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Outline of Financial Modelling Assumptions for Local Government Merger Proposals

TECHNICAL PAPER

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Financial modelling assumptions

KPMG was engaged by the NSW Department of Premier and Cabinet to prepare independent modelling of the potential financial impacts of selected council mergers. The financial modelling undertaken relied on publically available council data and a financial model developed by KPMG. The financial model drew on a series of assumptions to estimate the potential savings, costs and overall financial impacts of council mergers.

This paper provides an outline of the assumptions underpinning KPMG's financial model. The components of the benefits and costs included in the financial analysis are provided in the following tables, including the key data sources used in this analysis. Other parameters, such as the applied discount rate and time period of net financial impacts are also provided in this paper.

Table 1 Outline of merger benefit streams

	Approach	Data source(s)
1. Merger benefit components		
Savings from materials and contracts expenditure	**Description:** Starting in the first year of a merger, and growing gradually over three years, an annual cost saving is applied to a council's budgeted materials and contracts expenditure. **Assumptions** • The assumed value of efficiency savings was up to 3 per cent of a council's expenditure on materials and contracts as reported in long term financial plans. • This assumption was capped at 2 per cent for regional councils – reflecting the wider geographic dispersion and smaller scale may mean procurement and consolidation of contracts may be more difficult to achieve in some areas. • For all councils, it was assumed that only 80 per cent of items reported under 'materials and contracts' are subject to scale efficiencies. • These efficiency savings are achieved on a scaled basis. For example, it is assumed that the efficiencies achieved in Year 1 of the merger are one-third of total possible efficiencies (i.e. one-third of the 3 per cent savings potential for metropolitan councils). This assumption remains the same in Year Two, increasing to two-thirds of total possible efficiencies in Year Three and then fully realised by Year Four.	Council long term financial plans (from 2013-14; general fund where available).
Savings from councillor expenditure	**Description:** Councillor fees are reduced as a result of the mergers (fewer councillors will exist following merger implementation). This will be, in part, offset by potential increases in annual fees paid to councillors. **Assumptions** • The number of councillors for a new merged entity will mirror the highest number of councillors that currently	OLG Annual Data Return (2013-14).

	exist in any one of the councils participating in the merger. • The dollar value of savings is sourced from actual 2013-14 reported data on councillor fees by council. This figure is grown at a standard wage growth rate of 2.3 per cent over the period. • This savings are offset by the assumption that all newly elected councillors (metro and regional) will receive a fee of $30,000 per annum. This fee is greater than the top remuneration level currently received by councillors (with the exception of the City of Sydney).	
Savings from reduced salary and wage expenditure	**Description** Staffing reductions are assumed to occur gradually with a modest level of voluntary attrition in the first three years of amalgamation. After the three year employment protection period, savings are generated by reducing duplication of back office, administration and corporate support staff functions. This approach assumed council mergers would not directly impact staffing allocations for council frontline service delivery roles. **Assumptions – Metropolitan Councils** • Overall staffing efficiencies were estimated at 7.4 per cent for metropolitan mergers. • Reductions in the cost of Tier 4 (General Manager (GM)) salaries (due to the reduced number of GMs in a post-merger environment) using historical salary data reported to the Office of Local Government. • Reductions in the costs of Tier 3 (Directors) salaries are also assumed on the basis that Tier 3 salaries are equivalent to approximately 75 per cent of the Tier 4 (GM) reported salary. • For metropolitan councils it is assumed that a merger leads to a loss of four (4) Tier 3 positions per council. • It is assumed that 1 General Manager and 4 Directors continue to operate post-merger. **Assumptions – Regional Councils** • No net staffing reductions were assumed for regional councils. • However, efficiencies are generated by a merger that allows a regional council to re-allocate duplicated back-office, administration and corporate support roles to frontline service positions. • These efficiencies are assumed to be equivalent to between 3.7 to 5 per cent of a council's employee salary and wage costs (with larger regional councils having a	Council long term financial plans (from 2013-14; general fund where available). OLG Annual Data Return (2013-14) Comparator and jurisdictional analysis / merger business cases

	greater capacity to achieve a higher staffing efficiency). • Reductions in Tier 4 (GM) salaries (due to the reduced number of GMs in a post-merger environment) uses historical salary data reported to the Office of Local Government. • Reductions in Tier 3 (Directors) salaries are also assumed on the basis that Tier 3 employee salaries are equivalent to approximately to 75 per cent of the General Manager's reported salary. • For regional councils it is assumed that a merger leads to a loss of two (2) Tier 3 positions per council. • It is assumed that 1 GM and 2 Directors continue to operate post-merger.	

Source: KPMG

Table 2 Outline of merger costs streams

	Approach	Data source(s)
2. Merger cost components		
ICT Costs	**Description** To ensure a merged entity can be operational and functional from launch, a number of minimum information and communications technology (ICT) investments and common applications are required: • email systems so that each employer of the merged entity has access to, and uses, a single common email address and server; • business applications to enable basic reporting requirements; • website overlay to create a single online portal for the merged entity; and • limited data migration so that, for example, current financial year data for the merged entity can be accessed from a single ICT system. The immediate ICT requirements will therefore be focused on enhancing existing ICT systems that will continue to operate in the background. The following tables provide a summary of the expected costs from establishing this 'veneer' solution for each merged entity. **Assumptions** Introduce ICT 'veneer' solution, based on: • Small Regional Cluster = $2.26m • Medium Regional Cluster = $2.80m • Metropolitan Cluster = $3.35m In addition, a +30 per cent contingency component is added to the above costs as appropriate in early planning of ICT projects. These assumptions have been based on input from: • a selected number of industry representatives consulted by DPC drawing on recent experience in planning and implementing ICT solutions for council entities; and • analysis undertaken by KPMG based on advisory services to Queensland local councils involved in de-amalgamations.	Selected industry consultations undertaken by DPC. Previous KPMG analysis undertaken for Queensland councils involved in de-amalgamations.

Costs from transition	**Description** Additional one-off costs, including office relocation, staff training and general transition-related expenditures are calculated as a percentage of operating expenditure based on case study examples from regional and metropolitan amalgamations. **Assumption** Transition costs are estimated to be 2 per cent of a merged entity operating expenditure in the first year of operation.	Council long term financial plans (from 2013-14; general fund where available).

Costs from redundancies	**Description** Each council's costs to make an employee redundant are a function of each council's average salary, paid out for a standard number of weeks, and accumulated leave (average per employee) paid out in full. **Assumptions** *General staff* The calculation of redundancy payments for general staff is based upon: • Average salary and average employee entitlements per council (as calculated in 2013-14); and • Average tenure of employees (based on median turnover results for the sector). This is equivalent to a median turnover rate of approximately 10 per cent per year in the local government sector. Based on established practices and the average tenure for the sector, the redundancy payment would be provided for sixteen (16) weeks. *Tier 3 / 4 Redundancy Payments* The first year of redundancies is assumed to comprise the council's General Manager (Tier 4) and other Tier 3 equivalent employees (Directors). The calculation of redundancy payments for Tier 3 / 4 staff is based upon: • Council-reported General Manager salaries and an assumption of four (4) Tier 3 equivalent employees being made redundant at 75 per cent of the General Manager wage (metro councils only); • Council-reported General Manager salaries and an assumption of two (2) Tier 3 equivalent employees being made redundant at 75 per cent of the General Manager wage (regional councils only); • Redundancy packages entitling these employees to 38 weeks salary and the average employee leave entitlement per the respective council.	OLG Annual Data Return 2013-14 Fair Work Ombudsman (2014), Redundancy pay and entitlements schedule

Source: KPMG

Table 3 Outline of treatment of merging councils that are split

	Approach	Data source(s)
3. Treatment of councils that are split in a merger		
	Description A council that is split has its financial statements (operating revenue / expenditure) split on a per capita basis and apportioned accordingly to each new council.* *Note that Jerilderie Shire Council had its financial statements split on a 50:50 basis rather than a per capita basis. **Treatment of merger benefits (for split councils).** For metropolitan councils the assumptions for savings from staff reductions are half (or 3.7 per cent) of those savings achieved in a normal 'whole' merger scenario. This reflects the reduced levels of duplication from merging only part of a council and, consequently, more limited scope for staffing reductions. The treatment of other merger savings (such as materials and contracts) are the same as those outlined in Section 1. **Treatment of merger costs (for split councils)** The same merger costs outlined in Section 2 above are also applied to mergers involving split councils. **Other notes** Councils that are part of a merger but lose a portion of its area to another merger cluster (e.g. Hornsby or The Hills), will have its financial statement adjusted to reflect the reduced revenue / expenditure profile. These adjustments are generally made on a per capita basis. The asset base and infrastructure backlog of split councils has been apportioned by land area (sq km) rather than a per capita basis. This reflects the fixed and built nature of these assets (such as roads and footpaths).	ABS Statistical Area 1 (SA1) population data

Source: KPMG

Table 4 Outline of other key financial modelling assumptions

	Approach	Data source(s)
4. Other		
Financial Year Data	To provide a consistent basis for collating and comparing council financial statements, individual council income statements and long term financial plans for the 2013-14 financial year were used for input to the financial analysis. It is important to note: • These financial statements were accessed from publically available sources. • Where available, income statements for a council's 'general fund' were the preferred data source. • While some councils have since updated financial statements – to ensure consistency of approach financial statements released by councils have not been relied upon. • Some councils' financial statements were either incomplete (did not provide full 10 year projections), or included errors in calculations. Where appropriate, trend data has been used to estimate missing / incorrect data.	
Asset Base estimation	The asset base referred to in council merger proposals is related to the written down value (WDV) of *infrastructure assets* only, e.g. buildings and other structures, roads, bridges, water, sewerage and recreational facilities. It is subject to data reported in OLG annual data returns and, in some cases, may differ slightly from other measures of asset bases reported by councils.	OLG Annual Data Return 2013-14
Infrastructure Backlog estimation	The infrastructure backlog is based on each council's *estimated cost to bring to a satisfactory standard* reported in 2013-14 financial statements. The infrastructure backlog ratio is calculated by dividing the backlog figure by the infrastructure asset base (WDV) noted above. The ratio may differ slightly from council-reported ratios due to the inclusion of depreciable land and other specialised asset classes that may not have been captured in the OLG data return template.	OLG Annual Data Return 2013-14
Other assumptions	<u>*Inflation*</u> A simple rate of 2.5 per cent was used over the time period to be consistent with the RBA target band of between 2 and 3 per cent. <u>*Discount rate and time period*</u> A 9.5 per cent nominal discount rate was used to maintain consistency with the NSW Treasury Guidelines for Government Business Cases. Present value figures are represented in 1 July 2015 dollars. The financial analysis is conducted over a twenty (20) year time period from 2015-16.	RBA (2014), Inflation Target NSW Treasury (2007), *NSW Government Guidelines for Economic Appraisal*

Source: KPMG