Report to Good for Manly Executive

High Level Summary of Financial Issues arising under Council Merger Options ©

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1-Introduction

This Report has been prepared for the Good for Manly Party. It is a high level summary of the KPMG analysis of "Council Amalgamation Options" for Manly Council and Pittwater Council. I have attempted to make a limited comparison to any other relevant external material, prepared for Warringah Council, which is in the public domain. I focused on financial and economic aspects only. I have refrained from making any judgements on any of the Amalgamation Options presented. However I have pointed out some issues which may warrant closer attention and have tried to simplify some of that external analysis.

At the time of issuing its Report KPMG did not have access to the "Methodology for Assessment of Council Fit for the Future Proposals" which the NSW Independent Pricing and Regulatory Tribunal (IPART) released in late April 2015.Accordingly KPMG has not considered any of the issues raised in that Consultation Paper. Nor have I.

2-Executive Summary

The consistent position of the three Councils is that they do not wish to merge/amalgamate. On the basis that their preference may not be acceptable to the NSW Government they have formulated other Options, and their preferences are not consistent. Their reasons vary widely.

The respective Reports reviewed by me and which the Councils have received are also fundamentally different; making valuable comparison difficult. Their different approach to financial analysis probably restricts Manly and Pittwater Councils' ability to form a conclusion about the most appropriate action to take.

The metrics included in the Reports are not necessarily those that one might associate with a financial analysis undertaken in an ordinary commercial environment. The amount of "savings/benefits" which the Reports identify and present are primarily predicated on an across the board net reduction, over 10 years, in the number of Council employees. It is also likely that there will be demand for an increase, near term, in the number of executive level staff to facilitate the merger/amalgamation. It is therefore, arguable that these "savings/benefits" will materialise at the projected level.

There is a general consensus in the Reports that one Northern Beaches Council will generate the most "savings/ benefits" to its residents. The degree to which this might be realised varies markedly between Reports.

However, the Reports do not expressly state how the Councils will utilise or distribute these "savings/benefits" among ratepayers; for example by a reduction in their rates. Given that each of the Reports indicates that the "savings/ benefits" will materialise over 10 years it is possible none of the "savings/benefits" will flow through to ratepayers in a direct way.

If financial metrics are regarded as the dominant criteria for amalgamating/ merging, one Northern Beaches Council is by implication, the preferred Option.

There appears to be only marginal, at best, financial support for the formation of a Greater Manly Council and a Greater Pittwater Council. Strong control in the merger/amalgamation execution process will be critical to prevent this Option resulting in substantial disadvantage for ratepayers.

Many of the measures Local Councils and their constituency seek to measure themselves by and against focus on non financial metrics which are difficult to assess and measure objectively. Non financial metrics tend to focus on perceptions-how the Councils serve and respond to their constituent's needs and desires for services and infrastructure. In other words it is possible that resident stakeholders in the three Councils are likely to value non financial data, more highly than financial data. Potentially, this may be a more powerful deciding factor given that each Council has been assessed by the Local Government Review Panel as being financially viable.

The Reports prepared for the three Councils appear to have addressed a number of these issues by benchmarking their non financial metrics against a broad grouping of other Councils, applying the Independent Government Review Panel (2014) and the 'Fit for the Future' criteria. In summary, the three Councils rank in the top performing group of Councils.

The Consultation Paper issued by IPART would appear to rate its measurement criteria more highly than some of the analysis and conclusions which the Reports have used and drawn.

3-KPMG Reports for Manly and Pittwater Councils

KPMG were engaged by Manly Council and Pittwater Council to perform a review of the various Options the Councils considered appropriate.

In that context KPMG issued its "*Independent Review of Structural Options for Manly Council and Pittwater Council"* dated 1 April 2015, in two parts, namely

- Part A- "*Summary Report*," and
- Part B-"*Compendium Report and Appendices*."

The following is a high level summary of KPMG's Key Findings;

- "...each of the Northern Beaches Councils broadly met the key 'Fit for the Future' (FTF) financial benchmarks-even in the absence of council mergers;"
- "...both Manly Council and Pittwater Council will be able to achieve all of the FTF benchmarks by 2020 in all of the reform scenarios considered;"
- "...the potential financial impacts of Council merger Options indicated...each Option offered net benefits/savings of between $ 3.3 m and $ 34.5 m...in Net Present Value terms;"
- "...when financial support from the NSW Government...is factored into the savings they increase...to between $ 13.7 m and $ 44.9 m;"
- "There is strong evidence to suggest that both...Councils...demonstrate 'strategic capacity; '..."
- "The examination of the impacts of non-financial factors indicted that each structural option offered both advantages and disadvantages..."
- "Important non-financial factors...include implications of merger options for the community and governance, the environment and service delivery;" and
- "A review of demographic and socio-economic characteristics...highlighted both shared interests and distinct variations that may impact...service and infrastructure needs...."

The KPMG review considered 5 major aspects of the merger proposals, namely:

- Financial and Economic;
- Community and Governance;
- Geography and Environment;
- Demography; and
- Service Delivery.

The 'Structural Options' analysed in depth by KPMG were:

- Option 1-No Merger;
- Option 2-North /South divide along Warringah Road to create a Greater Manly Council and a Greater Pittwater council; and
- Option 3-Merger of the three Councils into one Northern Beaches Council.

I have only considered the first, "Financial and Economic."

In addition, KPMG identified an "Alternate Structural Option," namely a merger of Manly and Warringah Councils. However, KPMG do not appear to have subjected this Option to the same level of financial analysis as it did for the other three options. I have not considered it.

It is to be noted, by comparison, that the independent analysis undertaken on behalf Warringah Council also considered that Option, as Option 3 and, a merger of Pittwater Council with Warringah Council, as Option 4.

The following table may be of assistance to reconcile or orientate between the primary Reports prepared for the three Councils,

	Manly/Pittwater	**Warringah**
• No Merger	Option 1	Option 1
• Greater Manly/Greater Pittwater	Option 2	Option 5
• Northern Beaches Council	Option 3	Option 2
• Merger of Manly with Warringah	Alternate	Option 3
• Merger of Pittwater with Warringah	N/A	Option 4

Based on KPMG's financial analysis there would be a "positive benefit" flowing from either Option 2 or 3.That is KPMG predict an amalgamation/merger will generate savings in operating costs (OPEX) over 10 years.

In Option 2, KPMG forecasts that the savings, over 10 years, "will mainly stem from reductions in the total number of Council employees (41 FTE) and improved operating efficiencies, (OPEX) . Further, KPMG predicts "...relatively higher upfront implementation costs given the need to create two new Councils which results in the...benefits...not being realised...until later."

Although the financial and economic analytical methods applied in the Reports appear to be different, each of them shows a clear (albeit at a different level) economic benefit in terms of cost savings from the formation of a single, Northern Beaches Council.

Under Option 3, KPMG also forecasts the "saving/benefits" will mainly arise from "...reductions ...in the number of FTE employees (101) and improved operating efficiencies," (OPEX).

KPMG do not appear to have predicated how the "savings/benefits" will translate into a definable benefit for rate payers, such as a reduction in rates.

None of the Reports consider the proposed rate setting methodologies which a merged/amalgamated Council will need to embrace. Given the wide disparity in Rateable Values and the Unimproved Capital Values among the merged/amalgamated Council areas this will be a critical issue for the perception of equity among ratepayers.

KPMG has translated the "estimated savings/ benefits" arising from any merger into present day dollars (i.e.Net Present Values-NPV).

Set out below is a summary of the results of the Financial Analysis undertaken by KPMG. I have identified some points for clarification.

Without OLG Merger Financial Assistance

	Manly/Pittwater Council's		
	Option 2		**Option 3**
-Present Value of OPEX "Savings/Merger Benefits"	$ 29,221 m		$ 54,951 m
-Deduct, Present Value of OPEX Costs	(25,975 m)	**(iii)**	(20,453 m)
-NPV of Merger Benefits (iv)	**$ 3,246 m**		**$ 34,498 m**
-NPV as a % of Operating result	1.9 %		20.4 %
-NPV as a % of Council size	.2 %	**(v)**	.6 %

Incorporating OLG Merger Financial Assistance

-Present Value of OPEX "Savings/ Merger Benefits"	$ 29,221 m		$ 54,951 m	
-Deduct, Present Value of OPEX Costs	(15,475 m)	**(i)**	(9,953 m)	**(ii)**
-NPV of Merger Benefits	**$ 13,746 m**		**$ 44,998 m**	
-NPV as a % of Operating result	8.1 %		26.4 %	
-NPV as a % of Council size **(v)**	1.6 %	**(v)**	2.1 %	

4-Points to note/ observations:

(i) KPMG flag that the reduction of $ 10.5 m **depends** on Option 2 being eligible for the "**possible**" OLG Merger Financial Assistance Package- (i.e. the Financial Assistance is not certain). At this level the outcome form this Option, over 10 years, is marginal at best.

(ii) By comparison, KPMG flag that "**this is eligible**" for OLG Merger Financial Assistance Package, presumably because it meets the OLG aims. This highlights how important receipt of the OLG Merger Financial Assistance Package is to this Option-it "improves" the projected "Merger Benefits" by a factor of 4.

(iii) It is unclear, on what basis the cost of establishing two new Councils would be greater than that of merging three Councils-I doubt that the alleged "economies of scale," predicted to flow from the merging of three existing Councils, would materialise to be less, to that extent. On the surface, at least, it would seem that the transactional and integration cost would be greater under Option 3 than in Option 2.

(iv) This shows that KPMG predict that, on a non financial assisted basis, both merger Options will generate **benefit/savings ranging** from $ 3,246 m to $ 34,498 m.
On a financially assisted merger basis, KPMG foreshadow that both Options will generate **benefits/savings** of between $ 13,746 m and $ 44,998 m.

These estimated results vary materially and depend almost entirely on the reduction in employee head count being achieved and the execution of a highly efficient and effective merger. The "savings" estimated to materialise over 10 years, are not predicted to occur until the latter part of the "merger cycle" when the circumstances and outcomes of LGA's are uncertain at best.

In my experience mergers of highly complex and disparate organisations which utilise large work forces often do not fully achieve the estimated values/benefits attributed to them and the perceived benefits may not materialise.

There is evidence to confirm that in commercial environments, mergers are unwound in subsequent years because they did not achieve the optimum objectives originally set for them. In a commercial environment the key stakeholders (such as shareholders, creditors and employees) often suffer materially as the hoped for value increment has been destroyed. If this were to occur in the LGA context it would be to the detriment of ratepayers particularly and NSW generally.

(v) I fail to see the logic or relevance of this measure- who knows how big a merged Council will be in 10 years time.

Readers might refer to a useful summary of the "Implications for Council Services" under Option 2 and 3 which KPMG have prepared.

5-Reports for Warringah Council.

Warringah Council's rationale for a Northern Beaches Council has been based, in large part, on;

- "*An updated and expanded economic report"* by SGS Economics and Planning Pty Ltd (**SGS**); and

- A "*Community Perception Survey*"-an independent telephone survey by Jetty Research Pty Ltd (**Jetty Research**) of over 400 residents in each of the three Councils (1,200 residents).

SGS-Report

In February 2015, SGS issued a Final Report entitled "*Local Government Structural Change-Options Analysis: Supplementary Study."* This Report updates and extends the original (2013) SGS report and incorporates new merger options which had been identified by Warringah Council.

The SGS analysis considers, against the status quo of retaining three separate Councils on the Northern Beaches, four (4) merger options, as set out earlier.

SGS report that "*the financial analysis indicates that creation of one Northern Beaches Council ...is the preferred option... from a purely financial perspective."*

The SGS results predict that, over 10 years, a Northern Beaches Council **will realise savings** of $ 234 million in 2015 present values.

When the infrastructure backlog and debt are taken into account SGS predict a **saving** of $165 million in 2015 present values will be achieved.

According to SGS-The key driver to achieving the Northern Beaches Council results *will be "The establishment of a new entity which adopts the systems and processes of a better performing (least per capita cost) council."* Unstated, that of Warringah.

Conversely, the results prepared by SGS for Warringah's Option 5 - (Greater Manly/ Greater Pittwater) - purport to show that, in historic values, there will **not be any savings**. That is, it will be value destructive. SGS estimates that Warringah's Option (5) **will generate a Loss of $ 248 million** over 10years. Further, "when the backlog of infrastructure and debt" is taken into account Option 5 **will generate a Loss of $ 179 million.**

Significantly, *SGS claims that Option 5 "is not financially viable ... over 10 years" and "the loss is due to the new council being driven by Manly and Pittwater's per capita expenditure (representing their systems and processes) which (Warringah) claim are higher than Warringah's."*

The Mayor of Warringah Council used some statistics in an "*Information Pack for Warringah Residents."* to support his claim. SGS had calculated the 2013-2014 cost of providing services per resident and compared them with the Operating Expenses (OPEX) , (excluding Kimbriki costs), of each Council. This was divided by the 2013 population of each Council. The analysis asserts that Manly Council's cost of providing services per resident is $1,349- higher than Pittwater (at $ 1,165) and Warringah (at $831). By implication the cost of providing services in Manly is 62 % higher than that of Warringah and in Pittwater 40 %

higher than that of Warringah. This is Warringah's key driver to justify it as the most efficient Council.

On their face these statistics may not reflect the fact that because "Manly is a destination." Manly Council needs to absorb and cater for the cost of the 8 million annual visitors to the LGA. In fairness, of course, it does not appear to attempt to reflect the economic and financial benefit they bring to Manly. It would be unlikely that either of the Council merger Options would change that dynamic.

Equally, the choice of Manly as an important transport hub for access to the City is unlikely to change under any merger Option. It is likely that by the use of innovative planning the transport throughput may actually increase, placing further demand and strain on Manly Council's unrecognised cost of catering for residents of its neighbouring Councils.

6 - Points to Note and Observations about the SGS Report

The SGS financial analysis appears to vary markedly from the analysis undertaken by KPMG. This will be a major factor that both Manly and Pittwater Council will need to address and rebut if their favoured Option is to gain traction and acceptance.

A key factor in the process will be to make reliable, like for like, comparisons of the financial and statistical data relied upon. There's a need for a consistent set of data to be prepared before any objective conclusion of which Option is preferable. It appears that different data may have been used, and possibly, different conclusions drawn from it.

SGS also predict that the potential savings it has identified will arise in four key areas of Governance, Administration, Public Order and Services and Environment. Interestingly, under its Option 5 -(Greater Manly/ Greater Pittwater)- SGS predict cost savings/benefits in Governance-(reduction in Councillors), but substantially increased costs in Administration, Public Order and Services Environment. It does not appear to envisage a material reduction in employee headcount. This appears to be a major point of difference requiring reconciliation.

Another issue of importance to reflect on is the accurate state of the respective Council's "Asset Backlog," and the projected Capital Expenditure (CAPEX) by the Councils. Manly's situation with respect to the Whistler Street Car Park and the "planned" Car Park under Manly Oval is relevant here.

Perhaps there needs to be a "Standstill Agreement" between the Councils. This might allow them to uniformly measure and account for their respective current and planned Asset Disposals, CAPEX, Amortisation, recognition of interest expense and the method by which it is carried on their Balance Sheets or charged against revenue.

Similarly, LGA population data needs to be uniform. Currently there is 2011, 2012 and 2013 data in use by the different analysis. As the data is inconsistent, the outcomes and population projections drawn from it may vary, albeit slightly.

Jetty Research

Jetty Research issued its Final Report to Warringah Council on the results of "*A random telephone survey of 1200 Sydney Northern Beaches residents in relation to local government reform and community attitudes regarding a single Northern Beaches Council.*"

The Jetty Research fieldwork covered 1215 people who were 18 years or over "*to achieve a robust mix of ages and genders within residents of Manly, Pittwater and Warringah LGA's.*" The survey results "*relied on a sampling error of +/- 2.7 % at the 95 % confidence level.*" They are non financial results.

Jetty Research hasn't made a recommendation. They have presented the results of their work, leaving Warringah Council (and others) to extrapolate the data and draw its own conclusions.

7-Conclusion

Under the KPMG analysis the formation of two Councils, (Greater Manly and Greater Pittwater) –Option 2- is at best only viable if the NSW Government provides the full value of the Merger Incentive Funds. Because of the uncertainty of future OPEX, new Council establishment costs and realisation of merger efficiencies, this is a marginal Option, at best.

The SGS analysis paints the Option for a Greater Manly Council and a Greater Pittwater Council as a worst case- value destructive, strategy.

According to KPMG the creation of a single Northern Beaches Council- (Option 3)- appears capable of standing on its own, generating net savings/benefits to ratepayers across the spectrum. The different analysis undertaken by SGS for Warringah Council also supports a single Northern Beaches Council.

It would be important to understand the rationale for the purported (very large) savings SGS predict compared to those envisaged by KPMG.

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He has wide experience advising international companies and representing their interests when dealing with Governments. He was also a Non Executive Director and Chair of the Audit Committee of a Bio-Technology Company, listed in the USA.