is also currently pursuing various operating cost savings initiatives to support more immediate financial improvement in the General Fund.

- The recent rate harmonisation resulted in a $0.3m shift of rate revenue from ratepayers in the former Gundagai Shire area to those in Cootamundra. Comparison to peer councils in the Large Rural category indicate CGRC's rates today are below average.
- Since the merger, approximately $41.5m has been invested in new infrastructure projects and asset renewal which has largely been funded by merger grants and reserves. The infrastructure backlog of $26.1m reported in FY19 is expected to reduce following completion of current upgrade works in the Water Fund and Sewer Fund.

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

- CGRC's FY20 financial statements are not yet available. Deloitte's analysis of FY20 financial performance is based on draft general ledger data provided by CGRC.
- CGRC has reported a cumulative operating deficit of $3.1m in the 4-year period since the merger, after the receipt of $21.0 of merger grant funding to support the integration and investment in infrastructure and community projects.
- Year on year, CGRC's operating result has fluctuated due to:
  - The timing of receipt of recurring operating grants, including advance payment of Financial Assistance Grants
  - One off capital grants received for storm damage recovery, various Stronger Country Communities Fund projects and the new Gundagai Sewer Treatment Plant (in process)
  - Timing of delivery of grant funded projects, including community-owned projects managed by CGRC
  - Variations in the value of RMCC contract revenue based.
- The cumulative operating deficit position appears to be driven by growth in CGRC's cost base against a relatively stable own source revenue base, noting that rate revenue has been subject to the rate path freeze.

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

$m	FY17	FY18	FY19	FY20	4 Yr
				DRAFT	
Rates and Annual Charges	12.9	12.3	12.9	13.0	51.4
User Fees and Charges	6.6	6.1	8.6	8.1	29.4
Other Revenue	2.5	2.0	2.0	1.9	8.9
Operating Grants	16.8	8.6	12.0	8.4	45.5
Capital Grants	9.9	2.3	7.3	3.5	23.0
Other Income					
Net gain from the disposal of assets	0.0	0.5	0.0	0.0	0.0
Revenue	48.6	31.8	42.8	34.9	158.2
Employees	(12.1)	(12.5)	(12.4)	(12.7)	(49.7)
Materials	(9.6)	(13.4)	(12.5)	(14.7)	(50.2)
Depreciation	(9.3)	(8.1)	(8.9)	(9.2)	(35.5)
Other	(5.7)	(3.6)	(3.8)	(3.7)	(16.7)
Non-operating expenses					
Net Losses from the disposal of assets	0.0	0.0	(0.8)	0.0	(0.8)
Revaluation decrement / impairment of IPP&E	(6.9)	(1.3)	0.0	0.0	(8.2)
Expenses	(43.6)	(38.9)	(38.5)	(40.3)	(161.2)
Net Operating Result	**5.1**	**(7.1)**	**4.3**	**(5.4)**	**(3.1)**
Net Operating Result before Capital Grants	**(4.9)**	**(9.4)**	**(2.9)**	**(8.9)**	**(26.0)**

Operating Performance Ratio (%)	5%	-30%	-6%	-28%	
Own Source Revenue (%)	45%	65%	54%	66%	

Notes:

- FY17 reflects a 13.5 month period from 13 May 2016 to 30 June 2017.
- FY20 financial performance data is 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%.

CGRC's Cost Base

- To date, CGRC has not realised economies of scale or net cost savings as a result of the merger.
  - After incurring higher costs in FY17 due to the merger process, CGRC's cost base has grown to be approximately 22% higher than the aggregate cost base of the former Gundagai and Cootamundra Councils (adjusting for inflation impacts). Factors contributing to this cost growth include:
    - A larger and higher cost organisation structure, with any executive-level consolidation savings realised on merger reinvested into other new roles
    - Higher costs of maintenance within the Water Fund and Sewer Fund
    - Higher materials and contracts costs, that are partly attributable to delivery of community projects (grant funded) and RMCC contract works
    - Higher depreciation rates applied to road infrastructure to align to industry standards.
- In relation to CGRC's organisation structure:
  - The current approved structure is 163 FTE which is approximately a 19 FTE (net) increase (+12%) on pre-merger levels. There were minimal FTE reductions as a result of the merger (1 FTE), and there has been subsequent resource investment in project management, higher regulatory and quality requirements of a larger organisation and insourcing planning and surveying capability.
  - In 2018 CGRC implemented its current leadership structure, consisting of a General Manager, a Deputy General Manager and 10 Managers, in an effort to better manage council operations across a large geographic area. The structure duplicates key operational roles in each of Cootamundra and Gundagai.
  - The average cost per employee has increased since the merger due to:
    - annual award increases under the Act
    - progression of employees through award salary bands under the Act
    - alignment of management salary structures between Cootamundra and Gundagai, which resulted in an uplift in the average rates for Cootamundra management staff
    - employment of consultants to assist with implementation of capital and community projects
    - the recruitment of new, specialised roles due to the investment in organisation capability to cater for the needs of a larger organisation, where some of this capability was previously sourced via external service providers.

CGRC's Long Term Financial Plan

- CGRC's Long Term Financial Plan 2021 – 2030 (LTFP) reflects budget repair priorities to improve CGRC's consolidated operating result across the 10-year forecast period. LTFP forecasts at a fund level show:
  - The Water Fund and Sewer Fund to return to operating surpluses before capital grants in FY21. The Water Fund and Sewer Fund are assumed to have been 'reset' to sustainable levels as a result of increased and harmonised fees and charges implemented in FY20.

- The General Fund to continue incurring operating deficits before capital grants (albeit reducing) throughout the 10-year period notwithstanding the assumed implementation of key budget repair initiatives including: (i) implementation of an SRV from FY22 and (ii) annual operating cost savings ($3.1m) from FY21.
- CGRC is currently working through its SRV strategy to determine the quantum and timing of the potential SRV from FY22. The current proposed approach is a 52% SRV in aggregate, to be applied over three years.

- With ongoing General Fund operating deficits forecast throughout the 10-year period, further operating cost savings may be necessary to deliver breakeven operating performance and therefore General Fund financial sustainability.
- In addition to the SRV and operating cost savings, CGRC's ability to achieve financial sustainability targets will also depend on:
  - Securing operating grants at historical levels or above
  - Securing additional RMCC contract or other external works income
  - Continuing to capitalise c.30% of infrastructure team employee costs.
- CGRC's ability to achieve financial improvement targets may be constrained by i) the geographic spread of services and community, ii) the age and condition of infrastructure, particularly in a scenario where the backlog increases due to financial constraints, and iii) the need for stronger alignment of community stakeholders on financial sustainability objectives and urgency of improvement actions.
- The LTFP indicates unrestricted cash balances could be depleted within 3 years if annual operating cost savings and proposed SRV are not achieved as planned. Unrestricted cash at 30 June 2019 was $3.4m. With FY20 financial statements not yet available, it is not possible to assess how CGRC's current unrestricted cash position might impact the LTFP forecast cash position.

4. DEMERGER CONSIDERATIONS

Demerger Costs

- A demerger of CGRC will result in one-off costs being incurred to separate the former Cootamundra and Gundagai councils which, in the absence of specific third party funding, would need to be borne by the community.
- The 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. A provision for staff retraining and minor redundancy costs has also been assumed based on the principle that both councils will seek to realign their organisation structures back to pre-merger levels if a demerger were to proceed. 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.
- There is also expected to be additional recurring costs associated with the need to duplicate Councillor structures, estimated to be $0.1m per annum for both Cootamundra and Gundagai. The executive leadership teams for both councils are assumed to be filled by existing roles (with GM, Deputy GM and 10 Managers). As such, no additional headcount or costs have been assumed in this regard.
- CRGC estimates the demerger costs to be $1.75m. Based on its analysis of available benchmarks, Deloitte estimated that one-off demerger costs could be in the range of $1.8m to $4.2m.
- For the purpose of the demerger analysis, Deloitte has assumed the mid-point of this range of $3.0m and that each new council would fund its own share of costs.

- With CRGC having limited unrestricted cash resources to fund these costs, and in the absence of external funding, demerger costs will need to be borne by the community. The impact of the estimated cost on ratepayers has been presented below on a per rateable assessment basis. The ratepayer impact is more pronounced in Gundagai than Cootamundra due to its relatively smaller ratepayer base sharing the costs.

Figure 2: Demerger cost estimates and ratepayer impacts

Indicative Demerger Cost Range	Cootamundra			Gundagai		
$m	Low	High	Mid	Low	High	Mid
One-off separation cost	0.9	2.1	1.5	0.9	2.1	1.5
Recurring costs	0.1	0.1	0.1	0.1	0.1	0.1
Rateable Assessments (No)	4005	4005	4005	2430	2430	2430
$ / Rateable Assessment ($)						
One-off separation cost	225	524	375	370	864	617
Recurring costs	25	25	25	41	41	41

Note: Rateable Assessment numbers are per CGRCs FY20 Revenue Policy dated 25 June 2019

- The demerger cost range as presented above should be considered a high-level estimate and indicative only. The actual costs could be somewhat higher or lower depending on a range of factors including the ability of the councils to reach consensus on legal, financial and commercial separation matters, including the allocation of its cash reserves, and the financial capacity of the new councils and/or its community to fund such costs.

Financial Sustainability of New Councils vs "Base Case" (ie Continuing CGRC)

- 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 CGRC's FY20 draft financial data 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	(0.1)	6,435	(23)	-
Demerged Cootamundra	1.2	4,005	292	315
Demerged Gundagai	(1.5)	2,430	(624)	(601)

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

*Number of rateable assessments is per FY20 Revenue Policy dated 25 June 2019

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

5. Base Case (ie Non-Demerged) Observations

The Base Case scenario indicates that in FY25, CGRC is forecast to incur an operating deficit before capital grants of $0.1m which equates to approximately $23 per rateable assessment. This result relies on the success of council achieving a 52% SRV and $3.1m of cost savings in FY21. Operating cost saving initiatives for the General Fund are in progress.

The demerger scenario analysis indicates a demerger could impact Cootamundra and Gundagai ratepayers differently, with Gundagai's financial capacity less sustainable than Cootamundra's.

6. Cootamundra Demerged Scenario Observations

- The Deloitte analysis assumes a demerged Cootamundra would (i) implement a 52% SRV over 3 years, consistent with CGRC's current proposal and (ii) achieve annual operating cost savings of $2.2m from FY21. The analysis shows these savings could be achieved via a return to the pre-merger headcount plus an 11% ($1.1m) reduction in the remaining addressable cost base.
- The high-level scenario analysis indicates that in FY25 (year 5) Cootamundra's forecast operating surplus would be $1.2m which equates to a $292 surplus per rateable assessment, $315 per rateable assessment greater than the Base Case ($23 deficit). This indicates that Cootamundra's ability to achieve an operating surplus in the next 5 years is likely to be enhanced in a demerged scenario, and could be achieved with a lower SRV or a lower level of cost savings.
- The key factors influencing this outcome relative to the Base Case include:
  - Harmonisation of rates which, combined with property valuation impacts, resulted in a $0.3m increase in rate revenue generated in Cootamundra
  - Cootamundra retaining all forecast RMS RMCC contract revenue, with works currently limited to Cootamundra (revenue of $2.9m forecast in FY25)
  - A larger population and ratepayer base to absorb the impact of any one-off items (including demerger costs) and normal trading fluctuations.

7. Gundagai Demerged Scenario Observations

- The Deloitte analysis assumes a demerged Gundagai would (i) implement a 52% SRV over 3 years, consistent with CGRC's current proposal and (ii) achieve annual operating cost savings of$0.9m from FY21. The analysis shows these savings could be achieved via a return to pre-merger headcount and a 9% ($0.6m) reduction in the remaining addressable cost base.
- The high-level scenario analysis indicates that in FY25 (year 5) Gundagai's forecast operating deficit before capital grants would be $1.5m which equates to $624 deficit per rateable assessment, $601 per rateable assessment lower than the Base Case ($23 deficit). This indicates that Gundagai's ability to achieve financial sustainability in the next 5 years is likely to deteriorate in a demerged scenario, absent additional funding or further cost savings. This indicates Gundagai would need to pursue a higher SRV or deliver higher annual cost savings to be financially sustainable in this period.
- Forecast Gundagai operating deficits would likely risk cash reserves being depleted in the 5 year period, with either additional funding or scaled back capital expenditure required to maintain operating liquidity.
- The key factors influencing this outcome for Gundagai relative to the Base Case include:
  - Harmonisation of rates which, combined with property valuation impacts, resulted in a $0.3m decrease in rate revenue generated in Gundagai
  - Less relative access to third party revenue given that RMS RMCC works in Gundagai (which is limited to one road) are currently completed by Snowy Valleys Council.
  - A relatively 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 when considering the impact on a per ratepayer basis.

8. PATHWAYS TO FINANCIAL SUSTAINABILITY

- For clarity, the analysis in Figure 3 above does not represent and should not be interpreted as an intention by – or recommendation to - councils to increase rates by these amounts under the Base Case or a demerged scenario. Rather it is a comparative indicator of the demerged councils' capacity to achieve financial sustainability in that year, relative to the Base Case. The SRV within the scenarios is also an assumption that remains subject to CGRC review and decision making ahead of any application to IPART.
- In all scenarios, it is assumed that a 52% SRV is applied to all to ratepayers, and an aggregate annual operating cost savings of $3.1m are to be achieved from FY21 (Cootamundra $2.2m; Gundagai $0.9m in the demerged scenario).
- However, even with these financial improvements in place, other General Fund initiatives may be required to ensure it is financially sustainable, including:
  - Securing additional operating grants or other third part revenue streams
  - More aggressive cost reductions which may include headcount reductions below pre-merger levels, implementing alternative operating or service delivery models such as outsourcing or shared service strategies, limiting non critical capital spend and general austerity measures, noting this will impact current service levels. In this regard, a demerged council may have more flexibility to achieve cost savings as a result of:
    - Removal of the minimum Rural Centre FTE constraints for Gundagai which currently apply to CGRC
    - Potential for greater alignment between Councillors, management and community in relation to service level requirements in a financially constrained environment.
- The following sections illustrate the options available to councils to achieve a breakeven operating result (before capital grants). The tables show various combinations of (i) the % SRV applied to annual rates, and (ii) additional external revenue and/or operating cost savings that would be required.

CGRC Base Case Sustainability Pathway

The Base Case financial improvement strategies include a 52% SRV and $3.1m in operating cost savings that would result in a small forecast operating deficit (before capital grants) of $0.1m at the consolidated CGRC level.

The required SRV varies according to the level of incremental annual revenue and cost savings that can be achieved. As an example, if CGRC pursued a 25% SRV, it would require annual operating cost savings of $5.0m-$6.0m to achieve a consolidated operating breakeven result before capital grants.

Additional external funding or cost savings	SRV required			
$m	0%	25%	52%	75%
-	(6.8)	(5.3)	(3.2)	(1.4)
1.0	(5.8)	(4.3)	(2.2)	(0.4)
2.0	(4.8)	(3.3)	(1.2)	0.6
3.1	(3.7)	(2.2)	(0.1)	1.7
4.0	(2.8)	(1.3)	0.8	2.6
5.0	(1.8)	(0.3)	1.8	3.6
6.0	(0.8)	0.7	2.8	4.6

Cootamundra Sustainability Pathway

As an example, if Cootamundra could achieve $2.5m in annual incremental income or operating cost savings, it would only require a 25% SRV in order to achieve a consolidated operating breakeven result before capital grants in FY25. Cootamundra's capacity as a standalone council to achieve these savings or incremental income over this period has not been tested.

		SRV required			
	$m	0%	25%	52%	75%
Additional external funding or cost savings	-	(3.2)	(2.3)	(1.0)	0.1
	1.0	(2.2)	(1.3)	(0.0)	1.1
	2.2	(1.0)	(0.1)	1.2	2.3
	3.0	(0.2)	0.7	2.0	3.1
	4.0	0.8	1.7	3.0	4.1
	5.0	1.8	2.7	4.0	5.1

Gundagai Sustainability Pathway

As an example, if Gundagai achieves the planned SRV of 52% it would require either a $2.5m uplift in annual income from grants and third party contracts or annual cost savings in order to achieve a consolidated operating breakeven result before capital grant in FY25. This $1.4m higher than the $0.9m of operating cost savings included within the demerger analysis. Gundagai's capacity as a standalone council to achieve incremental income or cost savings over this period has not been tested.

		SRV required			
	$m	0%	25%	52%	75%
Additional external funding or cost savings	-	(3.8)	(3.2)	(2.4)	(1.7)
	0.5	(3.3)	(2.7)	(1.9)	(1.2)
	0.9	(2.9)	(2.3)	(1.5)	(0.8)
	2.0	(1.8)	(1.2)	(0.4)	0.3
	3.0	(0.8)	(0.2)	0.6	1.3
	4.0	0.2	0.8	1.6	2.3

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 their forecast positions.

The other key risk identified is the SRV and operating cost savings that are currently being pursued by CGRC. These are critical to the financial sustainability of both the existing and demerged councils (albeit at different levels given the different impacts of the merger between Cootamundra and Gundagai). If cost savings are not achieved, the SRV would need to be higher for council to achieve their financial sustainability targets. Conversely, if the SRV is not available at a level deemed appropriate by the council, additional cost savings will be required.

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. CGRC's FY20 balance sheet information is not available at this stage, however CGRC management has advised Deloitte of the consolidated cash and investment position as at 30 June 2020. For the purpose of this analysis, cash reserves have been allocated in proportion to the 2016 pre-merger cash position (Cootamundra 62.0%; Gundagai 38.0%). 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. The unrestricted cash balance as at 30 June 2020 has not been confirmed which limits the ability to analyse the forecast liquidity position and viability of both CGRC and the demerged councils.