Crowe Horwath

Review of South East Councils Feasibility Study Financial Analysis

June 2018

Contents

Summary of Observations and Recommendations

Several South East local government councils, with the support from the Tasmanian Government took part in a study to explore the merits of shared services and different amalgamation options. The *South East Feasibility Study*[1] (the Feasibility Study) was finalised in September 2016, with Sorell and Tasman Councils formally requesting a review into potential voluntary amalgamation and resources-sharing options. Crowe Horwath was engaged by the Local Government Board to provide financial analysis to inform the review.

Current Financial Sustainability

An analysis of selected measures over the past three years showed that both Sorell and Tasman Councils are not at imminent risk of being financial unviable, based on historical financial information:

- Both Councils reported underlying surpluses in each of the past three years as operating revenue exceeded operating expenditure;
- They had sufficient operating income to meet their existing obligations and their current assets, primarily cash, exceed their total liabilities;
- The usable level of transportation assets was adequate and capital expenditure on replacing them as they reached the end of their useful lives was reasonable.

However, the question of financial sustainability goes beyond the immediate ability of meeting existing financial obligations. For instance, a recent revaluation of Tasman Council's road assets is going to have a significant impact on its financial sustainability going forward, unless Council implements appropriate measures, including:

- The increased depreciation will reduce the underlying surplus, unless there is an increase in operating revenue or decrease in expenditure;
- A decline in the asset consumption ratio for transportation assets indicates that the aged condition of roads was less than previously thought;
- The asset sustainability ratio will deteriorate to a level which will put Council at a risk of underinvesting in its transportation assets. Unless there is an increase in capital spending, this is likely to result in additional maintenance cost in the future and undermine Tasman Council's financial sustainability.

The impact of the revaluation on depreciation and capital spending on existing assets has been factored into Tasman Council's updated long-term financial management plan. The revaluation should also be taken into consideration when comparing Tasman Council's financial performance with that of Sorell Council. At face value, Tasman Council may have 'outperformed' Sorell Council in terms of operating results, but this was largely due to comparatively low depreciation expenses. Similarly, asset management indicators were impacted by asset values which did not reflect the most current replacement costs of transportation assets and their remaining values.

Future Financial Sustainability

Sorell Council addressed the key observations made in the Feasibility Study on long-term projections and its current long-term financial management plan forecasts underlying surpluses which are used to fund capital spending. Tasman Council's long-term financial management plan also forecasts operating surpluses but does not appear to address capital spending. We were unable to comment on the projected long-term financial sustainability of both Councils based on their current long-term financial management plans because key assumptions used in projecting future revenue and expenses varied between the two Councils, some we deemed unrealistic or otherwise questionable and the plans did not adequately address long-term funding for key infrastructure assets.

To better assess and compare the future financial sustainability of both Sorell and Tasman Councils, their current long-term projections should be re-assessed using:

- Recent financial and asset management data, adjusted for non-recurring items to establish a base for projections;
- Standardised assumptions;
- Analysis of scenarios which are considered reasonable rather than analysing every possible outcome.

Projected Financial Sustainability of Voluntarily Merged Councils

The Feasibility Study identified that amalgamating Sorell and Tasman Councils into one south-east council would result in a greater operating surplus on average, mainly from employee cost savings, amounting to $0.9m in year one. In our view, those savings are optimistic, especially when considering that there was an increase in employee numbers since the Feasibility Study was completed.

The Feasibility Study estimated the cost of the amalgamation to be $1.1m. Apart from potential redundancy costs, we do not believe that the cost of amalgamation will be significant, because both Councils are already working together in many areas and the relatively small size of Tasman Council's operations will mean that a potential integration will not be overly complicated or costly.

We identified several assumptions used in the financial modelling that may need to be reassessed to better inform the decision about the short-term and long-term viability of the proposed south-east council. Because the original model was not made available to us, our review was limited to assessing the relevance of key assumptions used in the financial modelling.

The assumptions we deemed the most unrealistic or otherwise questionable were:

- Employee cost savings;
- Reduction in councillor expenditure;
- Rate growth factor applied to Tasman Council's revenue.

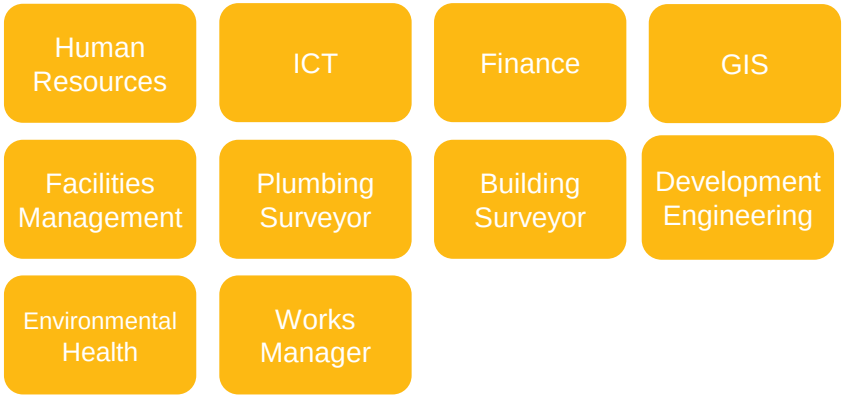
The modelling should be re-assessed based on updated Sorell and Taman Councils' long-term projections and standardised assumptions, including:

- Sensible reduction in staff numbers and related redundancy costs;
- A scenario which would include rationalisation of services by centralising administration in one location;
- Changes to the current resource-sharing arrangement by moving from fee for service to sharing actual staff positions and the possibility of the arrangement ceasing all together.

Extension of Shared Services Arrangements

The current resource sharing arrangements provide the necessary resources when needed on a fee for service basis. The level of resource-sharing between Sorell and Tasman Councils is relatively high and covers a number of areas from the traditional back office functions to functions covering key roles of local government. The current arrangement relies heavily on resources being provided by Sorell Council. Ending the current resource-sharing arrangement would have a greater financial impact on Tasman Council.

Sorell Council provides the following services to Tasman Council:



Tasman Council is the primary employer of the General Manager and the position is shared with Sorell Council on a 40/60 basis. There appears to be little scope for a further increase apart from potentially Sorell Council providing the services that Tasman Council procures from other councils and from an external consultant.

One option to consider would be changing the model from a fee for service to sharing actual staff positions (similar to the current arrangement of sharing the position of General Manager between Sorell and Tasman Councils or the model adopted by some other councils, for example Circular Head and Waratah-Wynyard Councils).

If the resource sharing arrangement between Sorell and Tasman Councils was to continue, it should be independently reviewed to assess its effectiveness and identify improvements and new areas where further savings from shared procurement, staff and plant and equipment or joint projects could be achieved (in addition to those already in place).

Word of Caution

In performing the analysis, we have relied on information and data supplied by Sorell and Tasman Councils and information gathered from various sources and publications, including reports by Tasmania's Auditor-General and annual reports of Sorell and Tasman Councils. We have made every effort to ensure the reasonableness of that information and its appropriateness for the purpose of this review.

Analysis of any kind involve judgement and assumptions. During this analysis, we have used professional judgment based on our experience and expertise and applied conservative assumptions which are more likely to understate the benefits of the potential merger.

Is Viability the same as Sustainability?

The terms sustainability and viability are often used interchangeably. The question of financial sustainability goes beyond the imminent ability of meeting financial obligations and refers to the financial capacity to provide services both now and into the future. In the context of local government, financial sustainability translates to a budget that is balanced over the medium to long term without the need for significant increases in rates and charges or cuts to services, while the burden is being shared fairly between current and future ratepayers.

To avoid any doubt, the focus of our analysis has been on the financial sustainability of both Sorell and Tasman Councils, unless stated otherwise.

Part A

Current and Future Financial Sustainability of Sorell and Tasman Councils

Current Financial Sustainability

There are several measures of financial sustainability used in the local government sector aiming at financial and asset management practices. It has been generally accepted that to assure long-term financial sustainability, councils should, at a minimum, budget and operate to break-even while managing their assets in a way that maximises service delivery and manages related risks. Surpluses over a longer period disadvantage ratepayers and losses are not sustainable in the long-term.

Sorell Council			Sustainability measure^	Tasman Council		
FY 2015	FY 2016	FY 2017		FY 2015	FY 2016	FY 2017
$2.66m	$0.33m	$0.02m	Underlying result	$0.73m	$0.80m	$0.90m
15.4%	1.9%	0.1%	Underlying result ratio	12.4%	13.3%	14.2%
Significant decrease in underlying surplus ratio of Sorell Council was caused largely by rising employee costs and depreciation expense on roads.			Operating result measures are discussed on page 8	Tasman Council did not experience the same increases in operating costs as Sorell Council but a recent revaluation of roads will have a significant impact on its underlying result going forward.		
$2.05m	$3.30m	$2.33m	Net financial liabilities	$4.3m	$5.3m	$5.6m
12%	20%	13%	Net financial liabilities ratio	73%	88%	87%
Sorell Council had sufficient operating income to meet its existing obligations and current assets, primarily cash that exceed total liabilities.			Cash management measures are discussed on page 9	Tasman Council's net financial liabilities ratio was significantly higher when compared to Sorell Council because of lower borrowings and a comparatively higher cash balance.		
61%	61%	61%	Transport assets consumption ratio	75%	74%	62%
117%	106%	116%	Transport assets renewal funding ratio	160%	169%	100%
77%	51%	113%	Transport assets sustainability ratio	100%	68%	119%
The asset consumption ratio for transportation assets was above the generally accepted benchmark of 60% and on average, expenditure on renewing or upgrading existing transportation assets was sufficient compared to the amount of depreciation.			Asset management measures are discussed on page 9	The drop in the assets consumption ratio indicates that the value left in roads is less than previously estimated. Tasman Council may by at risk of underspending on the renewal and replacement of road assets if capital spending does not increase in coming years.		

^Sustainability measures are defined and explained in the Appendices section on page 26

Underlying Result

Underlying result is the difference between recurrent or day-to-day income and expenses. The underlying surplus ratio is the underlying result expressed as a percentage of recurrent income.

Both Tasman and Sorell Councils reported positive operating surplus ratios in all three years since 2014-15, which is consistent with other rural councils, according to data published by the Tasmanian Audit Office[2]. Tasman Council recorded a higher average underlying surplus ratio than Sorell Council.

For the purpose of our analysis and to allow for better comparison between both Councils, we reviewed their financial statements for the past three years and, where necessary, made adjustments and recalculated both the underlying result and underlying surplus ratio.

In the case of Sorell Council, we excluded certain revenue items from recurrent income, because in our view, those items were not recurrent or were of a capital nature.

Sorell Council	FY 2015 $'000	FY 2016 $'000	FY 2017 $'000
Reported recurrent income	17,434	17,668	17,177
- *less* 2013 Tasmanian bushfire donations	(228)	(197)	(21)
- *less* distributions from liquidators	0	(263)	(9)
Revised recurrent income	17,206	17,208	17,147
Reported recurrent expenses	(14,551)	(16,874)	(17,128)
Revised underlying result	**2,655**	**34**	**19**
Revised operating surplus ratio	15.4%	1.9%	0.1%

Sorell Council's revised underlying surplus ratio was 0.1% in 2016-17. This was a significant decrease from the underlying surplus ratio of 15.4% in 2014-15 caused largely by an increase in employee costs and depreciation expense because of a revaluation of roads, buildings and stormwater assets during the period.

In the case of Tasman Council, we added back a loss on disposal of property, plant and equipment, because in our view, that expense was of a recurrent nature.

Tasman Council	FY 2015 $'000	FY 2016 $'000	FY 2017 $'000
Reported recurrent income	**5,914**	**6,056**	**6,386**
Reported recurrent expenses	(5,180)	(5,153)	(5,482)
- *add* loss on disposal of PP&E	0	(99)	0
Revised recurrent expenses	**(5,180)**	**(5,252)**	**(5,482)**
Revised underlying result	**734**	**804**	**904**
Revised operating surplus ratio	12.4%	13.3%	14.2%

Tasman Council's underlying surplus ratio was 14.2% in 2016-17 compared to 12.4% in 2014-15. Tasman Council did not experience the same increases in operating costs as Sorell Council. Its FTEs reduced from 23 in 2015 to 20 in 2017 and depreciation remained constant because Tasman Council has not revalued any of the major asset classes during the three-year period. However, a recent revaluation of road assets will have a significant impact on Tasman Council's underlying result going forward. The value of roads increased by $16m following a revaluation at 30 June 2017. Using the average depreciation rate for this class of assets, we estimate that the depreciation expense will increase by around $0.5m. Stormwater assets are due to be revalued in the near future. Observations about differences in valuation inputs are discussed later.

Cash Management

The net financial liabilities ratio, which measures the extent to which net financial liabilities (the amount of money owed by a council to others, including leave provisions, less money held, invested or owed to a council) could be met by operating revenue was positive for both Sorell and Tasman Councils.

The positive ratio indicates that both Councils had sufficient operating income to meet their existing obligations. Tasman Council's net financial liabilities ratio was significantly higher when compared to Sorell Council because of lower borrowings and a comparatively higher cash balance. Nevertheless, both Sorell and Tasman Councils had current assets, primarily cash that exceed their total liabilities and they both appeared to have the capacity to increase borrowings if required.

Assets Management

Generally, transportation assets represent the majority of councils' infrastructure assets and for this reason our focus was on those assets.

The asset consumption ratio for transportation assets, which measures the levels of service potential remaining in the assets, was just above the generally accepted benchmark of 60%[3] for both Sorell and Tasman Councils in 2016-17. Sorell Councils has maintained its transportation assets at this level for several years. Tasman Council has shown a drop in this ratio following the revaluation of its road assets in 2016-17, indicating that the value left in roads is less than previously estimated.

Also relevant is the asset sustainability ratio, which measures the rate at which assets are being replaced compared to the rate they are wearing out. Over the past three years, Sorell Council's capital expenditure on renewing or upgrading its existing transportation assets totalled $8.0m, which represented 96% of the amount of depreciation during the same period. Tasman Council spent $1.9m on renewing or upgrading its existing transportation assets, which represented 88% of depreciation on those assets. However, when compared to the expected rate of deprecation following the 30 June 2017 revaluation, the assets sustainability ratio is significantly lower at around 50%. Underspending on the renewal and replacement of assets has the potential to undermine financial sustainability because of additional maintenance and the need to renew and replace failed assets is likely to lead to sudden large rate increases. While the asset sustainability ratio results may vary between years because of operational reasons, it is important that the target of 100% is achieved over the medium term (this target is met in the recent version of Tasman Council's long term financial management plan).

Valuation differences

Unit rates, useful lives and remaining useful lives impact the calculation of fair value and annual depreciation. There are some differences in valuation inputs between the two Councils. Some of the differences reflect the nature of road network, where for example works on roads in built-up areas incur additional costs associated with traffic and project management and different design specifications. Sorell Council categorises unsealed roads into two classes, with roads in class 1 having a useful life of 5 years compared to 10 years assigned to roads in class 2. These differences impact comparability between the two Councils at varying degrees.

Road assets valuation input^	Sorell	Tasman
Sealed road surface ($/m²)	$15.22	$9.98
Sealed road surface useful life (years)	17	17
Unsealed road surface ($/m²)	$6.50	$6.00
Unsealed road surface useful life (years)	5/10	10

^ Average values as per asset register

Projected Financial Sustainability

A long term financial management plan (LTFMP) is an important component of a financial management framework. It enables councils to set priorities, based on their resourcing capabilities, to achieve their strategic objectives and community expectations in a financially sustainable way. LTFMP is, at a minimum, a ten year rolling plan linking together long term financial planning, asset management and strategic planning.

Sorell Council		Summary Financial Performance and Position as per LTFMP	Tasman Council	
FY 2018 (Budget) $'000	2019-2036 $'000		FY 2018 (Budget) $'000	2019-2038 $'000
(945)	**11,275**	**Operating surplus/(deficit) before capital amounts**	**(169)**	**12,199**
4,666	97,677	CAPEX on renewal/replacement of existing assets	1,789	33,010
(5,204)	(97,677)	*less* Depreciation	1,674	33,160
(538)	**0**	**= Net outlays on existing assets**	**115**	**(150)**
576	14,396	CAPEX on new/upgraded assets	983	0
(530)	(5,130)	*less* Amounts specifically for new/upgraded assets	(692)	(2,346)
46	**9,266**	**= Net outlays on new or upgraded assets**	**291**	**(2,346)**
(453)	**2,009**	**Net lending/(borrowing)**	**(575)**	**14,695**

LTFMP used in the analysis:

- Sorell Council: Long Term Financial Plan June 2017
- Tasman Council: Long Term Financial Plan January 2018

LTFMP Observations

Sorell Council's LTFMP (2019-2036) forecasts underlying surpluses in each of the 18 years. A previous version of the plan forecasted an overall break-even position over the period, although underlying deficits were forecasted in the first 11 years of the plan.

The key assumptions impacting the improvement in projected results were:

- 4% growth in self-generated income in 2019 followed by a 2.5% indexation each year after 2019;
- 2% indexation of financial assistance grants.

Capital expenditure on renewing or replacing existing assets is set to equal the annual depreciation expense. The LTFMP projects capital expenditure on new assets to be $14.4m, with the majority funded from underlying surpluses generated over the period and $5.1m subsidised by Roads to Recovery grants.

Tasman Council's LTFMP (2019-2038) forecasts operating surpluses in each of the 20 years. Tasman's 10-year plan (2016-2025) forecasted deficits in the first two years and surpluses in every year after that. The two plans were reasonably consistent.

For a council to be financially sustainable, it needs to not only budget and operate to break-even, it also needs to be able to maintain the condition of its infrastructure assets to deliver services to the community. Linking a long term strategic asset management plan with the LTFMP is critical when considering future asset management costs in order to achieve financial sustainability. Sorell and Tasman Council's LTFMPs do not provide that linkage to make a reasonable assessment.

For example, it is noted that Sorell Council's LTFMP does not reflect a new asset management plan. Even though the plan is still in a draft form, it was noted that the plan projects an increased spending on roads, which is to be partly offset by a reduction in capital expenditure in other asset categories. The new asset management plan could have a material impact on the LTFMP and should be considered in assessing Sorel Council's long-term financial sustainability as part of the review.

Tasman Council's LTFMP appears incomplete when it comes to funding for new assets, which means that there may be insufficient reserves to fund future capital expenditure on new assets. In 2016-17, Tasman Council paid $2.7m for plant, property and equipment, with $1.9 relating to roads. Tasman Council budgeted to spend $2.2m on capital expenditure in 2017-18 with majority relating to roads.

Considering the significance of asset management to councils' overall service delivery and financial sustainability, the long-term projections for both Sorell and Tasman Councils should be re-assessed using the most recent asset management data.

Crowe Horwath

Analysis of LTFMPs

Both Sorell and Tasman Councils used the 2017-18 budget as the basis for their forecasting but applied different assumptions when projecting future revenues and expenses. Those differences are shown below:

Sorell Council	LTFMP Item	Tasman Council
4% increase in 2019 2.5% increase annually after 2019 0.5% growth factor	Rates User charges and fees Other income	2.5% increase annually No growth factor applied
2.0% increase annually ^	Financial Assistance Grants	No indexation applied
$14,000 base 2.5% increase annually	Other grants	Not estimated
Average 2.74% interest rate applied to forecast cash balance	Interest revenue	2.5% increase annually ^
Estimated distributions based on $20m cap ^	TasWater distributions	2.5% increase annually ^
2.5% increase until 2020 3% increase after 2020	Employee benefits	2.5% increase annually
3% increase plus 2.5% of the value of new assets from 2020	Materials and services and Other expenses	2.5% increase annually ^
2018 depreciation is applied consistently over the period of the plan, increased for new assets (roads only)	Depreciation	2018 depreciation is applied consistently over the period of the plan and indexed annually by 2.5%
Not estimated	Gain or loss on disposal of assets	2.5% increase annually ^
No new debt has been assumed	Interest expense	No new debt has been assumed

^ Indicates critical inputs which should be standardised to better assess and compare the future projections of both Sorell and Tasman Councils

Comparability of LTFMPs

It is not possible to comment on the projected long-term (10 and 20 year) financial sustainability of both Councils based on the current LTFMPs without normalising the inputs and assumptions, which was outside the scope of this review.

The assumptions used in projecting future revenue and expenses were different, in some cases were deemed unrealistic or otherwise questionable and the LTFMPs did not adequately address long-term funding for key infrastructure assets.

Revenue Projections

The main sources of revenue for councils are rates and user charges. The 2.5% indexation rate appears reasonable, although it is high compared to the average CPI. Sorell Council's management confirmed the intent to increase rates by 4% in 2019.

The growth rate factor applied by Sorell Council was based on adjusted population growth statistics. The growth rate of 0.5% is conservative based on recent population and rateable properties data. The same data support the zero growth factor applied by Tasman Council.

Average annual growth (2012 – 2017)	Sorell	Tasman
Rate revenue	4.2%	3.6%
Rateable properties	2.1%	0.2%
Population	1.5%	(0.4%)

Financial Assistance Grants are a main source of revenue for regional councils. Lifting of the freeze on the indexation of Financial Assistance Grants by the Australian Government will not necessarily result in a corresponding increase in the funding for the State and distributions to individual councils. The assumption applied by Sorell Council that Financial Assistance Grants will increase annually by 2%, following the reinstatement of indexation, has the potential to overstate income projections, especially as Sorell Council's share of financial assistance grants has been decreasing over the past five years[4].

Sorell Council also assumed some level of ongoing operational grants which will indexed annually. Although the estimate is relatively insignificant, representing only 0.5% of total revenue, this assumption has the potential to overstate the future income projections if the funding is not ongoing.

The forecast distributions from TasWater in Sorell Council's LTFMP reflect the reduced distributions and the freeze on future increases. However, Tasman Council's LTFMP did not reflect this arrangement and potentially overstated its income forecast by $193,000 over the 20-year period.

Other Considerations

Other matters to consider could include:

- Existing services or new services proposed for which fees should be introduced;
- Capital or operating grants available for new services or planned infrastructure;
- Underutilised assets (buildings, land or plant) that can be leased commercially; and
- Long term estimate for Financial Assistance Grants and what is the likely future impact if these grants reduce.

Expenses Projections

Employee benefits are the main expenditure for councils and both Sorell and Tasman Councils aligned their projections with the general EBA indexation. The projections did not factor in reclassifications and annual and other increments relating to changes of bands nor did they consider future human resourcing requirements. These have the potential to underestimate the future employee costs.

Sorell Council indexed its materials and services and other expenses by 3%, compared to 2.5% used by Tasman Council. In addition, Sorell Council increased its materials and services expenses to reflect new or upgraded assets. The index used by Sorell Council is aligned closer to the Council Cost Index and as such would be a more appropriate reflection of estimated changes in the cost of materials and contract rates.

Index	5-year average	10-year average
Consumer Price Index (CPI)	1.7%	2.1%
Council Cost Index (CCI)	2.3%	2.8%

Sources:
Consumer Price Index (ABS Cat No 6401.0), All groups CPI Hobart, June quarter
Council Cost Index (Local Government Board of Tasmania)

Depreciation was based on budget. Tasman Council applied an annual indexation of 2.5% while Sorell Council maintained depreciation charges at 2018 levels with some adjustment made for new or upgraded road assets. Depreciation costs should be sourced from the asset management plans.

Tasman Council's projections included losses on disposal of assets totalling $209,000 over 20 years. Generally, losses or gains on disposal of assets would not be included in LTFMPs unless they reflect disposals of assets in asset management plans or are based on past experience. The approach of simply indexing the current year's budget estimate has the potential to misstate the projections.

Other Considerations

Other matters to consider could include:

- Anticipated increases or decreases in FTEs;
- Insurance cost based on past claims that may affect future premiums, values of new or revaluations of insurable assets;
- New or proposed buildings, street lighting and other similar facilities which may impact utilities charges; and
- Economic factors that will impact on the collectability of receivables and may lead to an increase in the provision for bad debts.

Cash Balance Projections

Tasman Council's LTFMP shows increasing cash balances over the 20-year period and relatively flat forecast capital expenditure with zero projections for capital expenditure on new or upgraded assets. Sorell council forecasts to maintain a relatively steady cash balance with capital expenditure being funded predominantly from operating surpluses.

Part B

Projected Financial Sustainability of Voluntarily Merged Sorell and Tasman Councils under Option 4

Assessment of Option 4

Option 4 is amalgamating Sorell and Tasman Councils into one south-east council. The Feasibility Study concluded that this option would result in a greater operating surplus on average, mainly from employee cost savings.

Reduction in Materials and Contracts Expenses

The Feasibility Study assumed a 1% saving in material and contracts or $67,052 in year 1 on the basis that the amalgamated south-east council would have increased purchasing power due to size and the ability to negotiate on key contracts.

Given the level of cooperation between Sorell and Tasman Councils that exists already and their present access to common use arrangements, such as the National Procurement Network, we are sceptical whether the amalgamated council will be able to realise the savings outlined in the Feasibility Study.

However, we believe that savings in this area could be achieved through rationalisation of services and assets. For example, centralising administration in one location would reduce the cost of utilities. Further savings would be achieved through reduced compliance and reporting costs, with direct savings including a reduction in audit fees and remuneration paid to members of the audit panel. Indirect savings would come from time and resources needed to prepare the annual financial report and audit panel papers, which could be redirected to other areas.

Reduction in Councillor Expenditure

The Feasibility Study assumed a reduction in the number of councillors from 16 to 9, which was to provide savings of $185,226 in councillor expenditure in year 1.

Based on the combined population of 16 789[5] and population density of less than 30 persons per square kilometre[6], the amalgamated council would be categorised as Rural Agricultural Very Large under the Australian Classification of Local Governments[7]. Reducing the number of councillors to 9 would then be consistent with the number of councillors in other Tasmanian councils within the same category[8]. Based on our calculations, the reduction in the number of councillors would save approximately $100,433 in year 1, which is $84,793 less than the savings identified in the Feasibility Study. This is an ongoing saving if the two Councils are merged.

Reduction in Employee Costs

The Feasibility Study assumed a reduction of 10.5 FTEs, which was to deliver $944,423 of savings in employment costs in year 1.

Currently, both Sorell and Tasman councils employ 82.3 FTEs, which is an increase of 6.7 FTEs on the figures used in the Feasibility Study, excluding childcare. The increase in FTEs partly reflects an increased level of services provided by Sorell Council to other councils, namely Brighton and Glamorgan Spring Bay Councils. Considering the existing level of sharing staff between Sorell and Tasman councils, we believe that it is unlikely that the proposed amalgamation would lead to the significant savings in employment costs as identified in the Feasibility Study.

A removal of duplicate positions will lead to savings in employee costs, however it should be noted that these is no duplication of executive or senior roles. These positions are already shared between the two councils. The actual savings will depend on the structure decided by management of the amalgamated south-east council. Savings could also be achieved by increasing the level of services provided to other councils.

Benchmarking against other councils proved to be difficult. The combined number of staff of Sorell and Tasman Councils is at the top end of the range of councils in the Rural Agricultural Very large category[9] (excluding outliers). For example, Waratah-Wynyard and Meander Valley Councils had 81 and 76 FTEs in 2016-17 respectively. However, the amalgamated south-east council would have a higher number of rateable properties (although combined population would be less than the population of Meander Valley Council and more than the population of Waratah-Wynyard Council) and a larger asset base to manage. On the other hand, the amalgamated south-east council would service a significantly smaller area with a road network close to Waratah-Wynyard in length but with a greater proportion of unsealed roads.

We also attempted to benchmark the number of staff against councils in other states which were classified as Rural Agricultural Very large and which received similar general purpose grant funding per capita or area. Those councils employed a significantly higher number of staff than Tasmanian councils in the RAV category.

Minor savings will be achieved if the existing practice of paying a 15% allowance to a small number employees who provide shared services to other councils is discontinued.

The Feasibility Study estimated the cost of the amalgamation under Option 4 to be $1.1m

Redundancy Costs

The Feasibility Study assumed a reduction of 10.5 FTEs, resulting in redundancy costs of $0.4m in year 1. The redundancy costs were calculated using the average salary and length of employment, utilising the top 20% of average salaries because it was assumed that the reduction of staff will occur at that level.

As mentioned previously, there appears to be no duplication of executive or senior roles and therefore the positions which would most likely be redundant are those at non-senior levels. On this basis, redundancy costs would be lower than the estimate in the Feasibility Study. Redundancy costs will depend on the structure decided by management of the amalgamated south-east council and other decisions, such as whether shop fronts will be retained in all current locations for the provision of face to face services.

It should be noted that Enterprise Bargaining Agreements (EBA) of both Sorell and Tasman councils have the same redundancy provisions, whereby redundancy pay is calculated as follows:

- 4 weeks in lieu of notice (5 weeks for employees over 45 years of age)
- 3 weeks pay for each year of service or payments under the National Employment Standards, whichever is greater
- $5,000 (pro-rata) if a targeted redundancy offer is accepted voluntarily
- Ex gratia payment in lieu of long service leave for employees with more than 5 years of continues services but not yet entitled to payment for pro-rata long service leave

It should also be noted that salaries under the Sorell Council's EBA appear to be, on average, 10% higher compared to Tasman Council. Therefore, additional costs may be incurred to achieve parity if the two councils were to amalgamate.

As part of any efficiency-improving reform, there are likely to be redundancies as workforce needs evolve. The average cost per employee is $69,000, so workforce redesign is a source of significant potential savings.

Furthermore, much of the downsizing associated with restructuring could be absorbed into ordinary levels of staff turnover.

Financial Assistance Grants

The Feasibility Study assumed no reduction in Financial Assistance Grants. The amalgamated south-east council will be entitled to the same amount of the general purpose grant for four years after the amalgamation that Sorell and Tasman councils would have been provided if they had remained as two separate councils. However, this does not mean that the amount of the general purpose grant will not change. For example, changes to revenue capacity or expenditure requirements of other councils may alter the relative needs percentages, which are used to allocate 70% of the general component pool. Similarly, the Tasmania's share of the funding pool may change because of changes to population numbers in other states and territories. The roads component may change as the cost adjusters are amended following the amalgamation. Nevertheless, we agree with the assumption that there will be no reduction in Financial Assistance Grants for the purpose of analysing the costs and benefits of the proposed amalgamation.

ICT and Other Transition Costs

The Feasibility Study estimated these costs to be $0.5m based on 4.7% of operating expenditure, less redundancy costs. We agree that additional costs will be incurred, such as bringing both Councils onto a single IT platform, merging data into common applications, setting-up reporting systems, developing a new website and other typical transformation costs. However, we do not believe that those costs will be significant, because both Councils are already working closely together in several areas and the relatively small size of Tasman Council's operations will mean that the integration will not be overly complicated or costly.

Contingency

The Feasibility Study applied a 20% contingency to the assumed amalgamation costs, which we believe is reasonable based on experience with amalgamations in other jurisdictions.

Revised Amalgamation Costs and Savings

Because the reduction in employee costs is unlikely to eventuate, at least not to the extent assumed by the Feasibility Study and our revisions to other assumptions, the potential amalgamation will unlikely deliver the estimated financial benefits in full.

Item	Estimated	Revised
Employee costs (ongoing savings)	$944,423	Unable to quantify
Materials and contracts (ongoing savings)	$67,052	$36,000
Councillor expenditure (ongoing savings)	$185,226	$100,433
Total Savings (ongoing)	**$1,196,701**	**$136,433**
Costs of Amalgamation in Year 1	**($1,112,659)**	**($600,000)**
Net Benefit/(Cost) in Year 1	**$84,042**	**($463,567)**

Financial Modelling Key Assumptions

Understanding the importance of financial modelling in the assessment of the feasibility of the selected option, we intended to review the financial model. However, because the model was not made available to us, our review was limited to assessing the relevance of key assumptions used in the financial modelling.

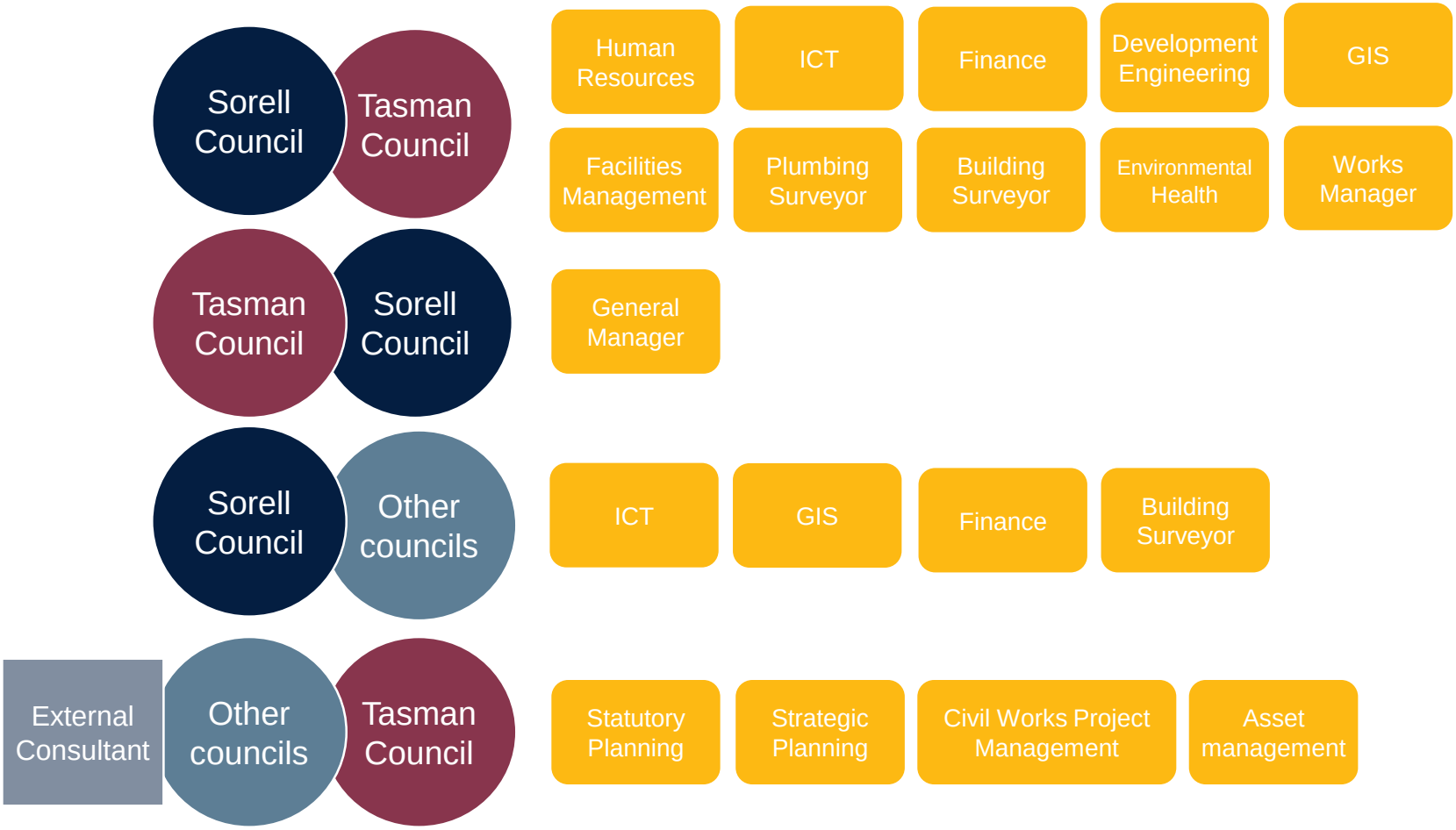
Feasibility Study assumption	Impact areas	Our assessment
CPI 2.63% based on a 10-year historical ABS data	Rates User charges and fees Materials and contracts	Consideration should be given to the appropriateness of CPI for escalation of cost and revenue. We consider the CCI published by the Local Government Association of Tasmania to be a better reflection of changes in the cost of delivering services in local government.
Interest rate 3%	Interest paid on borrowings	Our analysis showed that currently councils pay interest rates which are well in excess to the rate used in the Feasibility Study and will continue to do so up to another 5 years
Discount rate 3% (reflects cost of capital)	Present value calculations	The lower the discount the higher the present value of the net benefits.
Rate growth factor: Sorell 0.8% Tasman 1.8%	Rates User charges and fees Materials and contracts	Based on population growth and movement in the number of rateable properties, the growth factor for Tasman appears to be overstated. Tasman Council factored a zero growth factor into its long term financial planning. We do not consider the rate of 1.8% to be appropriate. Sorell has experienced a steady growth in population over the past 5 years as well as an increase in rateable properties. Sorell factored a growth rate factor of 0.5% in its LTFMP. On that basis, we consider the rate of 0.8% used in the modelling to be reasonable.
Financial Assistance Grants Nil increase	Revenue	Indexation on Financial Assistance Grants was restored in the 2017-18 budget. Indexation of the entire pool is based on CPI and population growth. General purpose entitlement changes in line with population share. Road entitlement % does not change. Payments to Tasmania appear to be have been indexed by 3% in 2018-19 and 4.2% in 2019-20 and Nil% in 2020-21. The assumption of zero increases appears to be reasonable.
Other returns	Revenue	Returns from investment in Southern Waste Solutions have not been included in the modelling

Part C

Extension of Existing Shared Services Arrangements under Option 0

Sharing Resources

The geographical proximity of Sorell, Tasman, Glamorgan Spring Bay and Brighton Councils has enabled the sharing of resource in several areas as shown below. The current arrangements are a basic resource sharing arrangement that provides the necessary resources when needed (a fee for service), thus reducing the need to employ a dedicated resource or use contractors.

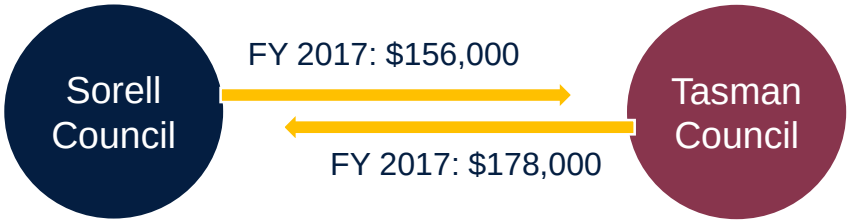


The Feasibility Study examined an incremental shared services model which identified areas where savings could be made and quantified those savings.

The success of any shared services model is contingent on the willingness of parties involved to work cohesively, implement new practices and systems and share not only the relevant resources but also risks associated with such an arrangement.

The level of cooperation between Sorell and Tasman Councils is relatively high. The resource sharing arrangement covers a number of areas from the traditional back office functions such as finance, ICT and human resources to functions covering key statutory responsibilities of local government such as land use planning and environmental health.

There is little scope for a further increase apart from potentially Sorell Council providing the services that Tasman Council procures from other councils and from an external consultant. However, it is noted that the resource sharing arrangement between Sorell and Tasman Councils relies heavily on resources being provided by Sorell Council. The only resource provided by Tasman Council is the position of General Manager, who is employed by Tasman Council and shared with Sorell Council on a 40:60 basis.



In 2016/17, the cost of resources provide by Sorell Council to Tasman Council was $0.178m. Sorell Council paid to Tasman Council $0.156m in return to cover its share of the cost of employing the shared General Manager.

Ending the current resource-sharing arrangement would impact both Councils. However, the impact on Tasman Council would be greater, unless it was able to procure resources from other councils or private sector providers. Not being able to share the cost of employing the General Manager and the cost of employing the staff currently shared between the two Councils would be in excess of the amount currently spent.

The current arrangement could be perceived by some as a loss of autonomy and local identity and control. Community needs and concerns should be carefully considered. If the resource sharing arrangement between Sorell and Tasman Councils were to continue or expand, it should be independently reviewed to ensure that costs and risks are equally shared, it is operating effectively and to identify areas for improvement and further opportunities.

Currently, only Kentish and Latrobe Councils share the General Manager position. They also share the cost of other skilled staff, some plant and equipment and some procurement. Their arrangement is different to the more common a fee for service arrangement used by most councils in Tasmania, including Tasman and Sorell Councils. A financial analysis undertaken as part of a 2016 review of the Kentish and Latrobe Councils' resource sharing arrangement found net savings to be between $0.594m and $0.768m in 2015-16, with the majority of savings stemming from sharing staff. Savings from sharing plant and equipment and shared projects and procurement were minimal in comparison[10]. A similar analysis of resource sharing arrangements between Circular Head and Waratah-Wynyard Councils, who no longer share the position of General Manager, put the savings at $1.00m in 2015-16. In this case, there was almost an equal split between savings from joint projects and shared procurement and shared staff[11].

When it comes to extending existing shared services arrangements of councils in the area, other considerations could include:

- Changing the model from a fee for service to sharing actual staff positions (similar to the current arrangement of sharing the position of General Manager between Sorell and Tasman Councils or the model adopted by some other councils, for example Circular Head and Waratah-Wynyard Councils);
- Sharing governance arrangements, for example audit panels (two of the three independent members, including the chair, are already shared between the two Councils);
- Integrating IT systems;
- Integrating asset management planning and capital works program;
- Establishing centres of excellence which set best practice and standards across participating councils;
- Setting-up service hubs to provide ratepayers access to local government services regardless of where they reside, similar to Service Tasmania; and
- Outsourcing.

Addendum

Financial Modelling

Financial Modelling

A previous review of Sorell and Tasman Councils' long term financial management plans (LTFMPs) showed that both Councils applied different assumptions when projecting future revenues and expenses. To provide a foundation for the assessment of their future financial sustainability, we adjusted their budgets for non-recurring items to establish a base for our projections and used standardised assumptions to model their financial data for the next 5, 10 and 20 years.

Normalising budget information

Both Sorell and Tasman Councils used their 2017-18 budgets as the basis for their long-term financial planning. We used the same budgets in our modelling because the budgets were reviewed by the audit panel of each Council approved by the councillors.

As the first step of the modelling, we normalised the budget information to establish a baseline on which to build the model. The adjustments, including our explanations why we made those adjustments, are detailed below. In addition, some line items were reallocated between categories to ensure consistent classification and indexation of like items of revenue and expenses.

Adjustment	Impact areas	Our explanation
Fire levy was eliminated from both revenue and expenses	Rates Other revenue Other expense	Fire levy is collected on behalf of the State Fire Commission. A 4% commission for collecting the levy was added to Other revenue.
Gains and losses on disposal of assets were eliminated	Other revenue Other expenses	Generally, losses or gains on disposal of assets would not be included in forecasts unless they reflect disposals of assets in asset management plans or are based on past experience.
Interest received and interest paid was estimated based on average cash and bank loan balances respectively	Other revenue Other expenses	Both actual and estimated cash balances and borrowings were taken into consideration when forecasting interest revenue and interest expense. The approach of simply indexing the current year's budget estimate had the potential to misstate the future projections.
TasWater distributions were recalculated	Other revenue	Forecast distributions from TasWater were adjusted to reflect a reduction in the total amount available for distributions to $20m per annum from FY2019 and the freeze on future increases.
Operating grants were eliminated	Other revenue	Operating grants are generally one-off or ad hoc and any grant income would be offset by the cost of activities for the which the grant was provided

Crowe Horwath

Standardising assumptions

The assumptions used in projecting future revenue and expenses were different between the two Councils, in some cases were deemed unrealistic or otherwise questionable. To provide consistency and comparability, we standardised the key assumptions which are detailed below. The assumptions were varied between Sorell and Tasman Councils only when warranted by the facts and circumstances of either of the two Councils. For example, recent population and rateable properties data supported the application of a growth rate for Sorell Council but not for Tasman Council.

Assumption applied	Impact areas	Our explanation
CPI 2.25% for years 1 to 5 CPI 2.50% for years 6 to 20	Rates User charges and fees Other revenue Other expense	The Consumer Price Index (CPI) provides a reasonable indication of changes in prices. The CPI data in our modelling was based on: • Projections over the period 2018-19 to 2020-21 contained in the Department of Treasury and Finance's *Revised Estimates Report 2017-18* (Table 3.1) for years 1 to 5. • Estimates used in Councils' LTFMPs for years 6 to 20.The estimates are not unreasonable when compared to an average CPI of 2.11% based on 10-year historical ABS data.
Revenue growth factor: 1% for Sorell for years 1 to 5 0.5% for Sorell for years 6 to 20 Nil for Tasman	Rates User charges and fees	The growth factor reflects recent population and rateable properties data. We used this data conservatively because population growth is only one of many factors impacting Council's revenue raising capacity.
CCI 2.31% for years 1 to 5 CCI 2.80% for years 6 to 20	Materials and services	The Council Cost Index (CPI) combines the wage price index, road and bridge construction index and the CPI and is therefore a reasonable indication of changes in the cost of delivering services in the local government. The CCI data in our modelling was based on either a 5-year or 10-year historical data published by the Local Government Association of Tasmania. The average chosen reflected the forecasting period. We used the 10-year average for long-term forecasting but opted to use the 5-year average for short and medium term projections.
Expenses growth factor: Sorell – as revenue growth factor 0.5% for Tasman for years 6 to 20	Materials and services	We applied the growth rate factor to material and services because development and population growth and growth in visitor numbers lead to an increased demand on existing infrastructure and services.
Wage Price Index 3.0%	Employee benefits	Even though the current enterprise agreements provide of an annual increase of 2.5% or CPI (whichever is greater), we decided to apply a 3% index to reflect movements between levels within the same band or promotions and is based on a 10-year average Tasmanian Public Sector Wage Price Index.
2.0% increase annually	Financial Assistance Grants Revenue	The allocation of funds between states and territories for the Financial Assistance Grant is increased annually in real per capita terms and includes a CPI adjustment based on the difference between the estimated and actual CPI from the previous year's grant, as well as a population adjustment. The Australian Government budget indicates an increase in Tasmanian's share of the funding pool in 2018-19 and the forward estimates.

Assets Management Assumptions

For a council to be financially sustainable, it needs to not only budget and operate to break-even, it also needs to be able to maintain the condition of its physical assets to deliver services to the community. Linking long term strategic asset management plans with financial management plans is critical when considering future asset management costs in order to achieve financial sustainability. Councils' LTFMPs did not adequately address long-term funding for key infrastructure assets.

There are several drivers of asset funding needs, including maintenance, renewals, and building new assets. For the purpose of the financial modelling:

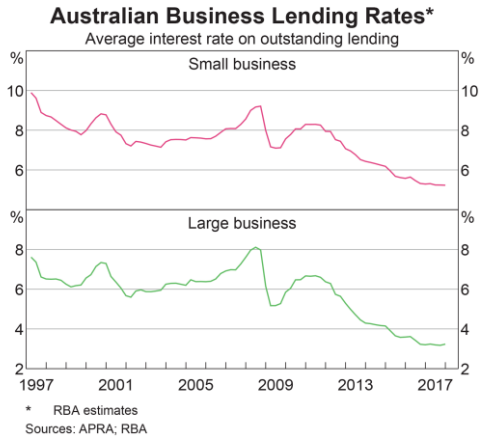
- Maintenance costs are included in materials and services expenses and are based on the approved budget.
- Renewals expenditure is based on the amount of depreciation expenses. This is because when existing assets need to be renewed, the capital costs is generally covered by the amounts that have been raised through depreciation charges during the life of the asset. Therefore, the financial modelling assumed that renewals expenditure will be equal to depreciation each year and over the 20-year period. This will not always be the case because depreciation is calculated generally on a straight line over the life of the asset, however renewal expenditure will not occur evenly during the life of the asset.
- Capital spending on new assets was not considered. This did not limit the financial modelling because capital expenditure is not expensed through the income statement. The cost of an asset becomes an operating expense through depreciation and interest if the capital project is funded by borrowings.

It was also assumed that a decision to invest in a new asset or upgrade or expand an existing assets would consider not only the financial capacity to deliver the project but also the cost of future maintenance and renewals and the impact on council's financial sustainability.

Regular revaluations of assets are important to ensure that depreciation expense reflects the current asset values and useful lives. Generally, councils apply relevant indices to asset classes between full revaluations. For the purpose of estimating the depreciation and renewals expenditure, we used the CPI (10-year average) to index the value of physical asset.

Cash Management Assumptions

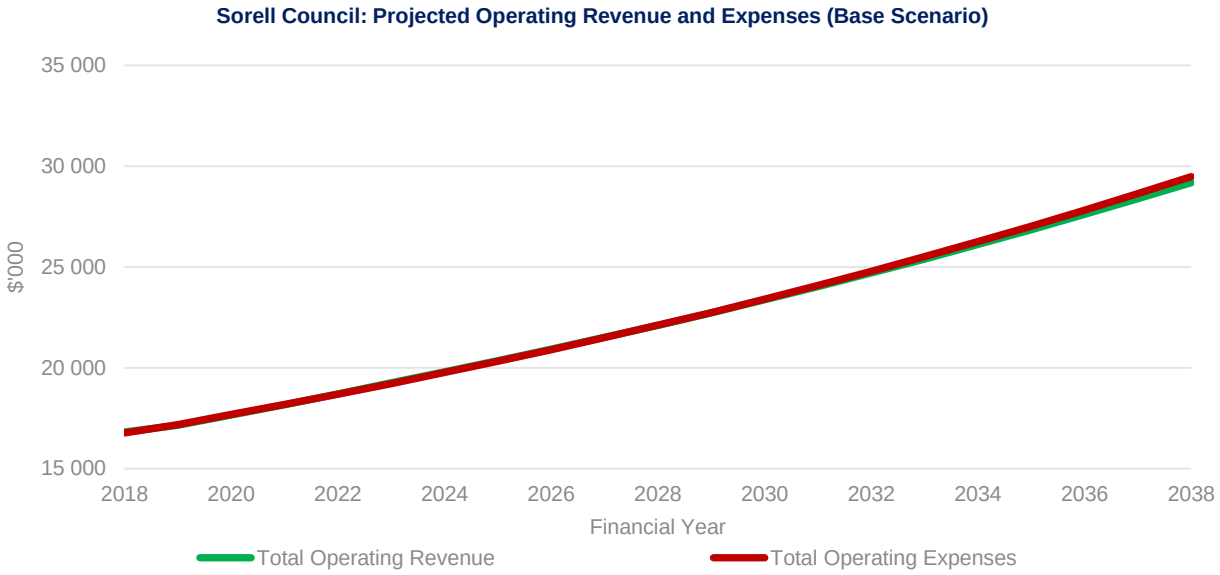
The financial modelling assumed that existing loans will be repaid over time at a rate existing repayments. No new borrowings were assumed, unless the cash balance fell below 50% of the average cash balance in recent years. The interest rate of 4% was based on business lending rates.

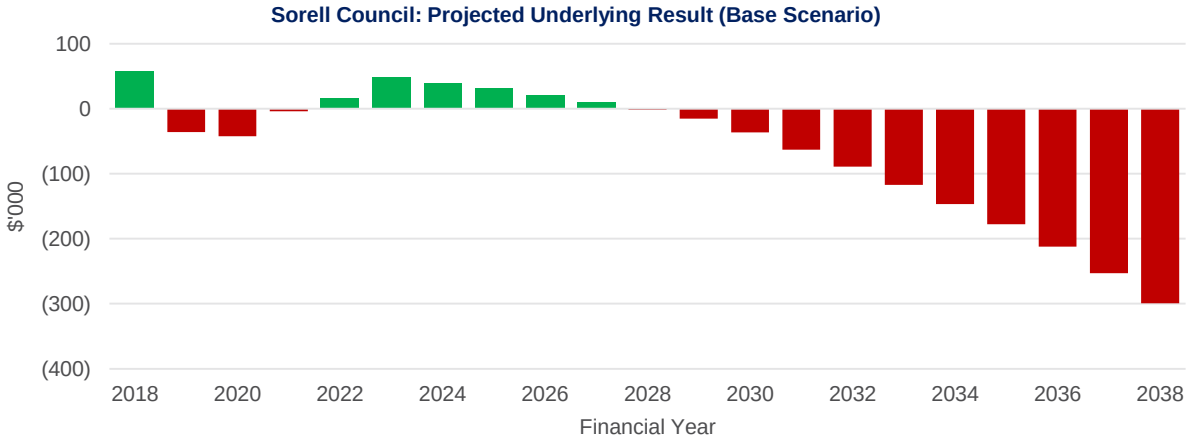


Sorell Council Projections

The normalised projections showed close to a break-even operating performance over the next 10 years. Expenses are projected to exceed revenue in the second part of the projections period, although the average operating deficit would be less than 1% of income.

Sorell Council's current LTFMP (2019-2036) forecasts underlying surpluses in each of the 18 years.





Sorell Council 20-year Projections

	Budget FY 2018 $'000	FY 2019 $'000	FY 2020 $'000	FY 2021 $'000	FY 2022 $'000	FY 2023 $'000	Year 6-10 $'000	Year 11-20 $'000	Total $'000
General rates only	10,517	10,861	11,217	11,584	11,963	12,354	67,583	169,331	294,892
Other fees and charges	2,767	2,858	2,951	3,048	3,147	3,250	17,781	44,551	77,586
Financial Assistance Grants	2,075	2,117	2,159	2,202	2,246	2,291	12,161	28,250	51,425
Distributions from TasWater	485	324	324	324	324	324	1,620	3,240	6,480
Bank interest on cash	126	119	111	106	102	98	440	661	1,636
Other	849	868	888	908	928	949	5,114	12,333	21,989
Total Operating Revenue	**16,819**	**17,147**	**17,649**	**18,171**	**18,710**	**19,267**	**104,699**	**258,365**	**454,008**
Employee benefits	5,690	5,861	6,037	6,218	6,404	6,596	36,071	90,293	157,479
Materials and services	4,845	5,006	5,173	5,345	5,523	5,707	31,498	80,694	138,946
Depreciation	5,204	5,284	5,442	5,565	5,711	5,850	31,525	76,020	135,396
Bank interest on loans	146	135	123	110	97	84	225	32	806
Other	877	897	917	938	959	980	5,281	12,735	22,706
Total Operating Expenses	**16,762**	**17,183**	**17,691**	**18,175**	**18,694**	**19,217**	**104,599**	**259,775**	**455,334**
Operating Surplus / (Deficit)	**57**	**(36)**	**(42)**	**(4)**	**17**	**49**	**100**	**(1,410)**	**(1,326)**

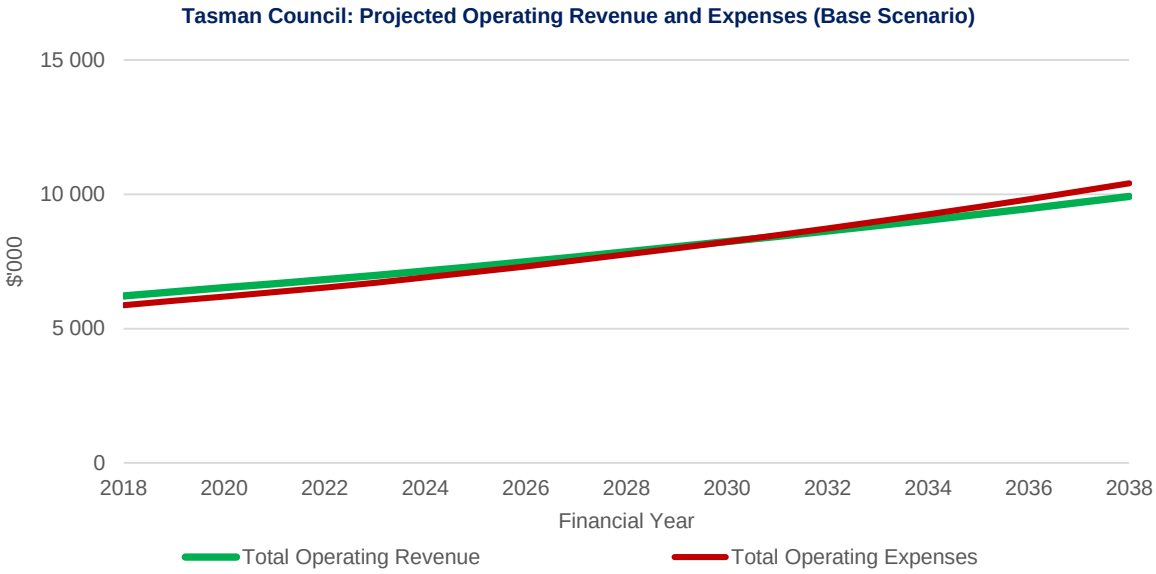
The table below compares the key assumptions applied by Sorell Council with the standardised assumption used in the financial modelling:

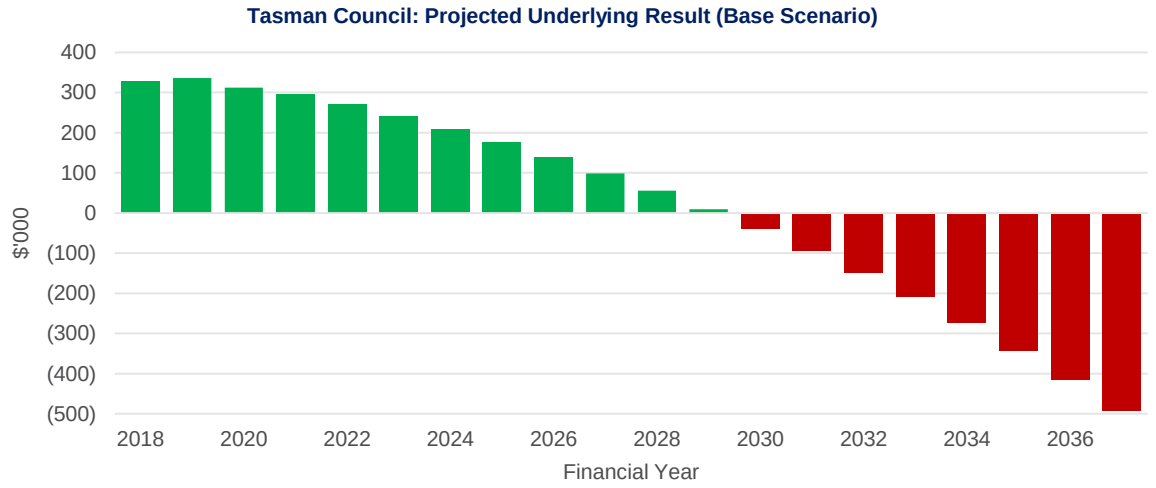
Sorell Council	Item	Standardised assumption
4.0% increase in 2019 2.5% increase annually after 2019 0.5% growth factor	Rates User charges and fees	CPI 2.25% and growth rate 1.0% for years 1 to 5 CPI 2.5% and growth rate 0.5% for years 6 to 20
2.0% increase annually	Financial Assistance Grants	2.0% increase annually
$14,000 base 2.5% increase annually	Other grants	Not estimated
Average 2.74% interest rate applied to forecast cash balance	Interest revenue	1.9% average rate
2.5% increase until 2020 3.0% increase after 2020	Employee benefits	3.0% increase annually
3.0% increase plus 2.5% of the value of new assets from 2020	Materials and services and Other expenses	CCI 2.31% and growth rate 1.0% for years 1 to 5 CCI 2.80% and growth rate 0.5% for years 6 to 20
No new debt has been assumed	Interest expense	Assumed borrowings only to cover cash deficits

Tasman Council Projections

The normalised projections showed that Tasman Council would generate sufficient revenue to cover its operating expenses until 2030. After that, Council would start incurring operating deficits. Overall, Council's net result over the 20-year period would be a surplus of $0.5m.

Tasman Council's LTFMP (2019-2038) forecasts operating surpluses in each of the 20 years.





Tasman Council 20-year Projections

	Budget FY 2018 $'000	FY 2019 $'000	FY 2020 $'000	FY 2021 $'000	FY 2022 $'000	FY 2023 $'000	Year 6-10 $'000	Year 11-20 $'000	Total $'000
General rates only	3,941	4,030	4,120	4,213	4,308	4,405	23,732	57,229	102,036
Other fees and charges	812	830	849	868	888	908	4,890	11,791	21,023
Financial Assistance Grants	955	974	994	1,013	1,034	1,054	5,597	13,002	23,668
Distributions from TasWater	15	10	10	10	10	10	50	100	200
Bank interest on cash	100	120	141	146	151	155	839	1,721	3,272
Other	394	403	412	421	431	440	2,373	5,721	10,201
Total Operating Revenue	**6,217**	**6,367**	**6,525**	**6,671**	**6,820**	**6,972**	**37,480**	**89,565**	**160,401**
Employee benefits	1,084	1,117	1,150	1,185	1,220	1,257	6,872	17,202	30,001
Materials and services	2,701	2,777	2,855	2,936	3,019	3,104	17,129	43,883	75,702
Depreciation	1,658	1,721	1,753	1,802	1,844	1,892	10,191	24,575	43,778
Bank interest on loans	21	13	10	6	2	(0)	(0)	(0)	30
Other	403	412	421	431	441	450	2,427	5,852	10,434
Total Operating Expenses	**5,867**	**6,039**	**6,189**	**6,359**	**6,525**	**6,703**	**36,618**	**91,512**	**159,946**
Operating Surplus / (Deficit)	**350**	**328**	**336**	**312**	**295**	**270**	**861**	**(1,947)**	**455**

The table below compares the key assumptions applied by Tasman Council with the standardised assumption used in the financial modelling:

Tasman Council	Item	Standardised assumption
2.5% increase annually No growth factor applied	Rates User charges and fees	CPI 2.25 % and no growth rate for years 1 to 5 CPI 2.5 % and no growth rate for years 6 to 20
No indexation applied	Financial Assistance Grants	2.0% increase annually
Not estimated	Other grants	Not estimated
2.5% increase annually	Interest revenue	1.9% average rate
2.5% increase annually	Employee benefits	3.0% increase annually
2.5% increase annually	Materials and services and Other expenses	CCI 2.31% and growth rate 0.5% for years 1 to 5 CCI 2.80% and growth rate 0.5% for years 6 to 20
2018 depreciation is applied consistently over the period of the plan and indexed annually by 2.5%	Depreciation	CPI 2.5%

Tasman Council – Resource Sharing

In 2016/17, the cost of resources provide by Sorell Council to Tasman Council was $0.178m. Sorell Council paid to Tasman Council $0.156m in return to cover its share of the cost of employing the shared General Manager.

We modelled a scenario where the resource-sharing arrangement would not continue and Tasman Council would:

- no longer be reimbursed for part of the cost of employing the General Manager (2017-18 budgeted reimbursement was used as the base); and
- employ two senior staff members to oversee functions such as finance, human resource, information technology, asset management and planning (includes on-costs).

The modelling showed that employing a full-time General Manager and two senior staff members to oversee functions covered under existing resource-sharing arrangements would add an additional cost of approximately $12.1m over 20 years (or $0.6m per annum).

Tasman Council	**FY 2019** $'000	**FY 2020** $'000	**FY 2021** $'000	**FY 2022** $'000	**FY 2023** $'000	**Year 6-10** $'000	**Year 11-20** $'000	**Total** **$'000**
General rates only	4,030	4,120	4,213	4,308	4,405	23,732	57,229	102,036
Other fees and charges	830	849	868	888	908	4,890	11,791	21,023
Financial Assistance Grants	974	994	1,013	1,034	1,054	5,597	13,002	23,668
Distributions from TasWater	10	10	10	10	10	50	100	200
Bank interest on cash	120	141	146	151	155	839	1,721	3,272
Other	403	412	421	431	440	2,373	5,721	10,201
Less GM reimbursement	(138)	(141)	(144)	(148)	(151)	(813)	(1,960)	(3,495)
Total Operating Revenue	**6,229**	**6,384**	**6,527**	**6,673**	**6,821**	**36,667**	**87,605**	**156,906**
Employee benefits	1,117	1,150	1,185	1,220	1,257	6,872	17,202	30,001
Add est. senior staff salaries	339	349	360	370	381	2,086	5,221	9,106
Materials and services	2,777	2,855	2,936	3,019	3,104	17,129	43,883	75,702
Depreciation	1,721	1,753	1,802	1,844	1,892	10,191	24,575	43,778
Bank interest on loans	13	10	6	2	(0)	(0)	(0)	30
Other	412	421	431	441	450	2,427	5,852	10,434
Total Operating Expenses	**6,378**	**6,538**	**6,719**	**6,896**	**7,084**	**38,704**	**96,733**	**169,052**
Operating Surplus / (Deficit)	**(149)**	**(154)**	**(192)**	**(223)**	**(263)**	**(2,037)**	**(9,129)**	**(12,146)**

Indexation of Financial Assistance Grants

As mentioned previously, the Australian Government budget indicates an increase in Tasmanian's share of the funding pool in 2018-19 and the forward estimates. This is partly a result of lifting the freeze on the indexation. However, increasing the share of the funding pool may not necessarily result in a corresponding increase in individual distributions to councils, calculations of which are subject to various factors.

For instance, the 2017-18 Tasmanian entitlement was estimated to increase by 2.8% on the previous year after the lifting of the indexation freeze. When the Tasmanian pool was allocated in that year, Sorell Council's allocation was 1.0% lower compared to the year before, while Tasman Council's allocation increased by 3.4%.

Historically, Tasman Council's share of the pool remained steady while Sorell Council's share of the pool has been declining. This indicates that indexation at the Federal level and increase in the funding pool do not necessarily translate to a corresponding increase in the funding to individual councils. The following table shows the impact of different index factors applied to Financial Assistance Grants revenue on Councils' projections.

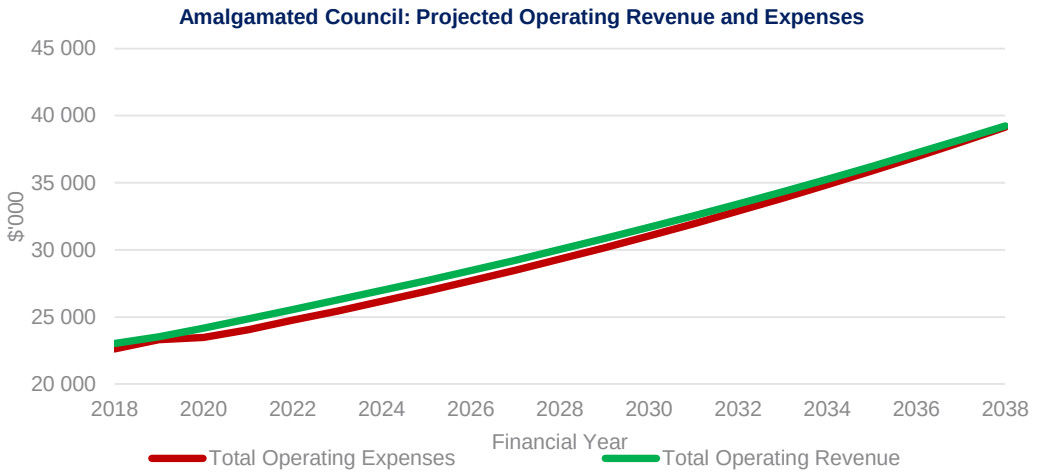
Sorell Council	**2% index** $'000	**1% index** $'000	**Nil index** $'000
Financial Assistance Grants	51,425	46,146	41,500
Total Operating Revenue	**454,008**	**448,201**	**443,355**
Total Operating Expenses*	**455,334**	**456,431**	**457,625**
Operating Surplus / (Deficit)	**(1,326)**	**(8,230)**	**(14,271)**

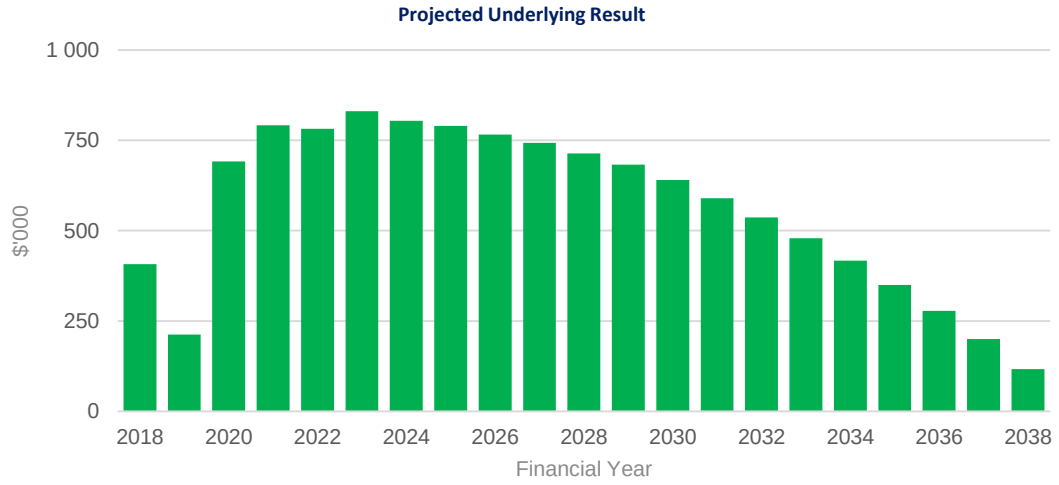
*The increase in operating expenses reflects interest on borrowings as a result of reduced cash balance following operating losses.

Tasman Council	**2% index** $'000	**1% index** $'000	**Nil index** $'000
Financial Assistance Grants	23,668	21,238	19,100
Total Operating Revenue	**160,401**	**157,710**	**155,332**
Total Operating Expenses	**159,946**	**159,946**	**159,946**
Operating Surplus / (Deficit)	**455**	**(2,236)**	**(4,614)**

Amalgamated Council Projections

Amalgamated Council Assumptions	Item
Same as those used in individual Council projections (assuming rates revenue neutrality)	Rates User charges and fees
2.0% increase annually	Financial Assistance Grants
Not estimated	Other grants
1.9% average rate	Interest revenue
3.0% increase annually	Employee benefits
Same as those used in individual Council projections	Materials and services
CPI 2.25% for years 1 to 5 CPI 2.5 % for years 6 to 20	Other expenses
Assumed borrowings only to cover cash deficits	Interest expense
Reduced councillor expenditure, compliance and reporting costs and other savings estimated at **$250,000 (ongoing)**	Other expenses
One-off transition costs estimated at **$600,000 (year 1 only)**	Other expenses





The modelling showed that the amalgamated council would generate operating surpluses for the entire projections period.

The estimated savings achieved by amalgamating the two councils are relatively small at 1.2% of total expenses. Operating surpluses will progressively decline as expenses are projected to grow at a faster rate than revenue. To remain sustainable in the long-term, the new council will need to further reduce costs or increase revenue. The projections include interest earned based on projected cash balances using an average interest rate. It should be noted that the projected cash balances do not reflect capital spending on new assets, which was not part of the financial modelling.

Amalgamated Council 20-year Projections

	Budget FY 2018 $'000	FY 2019 $'000	FY 2020 $'000	FY 2021 $'000	FY 2022 $'000	FY 2023 $'000	Year 6-10 $'000	Year 11-20 $'000	Total $'000
General rates only	14,458	14,891	15,337	15,797	16,271	16,759	91,315	226,560	396,929
Other fees and charges	3,579	3,688	3,800	3,916	4,035	4,158	22,671	56,342	98,609
Financial Assistance Grants	3,030	3,091	3,152	3,215	3,280	3,345	17,758	41,252	75,093
Distributions from TasWater	500	334	334	334	334	334	1,670	3,340	6,680
Bank interest on cash	226	244	256	260	269	279	1,557	3,856	6,720
Other	1,243	1,271	1,300	1,329	1,359	1,389	7,430	17,585	31,662
Total Operating Revenue	**23,036**	**23,518**	**24,179**	**24,850**	**25,547**	**26,264**	**142,399**	**348,935**	**615,692**
Employee benefits	6,774	6,977	7,187	7,402	7,624	7,853	42,943	107,495	187,481
Materials and services	7,546	7,533	7,770	8,014	8,266	8,526	47,054	120,548	207,710
Depreciation	6,862	6,734	7,056	7,154	7,373	7,537	40,645	98,009	174,508
Bank interest on loans	167	152	137	120	103	87	234	6	839
Other	1,280	1,909	1,338	1,368	1,399	1,431	7,708	18,587	33,740
Total Operating Expenses	**22,629**	**23,306**	**23,487**	**24,058**	**24,765**	**25,433**	**138,583**	**344,645**	**604,278**
Operating Surplus / (Deficit)	**407**	**212**	**691**	**792**	**782**	**831**	**3,816**	**4,290**	**11,415**

Other expenses in FY 2019 include the one-off transition costs estimate of $0.600m

Sensitivity Analysis

The outcomes of the financial modelling can be significantly affected if actual results are different to projections. The analysis below demonstrates the sensitivity of the financial modelling to changes in the projected revenues and expenses. The sensitivity analysis assumed two scenarios:

- Revenue projections will not be realised and income will be 0.5% lower per annum.
- Expenses will be 0.5% higher per annum.

Sorell Council	Revenue -0.5% $'000	Expense +0.5% $'000
Total Operating Revenue	429,579	454,008
Total Operating Expenses	455,334	481,499
Operating Surplus / (Deficit)	(25,755)	(27,491)

Tasman Council	Revenue -0.5% $'000	Expense +0.5% $'000
Total Operating Revenue	151,846	160,401
Total Operating Expenses	159,946	169,150
Operating Surplus / (Deficit)	(8,101)	(8,749)

Amalgamated Council	Revenue -0.5% $'000	Expense +0.5% $'000
Total Operating Revenue	582,626	615,692
Total Operating Expenses	604,278	639,038
Operating Surplus / (Deficit)	(21,652)	(23,346)

*The increase in operating expenses reflects interest on borrowings as a result of reduced cash balance following operating losses.

Appendices

Financial Sustainability Indicators Explained

The following financial sustainability measures were used in this review:

Sustainability measure	Method of calculation	Description
Underlying result	Operating revenue less operating expenses	Underlying result summarises recurrent revenue transactions and expense transactions incurred in the same period of time and calculates the difference.
Underlying result ratio	Underlying result divided by operating revenue	A positive result indicates a surplus with the larger the surplus the stronger the assessment of sustainability. However, too strong a result could disadvantage ratepayers. A negative result indicates a deficit which cannot be sustained in the long-term.
Net financial liabilities	Current (liquid) assets less total liabilities	Money held, invested or owed to council less what is owed by council to others.
Net financial liabilities ratio	Current (liquid) assets less total liabilities divided by total operating revenue	Indicates the extent to which net liabilities can be met by operating income. A falling ratio indicates that the entity's capacity to meet its financial obligations from operating income is strengthening.
Asset consumption ratio	Depreciated replacement cost of assets divided by current replacements costs	The average proportion of "as new" value remaining in the assets. This ratio shows the written down current value of depreciable assets relative to their "as new" value in current up to date prices. The ratio highlights the aged condition of physical assets with the benchmark between 40% to 60%. A ratio less that 40% indicates a deterioration of the asset base. Urgent investment may be required to ensure service levels are maintained.
Asset renewal funding ratio	The value of planned capital expenditure on renewals (planned) divided by the required capital expenditure on renewals (actual)	Measures the financial capacity to fund asset renewal as required and therefore continue to provide existing levels of services in future without additional operating income or reductions in operating expenses or an increase in net financial liabilities above that currently projected. A ratio of between 90% and 100% indicates that the Long Term Financial Plan makes adequate provision to maintain existing levels of service and renew or replace assets
Asset sustainability ratio	Capital expenditure on replacement or renewal of assets divided by the depreciation expense	This is the measure of the extent to which assets are being replaced as they reach the end of their useful lives. Capital expenditure on renewals (replacing assets already owned) is an indicator of the extent to which the assets are being replaced. A ratio of less than 90% over a period of time indicates under investing in renewal and replacement of asset base. This is a long term indicator, as capital expenditure can be deferred in the short-term if there are insufficient funds available from operations and borrowing is not an option.

Scope of Review

A desktop due diligence review of the financial analysis contained in the Feasibility Study including commentary by the participating councils on the Feasibility Study.

The State Government and participating councils jointly supported the cost of the $290 000 detailed financial analysis undertaken by KPMG.

The focus of this review was a due diligence review/commentary on the methodology and findings of the Feasibility Study as they relate to:

- **Part A** - the current financial viability and projected long-term (10 and 20 year) financial viability of the participating councils;
- **Part B** - the projected short term (four-year) and long-term (10 and 20 year) financial sustainability of a voluntarily merged Council (from the participating councils) under option 4; and
- **Part C** - the potential to deliver improved financial viability to the participating councils through the extension of these councils' shared services both between the participating councils and with other councils.

The due diligence check included a review of the findings and methodology of the Feasibility Study in the light of current data provided by the participating councils as well as commentary from the participating councils on the findings of the Feasibility Study.

The analysis and commentary had regard to the following matters (including current data):

- Viability of the participating councils (including reference to key financial indicators);
- Infrastructure gaps and condition;
- Basis of depreciation;
- Adequacy of rating history and rating policies of the participating councils;
- Fixed cost per ratepayer (current and projected);
- Impact on funding (for example State and Commonwealth grants);
- Savings from a merger (both within council operations and to ratepayers);
- Costs of integration arising from a merger;
- Potential economies of scale through:
  - cost savings (population size v expenditure on general operations); and
  - efficiency improvements (improved quality and range of services);
- Financial management and asset management systems;
- Other potential financial benefits and impacts; and
- Assumptions underlying the analysis and any risks associated with these assumptions.

Financial modelling was to include normalising recent budget information for both Sorell and Tasman Councils and using that information to forecast their results for the next 20 years based on standardised assumptions to allow for comparison between the two councils. Furthermore to consolidate the normalised projections, building savings/costs of amalgamation into the projections to forecast results of the amalgamated council for the next 20 years. The financial modelling should include sensitivity analysis, including an assessment of the impact of an overall increase/decrease in revenue and expenses.

References

1. KPMG 2016, *South East Councils Feasibility Study: Final Report*, Tasmania
2. Tasmanian Audit Office 2017, *Report of the Auditor-General No. 6 of 2017-18: Auditor-General's Report on the Financial Statements of State entities, Volume 3 - Local Government Authorities 2016-17*, Hobart
3. Tasmanian Audit Office 2015, *Report of the Auditor-General No. 11 of 2014-15: Road management in local government*, Hobart
4. State Grants Commission, *2017-18 Approved Recommendations* < http://www.treasury.tas.gov.au/Documents/2017-18%20Council%20Financial%20Assistance%20Grant%20Allocation%20Charts.pdf>
5. Australian Bureau of Statistics 2017, *3218.0 Regional Population Growth, Australia*, <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/3218.0Main+Features12016?OpenDocument>
6. See reference 5
7. Department of Infrastructure and Regional Development 2017, *Local Government National Report 2014-15,* Appendix F <http://regional.gov.au/local/publications/reports/2014_2015/LGN_REPORT_2014-15.pdf>
8. Local Government Board 2012, Report on a Review of Councillor Numbers, p. 59, http://www.dpac.tas.gov.au/__data/assets/pdf_file/0009/168714/LGB_Final_Report_PDF_Nov_2012.pdf
9. Tasmanian Audit Office 2017, *Report of the Auditor-General No. 6 of 2017-18: Auditor-General's Report on the Financial Statements of State entities, Volume 3 - Local Government Authorities 2016-17,* Comparative Analysis, Hobart
10. University of Technology Sydney: Centre for Local Government, 2016*, Review of Resource Sharing Arrangements Between Kentish and Latrobe Councils,* Sydney
11. University of Technology Sydney: Centre for Local Government, 2016, *Review of Resource Sharing Arrangements Between Circular Head and Waratah-Wynyard Councils*, Sydney

Basis and Use of Report

This report is prepared on the basis of the limitations set out below:

We were engaged by the Local Government Board to provide financial analysis to inform the Local Government Board Review into Amalgamation and Shared Services Options for South East Councils. This report has been prepared in accordance with the objectives and approach outlined in the Request for Quotation (RFQ reference 18/13504) and agreed in the Quotation Form and Supplementary Information dated 1 February 2018, including an agreement to perform financial modelling and subject to the following limitations:

- Our procedures were designed to provide a desktop due diligence review of the financial analysis contained in the Feasibility Study including commentary by the participating councils on the Feasibility Study.
- The focus of this review was to be a due diligence review/commentary on the methodology and findings of the Feasibility Study and to model financial performance of the participating council and the proposed amalgamated council.
- The matters raised in this report are only those which came to our attention during the course of performing our work. This report has been prepared at the request of the Local Government Board and is presented subject to the written terms of Crowe Horwath's engagement. Other than our responsibility to the Local Government Board, neither Crowe Horwath nor any member or employee of Crowe Horwath undertakes responsibility arising in any way from reliance placed by another party on our work. Any party, other than the Local Government Board, who chooses to rely in any way on the contents of this report, does it so at their own risk and Crowe Horwath accepts no responsibility to anyone other than the Local Government Board for the information contained in this report. In this regard, we recommend that parties seek their own independent advice.
- The services we have provided comprised an advisory engagement which is not subject to Australian Auditing Standards or Australian Standards on Review or Assurance Engagements, and consequently no opinions or conclusions intended to convey assurance have been expressed. In providing our services we have relied on information and data supplied by different parties and information gathered from various sources and publications. While we have made every effort to ensure the reasonableness of that information and its appropriateness for the purpose of our work, no warranty of completeness, accuracy or reliability is given in relation to the information and documentation provided by the parties consulted and the representations made. Where possible, we have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted.

Contact Us

Crowe Horwath Tasmania
ABN 55 418 676 841
Member Crowe Horwath International
Level 1, 142 Elizabeth Street
Hobart TAS 7000
Australia
Tel +61 3 6210 2525
Fax +61 3 6210 2524
www.crowehorwath.com.au