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# **THE NEWCASTLE REPORT - ISSUES FOR SUSTAINABILITY**

**EXECUTIVE SUMMARY**

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# The Newcastle Report – issues for sustainability

## Introduction

*Review Today* with the assistance of *GHD* (international asset management advisers), *Access Economics* (economic and public finance experts) and *Grange Securities* (funding analysts and facilitators), has undertaken a review of the financial sustainability of Newcastle City Council (NCC) including the condition of its infrastructure, asset management practices and financial governance.

This Overview Report summarises the main findings and conclusions of the three technical reports prepared by the *Review Today* team.

## Terms of reference

- The purpose of this review was to:
  - Assess the state of existing Council infrastructure;
  - Estimate the cost of fixing existing infrastructure and renewing it in future;
  - Estimate the cost of expanding infrastructure and services under restrained, responsive and existing spending strategies;
  - Explore whether modest, ambitious or current revenue policies could fund such spending strategies within a tolerable debt level and a healthy operating surplus; and
  - Identify non-revenue raising measures (e.g. productivity improvements) that might assist in this task.

## Terminology

- The main terms used in this report are:
  - Infrastructure: Council's physical (i.e. non-financial) assets excluding land.
  - Asset Group: a group of infrastructure assets that serve a particular purpose (e.g. roads).
  - Asset Set: the categories of assets that belong to a particular asset group (e.g. for roads the wearing surfaces, pavements, concrete/brick footpaths, asphalt footpaths, kerbs and guttering classified by regional and local roads).
  - Asset Maintenance: the cost of upkeep and repair to an asset so it does not deteriorate prematurely.
  - Asset Intervention Level: the minimum structural standard at which a physical asset is considered safe and sound.
  - Infrastructure Backlog: the cost of rehabilitating those assets that have already passed their 'used by dates' (i.e. intervention level).
  - Asset Renewal: applying current standards and technology, the cost of restoring an asset to its original service capacity when it reaches its 'used by date' (i.e. intervention level).
  - Asset Enhancement: the cost of expanding an asset beyond its original service capacity.
  - Infrastructure Growth: the cost of expanding the Council's total stock of assets.

- ❑ Services: Operating expenditure less asset depreciation and maintenance and debt charges (interest and principle repayments on loans).
- ❑ Sustainable: ensuring that municipal services and infrastructure of an acceptable standard can be funded by Council without introducing excessive rates, fees, charges or net debt and other financial liabilities that would severely disrupt the existing or future social and economic wellbeing of the community.

### **Demographic and economic outlook**

- For the next decade Newcastle's population is projected to expand by 0.3% per annum (compared with 0.8% for the whole of NSW).
- Newcastle is the regional capital of the Hunter Valley so acts as its social, cultural and economic hub, which puts considerable strain on its infrastructure.
- Its population of seniors exceeds the State average. The proportion of seniors within the community will rise significantly as the baby – boom generation born between 1946 and 1963 enters retirement'.
- Stripped of inflation, Newcastle's local economy is forecast to grow by about 2.5% per annum (versus 3% for NSW).

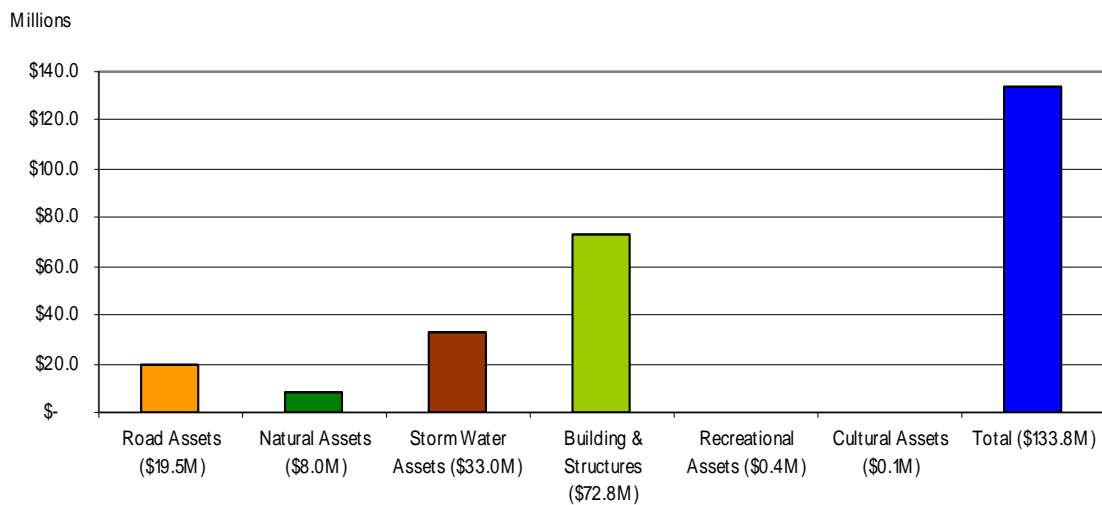
### **Public attitudes to Council**

- The community considers garbage collection, road maintenance, long-term city planning, maintenance of beaches, parks and recreation areas, environmental protection, traffic regulation and CBD parking to be the most important Council services.
- The public is least satisfied with CBD parking, CBD management, community involvement in council decisions, road maintenance, city planning, youth facilities, footpath maintenance and buildings and asset maintenance.
- Highest satisfaction exists for library services, garbage collection, swimming pools, beach maintenance, parks and recreation areas, sporting and cultural facilities even though a number of these services are considered of relatively lower priority.
- The public particularly wants better footpaths, nature strips, roads and associated infrastructure, parks, gardens, sporting ovals and playgrounds, ocean baths and beaches, but only 39% are prepared to pay for the better facilities. The rest want Council to cut other spending, reduce waste and achieve greater efficiencies to help pay for the upgrades.

## The challenge facing Newcastle City Council

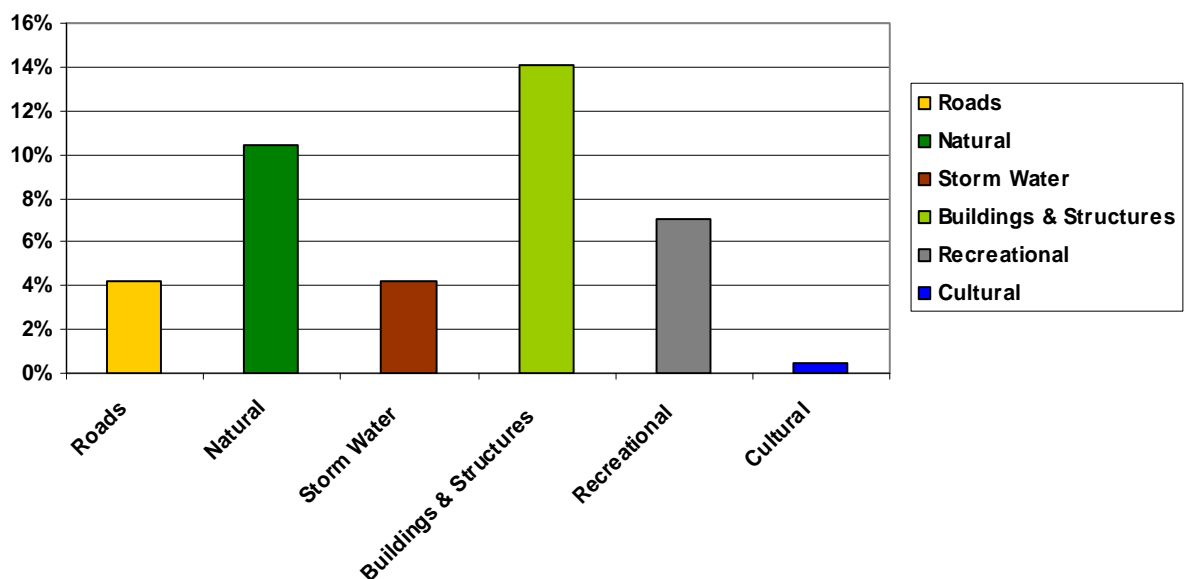
- The present condition of NCC's public infrastructure stock is as follows:
  - 8% is in very poor condition
  - 17% is in poor condition
  - 38% is in fair condition
  - 14% is in good condition
  - 11% is in very good condition
  - 12% is in excellent condition.
  
- NCC has a \$134 million infrastructure backlog. This consists mainly of buildings and structures; storm water drains; roads, kerbing and pavements; and natural assets such as trees and parks that are no longer structurally sound and safe.

### Council's Present Backlog Infrastructure



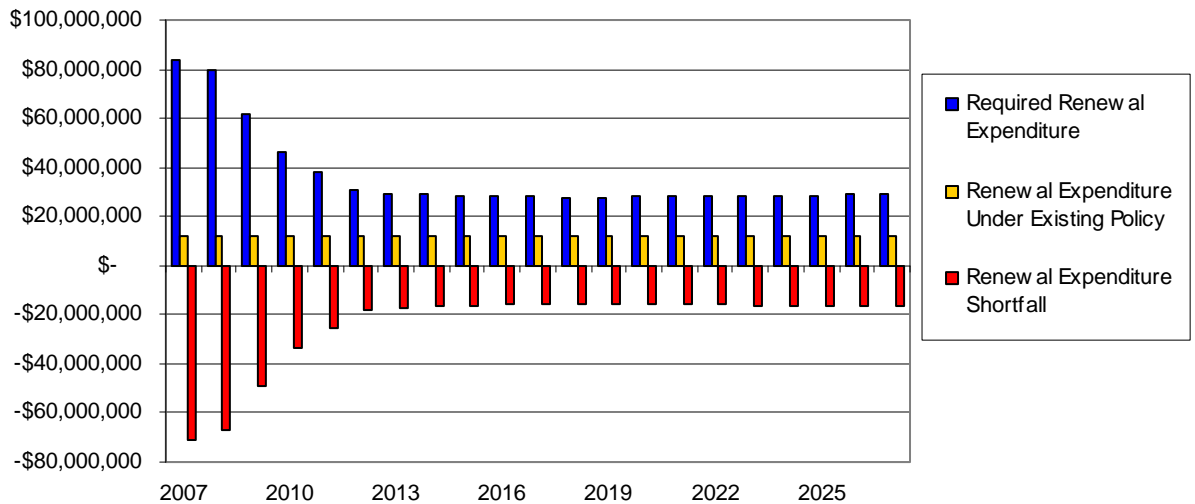
- The proportion of each major asset group that is currently in an unacceptable condition is shown below:

### Proportion of each Council Asset Group in an Unacceptable Condition



- \$630M needs to be invested in infrastructure renewals over the next 20 years if the condition of infrastructure is not to deteriorate further. Under present spending policies the projected shortfall in annual asset renewals is alarming.

### Existing Council Policy versus Required Infrastructure Renewal Expenditure

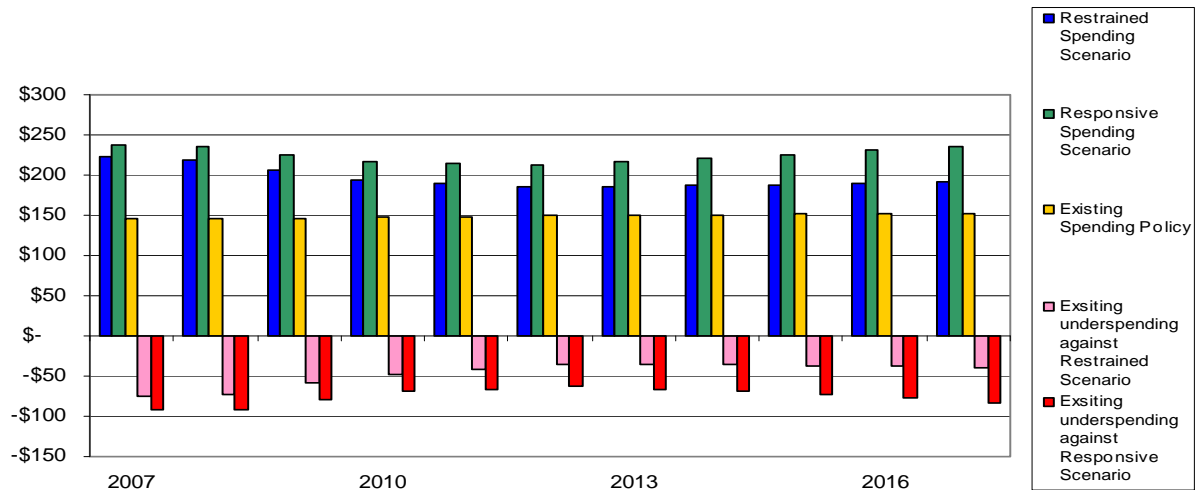


### Possible Spending Scenarios

- Council should not only maintain and renew its existing infrastructure, but also expand the stock of Council assets and services to meet the needs of new residents (+0.3% per annum) and increased economic activity (+2.5% per annum excluding inflation).
- Three Council spending scenarios were used for this review. The first reflects a restrained approach, the second a more responsive one and the last simply assumes existing spending policies are carried forward.
- The Restrained spending scenario assumes that:
  - Infrastructure rehabilitation and renewals are fully funded; but
  - The quantity of physical assets and public services expand by just over one quarter of the forecast rate of growth of the Newcastle economy (i.e. 0.7% per annum excluding price inflation).
- The Responsive spending scenario assumes that:
  - Infrastructure rehabilitation and renewals are fully funded; and
  - The quantity of physical assets and public services grow by about two thirds of the forecast rate of growth of the local economy (i.e. 1.7% per annum excluding price inflation).
- The Existing Policy spending outcome assumes that:
  - Infrastructure rehabilitation and renewals continue to be funded by about 37% of what is required over the next ten years; and

- The stock of physical assets and level of public services continue expanding at present rates following a slight budgeted cutback in services in 2007/08.
- Compared with the restrained spending scenario, Newcastle’s existing spending policies will fall short of requirements by an average of \$31 million per annum over the next ten years. The gap widens to \$70 million per annum against the responsive spending scenario.

### Existing Council Policy versus Alternative Total Spending Scenarios



- Council is not flush with funds – it already runs a small deficit both on its operating account (when capital grants are excluded from operating income) and its capital account.<sup>1</sup>
- Fortunately it has a very strong balance sheet – its net financial liabilities are only 3.4% of its total capital (i.e. financial and non-financial assets).
- Hence NCC has the scope to borrow more to fix its infrastructure, if it could strengthen its budget to pay for additional debt charges.

### Possible Revenue Raising Options

- The funding requirements of each spending scenario were tested against three possible revenue raising options; a modest one, an ambitious one and the existing revenue policy:
  - The Modest Revenue Option assumes Council’s ordinary income increases by just over a quartet of expected economic growth (0.7% per annum in constant prices).

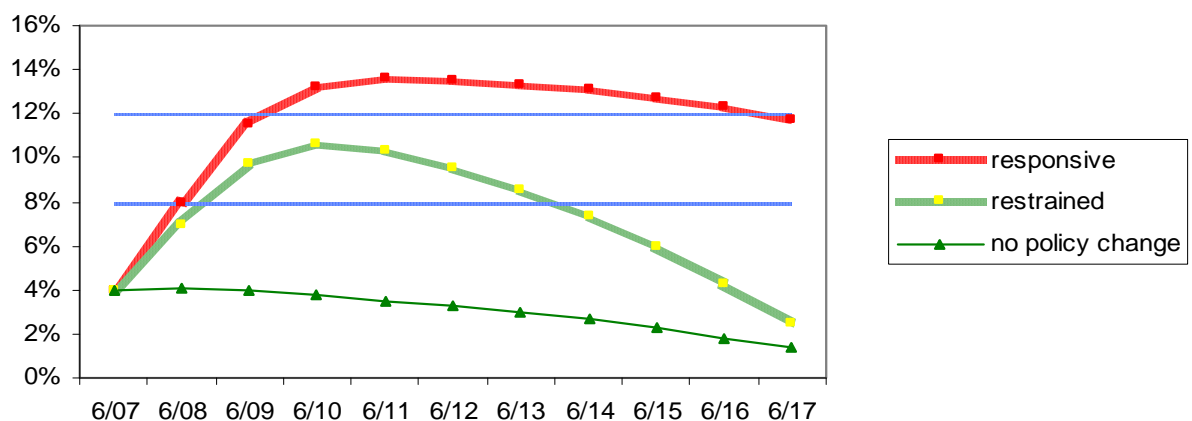
<sup>1</sup> In 2005/06 the NCC’s official accounts showed an operating surplus. This is because the Local Government Australian Accounting Standard AAS27 permits councils to include capital grants in their operating income. While this treatment is widespread throughout NSW local government, *Review Today* and its partner, *Access Economics*, believes it distorts the presentation of a Council’s accounts because capital grants are meant for spending on capital infrastructure, not operating services.

- ❑ The Ambitious Revenue Option assumes that over the next five years (a) rates increase sufficiently over 5 years to give Council a 2.5% operating surplus and thereafter grow by two thirds of the local economic growth rate (1.7% per annum in real terms); (b) fees and charges rise to the minimum of the top quartile of comparable councils and thereafter track inflation; and (c) developer charges rise to their Previous average level and thereafter grow in step with capital expenditure.
- ❑ The Existing Revenue Policy Outcome assumes Council's current revenue policies and plans remain in place.

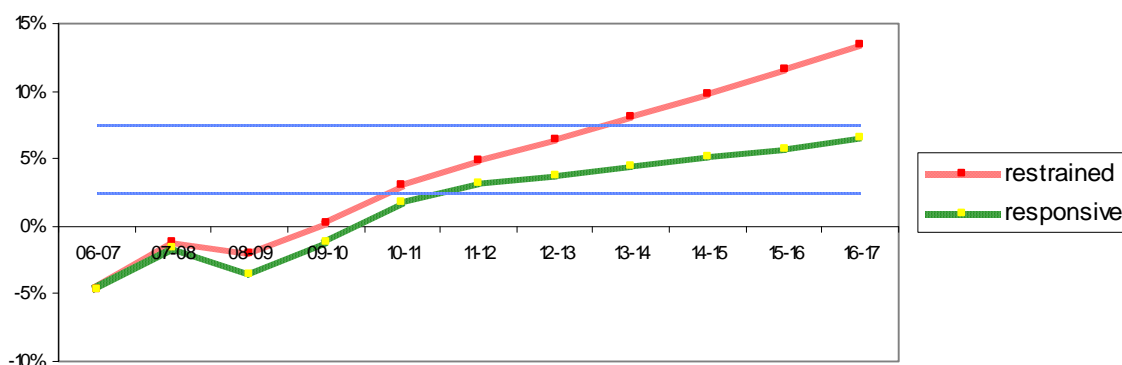
### Council's financial sustainability goalposts

- The review has refined the Local Government Inquiry's recommended financial goalposts for Local Government as well as customised them to the NCC's circumstances as a larger and more developed council.
- The most important fiscal targets are for NCC to:
  - ❑ Run an operating surplus (so that the present generation fully meets the cost of its use of services and assets); and
  - ❑ Ensure that any increase in borrowings do not result in its net financial liabilities exceeding 12% of the fair value of its total assets.
- A key question is:
  - ❑ *How does each spending scenario fare against these financial targets under each of the three revenue options?*
- The results for the ambitious revenue option are shown below.

### Council's Net Financial Liabilities Ratio with Restrained and Responsive Spending Scenarios under an Ambitious Revenue Option



## Council's Operating Budget Balance with Restrained and Responsive Spending Scenarios under an Ambitious Revenue Option



### What works, what doesn't?

- The review's analysis found that:
  - The restrained spending scenario could be easily funded by the ambitious revenue option, but not by the modest or existing revenue approaches;
  - The responsive spending scenario approached financial sustainability on the ambitious revenue option only by the tenth year; and
  - The spending outcome under existing policy could be funded by all revenue options, but would aggravate the infrastructure crisis. New resident, business, commuter and visitor needs would be ignored and the next generation would be forced to pick up the tab for the present generation's neglect.

### A greater revenue raising effort is needed

- A restrained (let alone responsive) strategy that addressed the infrastructure problem would require a greater revenue raising effort for NCC to remain financially sustainable (i.e. run a balanced budget and keep net financial liabilities to a manageable level).
- Unless the Commonwealth or State governments increased their grants to local government dramatically, such a revenue effort by NCC lies somewhere between the existing revenue policy and the ambitious revenue option.
- If the extra resources needed were tapped only from Council's own source revenues, the average annual compound rates of increase (over the next ten years) would be as follows:
  - A Rates: 3.3% to 6.3%;
  - Fees and charges: 3.2% to 4.2%; and
  - Developer charges: 3.2% to 17.6%.
- It should be noted that these increases are expressed in current (i.e. future), not constant (i.e. 2006/07) prices.
- The large upper increase in developer charges would merely restore them to their previous average level.

- These indicative annual increases are only ballpark numbers since the precise funding package necessary for achieving sustainability requires further modeling work once NCC has resolved what types of revenue raising and expenditure savings options it is prepared to consider.
- Also to the extent that Council found extra money through new revenue opportunities (e.g. leases) or pruning existing costs (e.g. efficiency savings) any increases in rates, fees and charges would be below those shown above.

### **Expenditure savings would also help**

- NCC estimate current and proposed initiatives could improve Councils financial position by about \$5.5 million per annum. This could be achieved through operational efficiencies, reordering service priorities, selling or partnering public assets, etc and would amount to a productivity boost of about 4% of total service costs.
- Community surveys show that there is a much higher priority for rehabilitating and renewing existing infrastructure than expanding its capacity. This may reflect that Newcastle is a well established city with a rich, but degraded asset base.
- Halting future infrastructure expansion for the next decade could save \$11 million per annum compared with the restrained or responsive strategies. This too would help contain any revenue hikes, but may result in greater pressures on infrastructure in future.
- These combined savings of \$16.5 million would help contain rises in rates, fees and charges by about 14.6% (almost 1.5% per annum compounded over the next ten years) compared with the ambitious revenue option.

### **But the scope for bigger cost savings may be limited**

- QMI's international benchmarking study found that NCC's management practices and performance are just outside the world class category. Maxwell's corporate overhead cost analysis concluded that the Council's back and middle office costs were significantly below those of other councils and less than half those of State agencies of comparable size.
- GHD's review of NCC's asset management processes and systems found them to be close to best practice and Access Economics' review of Council's financial management and governance rated them satisfactory overall.
- These results would suggest that the scope for huge efficiency savings and operational improvements at NCC is limited.

### **Savings and asset sales without revenue hikes won't fix the infrastructure crisis on their own**

- In any event the possible \$16.5 million of annual savings canvassed above won't be sufficient to avoid significant increases in rates, fees and charges in order to address NCC's infrastructure problem while also allowing services to improve at a modest pace (0.7% per annum in real terms).

- Hopefully other tiers of government will give serious consideration to the LGI's recommendation to inject an extra \$200 million per annum into NSW local government. But until there is a change of heart at State and the Commonwealth levels, councils have no choice but to resolve their own problems.
- With an adequate revenue base, NCC could afford to take on more debt within the limits prescribed in this report. Capacity for further borrowing by Council was acknowledged in the recent Standard and Poors' report

### **Increased revenue could service new debt to overcome the infrastructure backlog**

- Increased borrowings could be used to overcome the infrastructure backlog and renew assets that are coming to the end of their useful life.
- An Annuity Index Linked Bond would be the most cost effective way to fund NCC's \$134 million infrastructure backlog provided extra resources could be found to meet the annual loan payments.
- Such a funding instrument would:
  - Better share infrastructure costs between existing and future ratepayers;
  - Reduce upfront debt servicing costs and thereby allow Council to be more ambitious in tackling its infrastructure problems;
  - Enable Council to better match its liabilities to its long-life infrastructure assets; and
  - Significantly cut costs of funding long-term infrastructure compared with traditional forms of borrowing.
- Council's investment portfolio exceeds \$125 million, has performed well above benchmark (UBS 90 day Bank Bill Index). Except for Council's working capital most of these are tied funds so can not be used for discretionary purposes (e.g. rehabilitating and renewing general infrastructure).
- Council has \$25 million of traditional loans which were obtained at competitive interest rates. The average loan term of 7.75 years could be lengthened to more closely match the average remaining life of the assets funded by this debt.

### **What's the next step?**

- It is recommended that NCC use Review Today's finding to develop an appropriate long term spending, revenue, savings and borrowings strategy to overcome the city's infrastructure crisis within sustainable financial limits. The proposed strategy should be incorporated in NCC's draft management plan for consultation with the community.
- Based on this feedback the Council should review and update its 10 year financial plan and rolling infrastructure works program to:

- Rehabilitate infrastructure that is already decrepit;
- Renew infrastructure when it degrades below an acceptable standard in future;
- Expand the total infrastructure stock by enough to adequately cater for residential and business growth;
- Develop services in line with population growth and changing community needs;
- Generate additional resources from revenue measures, operational savings, re-ordering of spending priorities, infrastructure enhancement deferrals, asset leases or disposals and extra borrowings that would be sufficient to fund such a program; and
- Ensure that the outcome complies with sustainable financial targets (e.g. the recommended minimum surplus ratio and maximum debt ratio) during this period.

A handwritten signature in black ink, appearing to read 'Percy Allan', with a long horizontal stroke underneath.

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Sydney