Warringah Council

LOCAL GOVERNMENT STRUCTURAL CHANGE - SUPPLEMENTARY STUDY (FEBRUARY 2015)

Appendix 2.3

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WARRINGAH COUNCIL

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EXECUTIVE SUMMARY

Purpose

The NSW Government has proposed a reform of the local government sector to ensure the sustainability of the sector into the future. The Fit for the Future reform agenda includes a reshaping of governance arrangements and consolidation of local government in the Sydney metropolitan area. Based on analysis by the Independent Local Government Reform Panel (ILGRP) the Government's preferred option for Warringah is for Council to merge with Manly, and Pittwater Councils.

An initial study by SGS Economics in 2013, *Local Government Structural Change – Options Analysis,* provides a high level strategic and financial assessment of potential options for structural change.

The purpose of this report is to update and extend the 2013 SGS study, and incorporate new merger options identified by Council. The report provides a high level strategic financial appraisal for a status quo option as well as potential merger options, including the NSW Government's preferred option of creating a new single Northern Beaches Council.

Merger options

The analysis considers four merger options against the status quo of retaining three separate Councils on the Northern Beaches:

Option 1 (base case): Status quo of three separate councils
Option 2 (ILGRP preferred option): New Northern Beaches Council by combining Manly, Warringah and Pittwater Councils
Option 3: New Council by combining Warringah and Manly
Option 4: New Council by combining Warringah and Pittwater
Option 5: Two new councils formed by dividing Warringah between Pittwater and Manly

The following table shows the population (2011) and projected population (2013) for each of the five options.

TABLE 1. POPULATION BY OPTION

Option	LGAs	Population 2011*	Population 2031^
1 Status Quo:- three separate councils	Manly Pittwater Warringah	39,748 57,154 140,741	51,900 82,000 173,500
2 New Northern Beaches Council	Warringah + Manly + Pittwater	237,643	307,400
3 New Council: combine Warringah and Manly	Warringah + Manly	180,489	225,400
4 New Council: combine Warringah and Pittwater	Warringah + Pittwater	197,895	255,500
5 Two new councils formed by dividing Warringah between Pittwater and Manly	Manly with half Warringah AND Pittwater with half Warringah	110,000 127,000	138,650 168,750

* From 2011 Census figures, as the reference year used by the Fit for the Future program
^ 2031 projected population: from Planning and Infrastructure 2013, used in the Review Panel's final report.

High level financial analysis

A key focus of the financial analysis is to estimate the potential expenditure savings for the four potential merger options against the status quo (Option 1) and assess whether there is financial surplus remaining after addressing any asset renewal gaps or repayment of debts.

The analysis is based on a series of assumptions and criteria which would need to be clarified and adjusted in partnership with any merger Council once additional information and further detail (for example about governance arrangements) is available.

The analysis in this study is an approximation only. The intent is to identify a preferred option and to provide a solid basis for future discussions.

Merger costs

Any merger will incur transition costs. These costs can be difficult to establish, as they will be dependent upon the new organisation's business model including, but not limited to, proposed facilities and location, human resource management, cultural change initiatives.

For this study, only transition costs associated with systems and processes are included as these costs can be isolated and quantified. These represent the minimum costs which can be directly attributed to a merger. Using estimates from a UK case study[1], merger costs for aligning systems and processes are estimated at 1.4% of current operating expenses. This equates to $3 to $5.5 million (10 year present values) for the options considered, and occur over the first two years. Costs associated with redundancies are excluded in these calculations, as is any incentive funding by the Government.

Note that option 5 has higher merger costs resulting from dividing one council and integrating it into two existing councils, based on two sets of boundary changes.

Governance

The following numbers of Councillors are assumed under each option. Note that since option 5 will create two new councils, the total governance cost is higher than other merger options. These numbers would change depending on governance options that are chosen by any new organisation. Warringah's current governance cost under the status quo option has been used as a basis for estimating the new governance costs under each merger option. Unlike the 2013 SGS study, local community boards have not been considered, as this is just one of several forms of community governance which a new council would choose from.

TABLE 2. NUMBER OF COUNCILLORS BY OPTION

Options	LGAs	Councillors (including Mayor)	Governance costs	Per capita cost
Option 1 – status quo: Three separate councils	Manly Pittwater Warringah	9 9 10	$15.85 million	$64
Option 2 – Northern Beaches Council	Warringah + Manly + Pittwater	13	$3,425,500	$14
Option 3 – New Council: combine Manly and Warringah	Warringah + Manly	10	$2,635,000	$14
Option 4 – New Council: combine Pittwater and Warringah	Warringah + Pittwater	10	$2,635,000	$13
Option 5 – Two new councils formed by dividing Warringah between Pittwater and Manly	Half Warringah + Pittwater Half Warringah +Manly	10 10	$5,270,000	$21

Source: Advice from Warringah, 2014. All councillors are part time.

[1] This is based on consultation for an unpublished case study with UK's Cornwall Council completed by SGS in 2014.

Preferred option

The results from the financial analysis indicate that Option 2 (creation of one new Northern Beaches Council comprised of Manly, Pittwater and Warringah local government areas) is the preferred option for a potential merger from a purely financial perspective.

For Option 2, the total financial saving of $234 million (in present value) over 10 years represents around 9 per cent of the combined current expenditure of the three Northern Beaches councils (base case of this option). Even after funding the current asset backlog and borrowings, Option 2 is expected to generate a net surplus of $165 million.

The financial analysis indicates that Option 5 – dividing Warringah between Pittwater and Manly Councils – is not financially viable and would incur a cost of $179 million over 10 years. After asset renewal top-ups and debt repayments, it is estimated that Option 5 would result in a cost of $248 million over ten years. These losses would be collectively borne by the two new councils.

The following table summarises the differences between the options, and identifies key drivers of the financial savings for each option.

TABLE 3. COMPARISON OF OPTIONS FOR REGIONAL SAVINGS

Options	Baseline financial savings over 10 years (present value)	Net surplus after addressing backlog and debt, over 10 years (present value)	Key driver
Option 1 – status quo: Three separate councils	$0	n.a.	There is no change to current council finances, operations, assets, and debts.
Option 2 – Northern Beaches Council	Savings of $233.8 million	Savings of $165 million	The establishment of a new entity which adopts the systems and processes of a better performing (least per capita cost) council.
Option 3 – New Council: combine Manly and Warringah	Savings of $123.5 million	Savings of $88 million	Savings for the region from this Option is lower than Option 2, because operations at Pittwater remain unchanged (and does not generate any savings). It is higher than Option 4, since Manly expenditure is higher than Pittwater, and thus achieves greater savings by adopting Warringah's approach.
Option 4 – New Council: combine Pittwater and Warringah	Savings of $118.2 million	Savings of $68 million	In 2 of the 12 service areas Pittwater has lower costs than Warringah, but since the difference between Warringah and Pittwater is smaller than Manly and Warringah (Option 3), savings are lower. It is also assumed that Manly operations remain unchanged.
Option 5 – Two new councils formed by dividing Warringah between Pittwater and Manly	Loss of $179.3 million	Loss of $248 million	The loss is due to the new council being driven by Manly and Pittwater per capita expenditure (representing their systems and processes) which is higher than Warringah. Merger costs are also higher.

The following table shows the present value of service cost savings by option using average efficiencies (from economies of scale) estimated from an econometric model. Financial savings after fully addressing current asset backlogs and borrowing is also reported.

TABLE 4. NPV ($ THOUSANDS) OF AVERAGE EFFICIENCIES (COST SAVINGS)

	10 year present values at 2015				
Average efficiency (scale economies)	**Option 1**	**Option 2**	**Option 3**	**Option 4**	**Option 5**
Total net expenditure savings	$0	$272,907	$135,122	$75,987	$88,686
Savings as a % of base case	0%	11%	7%	4%	3%
Savings after addressing asset backlog and debt	n.a.	$204,241	$99,710	$25,699	$20,020

Source: SGS, 2015.
Note that since Option 5 has two councils, we derive an estimate for each council and then present the aggregate result here.

This sensitivity test shows that option 2 is likely to result in the highest financial savings (of $273 million) over 10 years from average efficiencies (generated by scale economies). This is around 11 percent of the Warringah, Manly, and Pittwater operating budget over the next 10 years (in present value terms).

These findings are consistent with the previous SGS study (2013) which modelled that a Northern Beaches Council would generate savings of $257.5 million (present value at the time) over 10 years. The difference between the 2013 study and the current study is around 10 percent, and is due to slightly different modelling assumptions[2].The multi-criteria analysis in that study also showed this as a preferred option based on social, strategic, operational, and financial factors.

[2] The 2013 SGS study found that Option 2 generates savings of $257.5 million (present value at the time) over 10 years. The difference between the 2013 study and this study is around 12 percent, and attributable to the following changes in the current study – the use of LTFP for growth assumptions, use of FY 2014 updated per capita service costs, use of 5.5 % nominal discount rate, removal of advisory boards, introduction of merge-costs, and changed treatment of administration costs (senior management was not separated in this study). However, broadly, the two results are comparable.

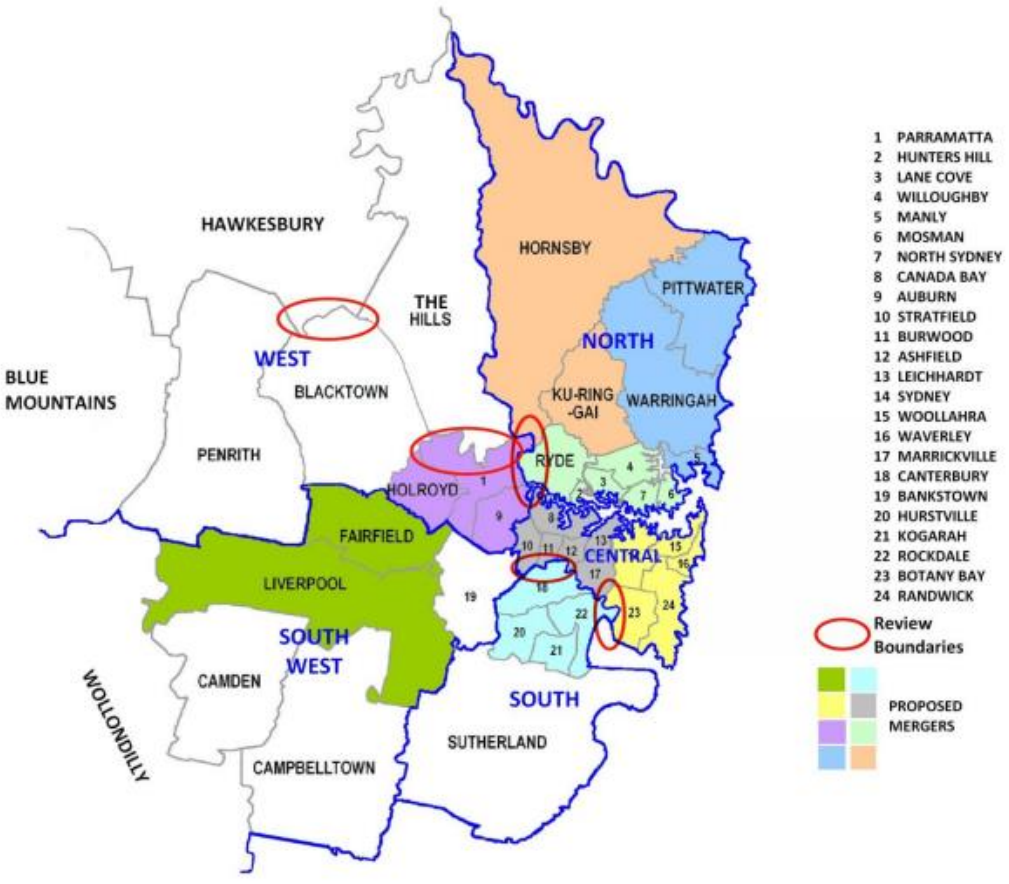
1 INTRODUCTION

1.1 Background

In early 2013, SGS Economics and Planning was engaged by Warringah Council to undertake a high level strategic and financial assessment of potential options for structural change to local government. These options included the preferred option identified by the Independent Local Government Review Panel (ILGRP), which was to combine Warringah, Manly and Pittwater Councils.

In October 2013, ILGRP released the report "Revitalising Local Government". This report identified a reshaping of metropolitan governance arrangements and consolidation of local government in the Sydney metropolitan area. The preferred options for Sydney Metropolitan Councils are shown below (ILGRP, October 2013).

FIGURE 1. PREFERRED MERGER OPTIONS FOR SYDNEY METROPOLITAN COUNCILS



Source: ILGRP, 2013

Under the preferred option, the ILGRP report recommended the potential merger of Manly, Pittwater, and Warringah Councils.

In September 2014, the State Government announced a "Fit for the Future" package of local government reform initiatives, which responds to the recommendations of the ILGRP.

The NSW Government is "committed to rebuilding NSW" and acknowledges the findings of the ILGRP, namely that "the system of local government is not working as well as it should be" (NSW Office of Local Government, September 2014). The NSW Government's "Fit for the Future" package includes a funding scheme designed to encourage local councils to develop the scale and capacity the Government believes is necessary for them to be financially sustainable and able to provide quality services and infrastructure into the future.

To that end the Government has provided a blueprint that outlines how it will assist voluntary reform of local government. Key elements included in the blueprint are set out below:

- $258m to help councils who have decided to merge to make the transition and provide services and facilities communities need.
- $13m to support local transition committees and ensure elected representatives are involved in the merger process.
- $5.3m to get new regional Joint Organisations up and running.
- Up to $600m potential savings from cheaper finance for Fit for Future councils to invest in local infrastructure.

The NSW Government will also assist by providing access to expert assistance, access to the Office of Local Government One Stop Shop for local government reform, facilitators and technical support.

1.2 Scope of this work

To support the continued discussions with the neighbouring councils in exploring the potential for creation of a new council on the Northern Beaches, SGS Economics and Planning has been asked by Warringah Council to update and extend the 2013 study. The scope of this work is to undertake a high level strategic financial appraisal for a status quo option as well as merger options to create one or two councils to serve the region.

In contrast to the 2013 study which used the 2011-12 data, this study is based on the 2013-14 financial data and projections from the most recent Long Term Financial Plan (LTFP) published by councils.

The options assessed in this study are described in the table below.

TABLE 5. POPULATION BY OPTION

Option	LGAs	Population 2011*	Population 2031^
1 Status Quo:- three separate councils	Manly Pittwater Warringah	39,748 57,154 140,741	51,900 82,000 173,500
2 New Northern Beaches Council	Warringah + Manly + Pittwater	237,643	307,400
3 New Council: combine Warringah and Manly	Warringah + Manly	180,489	225,400
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* From 2011 Census figures, as the reference year used by the Fit for the Future program
^ 2031 projected population: from Planning and Infrastructure 2013, used in the Review Panel's final report.

2 FINANCIAL ANALYSIS

This section provides a high-level financial analysis of the options.

A key focus of the financial analysis is to estimate the potential expenditure savings for the four potential merger options against the status quo (Option 1) and assess whether there is surplus remaining after addressing any asset renewal gaps or repayment of debts.

2.1 Economies of scale in mergers

Economies of scale relates conditions under which an increase in output (the quantity of goods and services produced) results in a reduction in per unit costs. These conditions arise where the production of goods or services includes large fixed costs. As output increases, the fixed costs of production can be spread over a larger base, resulting in a decline in the per-unit costs.

In the context of mergers of institutions, economies of scale may occur where duplication of services is avoided and fixed costs are spread over a larger base. Economies of mergers can relate to the following:

- **Economies of scale** - Conditions under which an increase in output (the quantity of goods and services produced) results in a reduction in per unit costs. These conditions arise where the production of goods or services includes large fixed costs, so that as output increases, the unit costs decline, as the fixed costs of production are spread over a larger base.
- **Economies of scope** - This is achieved where the delivery of more than one type of good or service by a single organisation delivers a lower average cost of production than if those services were provided by separate organisations. This generally results where complementary production processes are combined into a single entity.
- **Economies of specialisation** - As the size of organisations grows so does their capacity to employ specialised resources and utilise them in undertaking specialised activities.

Financial savings of mergers of institutions (private or public) can be a result of all three aspects described above. However, mergers of councils only benefits from economies of scale and specialisation, whereas the economies of scope may not be achieved as it is assumed that a larger council post-merger would deliver a similar range of services as provided by the smaller councils.

It is noted that some of these economies may also be achieved under different structural mechanisms (as opposed to mergers) and that savings may also be achieved in service provision through process improvement, consolidation and other management improvements. Alternate structural mechanisms, including a regional county council approach, are not the focus of the options included in this study as these are not considered viable long term options by the NSW Government.

Achieving potential savings in any merger option would require effective implementation of a merger plan focused on achieving the expenditure savings, and ongoing quality management and systems.

Use of resident population as a proxy for output

In this high-level analysis, the level of council's output is proxied by resident population. However, we acknowledge that this is not always a perfect proxy for the level of council services provided. This is because the mix of services delivered may differ from council to council. In addition, some expenditure items may be more closely aligned with other factors such as open space areas and road networks. In a similar vein, Dollery *et al* (2008)[3] argue that councils' level of production will also be affected by their 'non-discretionary' environment, their service quality and inter-council variation in service provision.

Nevertheless, we believe that resident population is a reasonable proxy for Local Government output for two reasons. Firstly, in many case, the quantity of council services is largely a function of population. Secondly, in most councils, rate capping is likely to limit the discretion of councils to 'embellish' their service offering on a per-capita basis. For these reasons, the size of the population serviced by a council will be the most important determinant of their level of services provided, making it a reasonable proxy for this high-level analysis. Data from any detailed service planning (including service costs and service level) from study area Councils has not been available for this high level analysis, and publicly available information has been used. While many Councils may not have this data for many service areas, any that was made available could be included in future more detailed development of the preferred option.

Use of per capita expenditure as a proxy for average unit cost

We acknowledge that expenditure (or total cost) = output × per unit costs. Because we use the resident population as a proxy for output, the per-capita expenditure used in this high-level analysis can be seen as a proxy for average unit costs[4]. Therefore, the terms - 'expenditure' and 'cost'- have been used interchangeably throughout the rest of the report.

[3] Dollery B, Byrnes, J and Crase, L 2008, 'Australian local government amalgamation: A conceptual analysis population size and scale economies in municipal service provision', *Australasian Journal of Regional Studies*, 14(2): 167-175.

[4] Total expenditure = output × per unit costs, and Total expenditure = population × per capita costs. Since the quantity of services provided by councils is in many cases a function of population (as argued above), per units costs are approximately equal to per capita costs.

2.2 Service expenditure savings

As discussed, scale economies are plausible at the aggregate level in the context of council mergers. This section examines economies of scale for different services being considered under various options.

In the course of modelling the options, we distinguish between service functions that are population related, and likely to achieve economies of scale, and those that are not as likely (i.e. expenditure remains the same). This is based on statistical analysis (using 2012 data) in the 2013 SGS study.

Services subject to economies of scale

Simple linear regression models were constructed to test the relationship between the per capita service costs for eleven services areas - Governance, Administration, Public order and services, Health, Environment, Community services and education, Housing and community amenities, Recreation and culture, Construction, Transport and communication, and Economic affairs[5]. These models were based on six LGAs considered in the SGS (2013) study – Warringah, Pittwater, Manly, Mosman, Ku-ring-gai, and Hornsby.

Based on high-level regression analysis of the eleven service areas, we find that the per-capita service costs under the following six categories are likely to be subject to economies of scale. That is, this high-level statistical analysis suggests that on average, per capita costs for the following six services fall as population increases.

- Governance
- Administration
- Public order and safety
- Environment
- Recreation and culture, and
- Transport and communication.

For the financial analysis, changes in service costs in five of the six identified service areas have been modelled on the basis of achieving the per capita service costs achieved by the 'reference council'. In options 2 to 4 this is Warringah, which achieves the best economies of scale currently and its approach could be scaled up for a new combined council. Similarly, for option 5 the north Council is more likely to adopt Pittwater's approach and the south Council Manly's approach.

These efficiencies - generated from the larger size of a merged council - are expected to result in lower average costs per capita as experienced by the 'reference council', implying a transition to processes and structures adopted by that council. This modelling approach has been adopted for this high level analysis. However, consultations with individual business units within study area councils would be required to identify the potential for change in service costs, once the preferred option has been agreed with the neighbouring councils.

While we assume that any larger council will achieve the 'reference council's' per capita service costs in the aforementioned six areas, there is one exception - governance. The governance cost (including Councillors fees) varies between options depending on the assumed number of councillors post-merger (see discussions in the next section), and does not increase with population.

[5] Refer to the SGS (2013) study for information.

Services not subject to economies of scale

The high-level regression analysis in the previous study also reveals that there is no strong evidence of economies of scale for the following five services. As such, the current per capita service costs of each council are assumed to remain in a larger council.

- Health
- Community services and education
- Housing and community amenities
- Mining, manufacturing and construction, and
- Economic Affairs.

The analysis found that the goodness of fit measure (R-square) is relatively low for the above services. In particular, health and community services, and education are skewed by Manly per capita service costs. Excluding Manly results in a near horizontal regression line (coefficient approaching zero) which suggests that per capita costs of these services is unlikely to decline with increasing population. Housing, and community amenities and economic affairs do not reveal declining per capita service costs for the LGAs considered.

While mining, manufacturing and construction does reveal a declining relationship between per capita service costs and population, data for this service function is not available for Pittwater and Hornsby. As such, it is difficult to be certain about the economies of scale in this service area. To be conservative, the per capita costs in this service area, of each council are assumed to remain unchanged post-merger.

Other model assumptions

Governance

Based on general population to councillor ratios, Warringah Council have suggested the number of councillors for each option, for the purpose of this analysis. For instance, the number of councillors suggested for options 2 to 4 is similar to other Sydney councils of these population sizes. For option 5, higher number of councillors is assumed since Pittwater and Manly currently have a higher level of representation.

The following numbers of Councillors are assumed under each option. Note that since option 5 will create two new councils, the total governance cost is higher than other merger options. These numbers would change depending on governance options that are chosen by any new organisation, and subject to agreement of merging bodies.

TABLE 6. NUMBER OF COUNCILLORS BY OPTION

Options	LGAs	Councillors including Mayor
Option 1 – status quo: Three separate councils	Manly	9
	Pittwater	9
	Warringah	10
Option 2 – Northern Beaches Council	Warringah + Manly + Pittwater	13
Option 3 – New Council: combine Manly and Warringah	Warringah + Manly	10
Option 4 – New Council: combine Pittwater and Warringah	Warringah + Pittwater	10
Option 5 – Two new councils formed by dividing Warringah	Half Warringah + Pittwater	10
Between Pittwater and Manly	Half Warringah +Manly	10

Source: Advice from Warringah, 2014. All councillors are part time.

Warringah's current governance cost under the status quo option has been used as a basis for estimating the new governance costs under each merger option. For example, since options 3 and 4 are assumed to require the same number of Councillors as per status quo, the governance costs under these two options are the same as Warringah's current governance costs. On the other hand, the Northern Beaches Council formed under option 2 is assumed to require 13 councillors, so the governance cost is scaled up.

To enable a clearer comparison, governance cost does not include any local community boards at this stage, in contrast to the 2013 study. Such boards are just one of several forms of community governance which a new council would choose from.

The following table reports the resultant governance costs per option. This highlights the large cost of the status quo of three separate councils for the region, represented by 28 councillors - almost double the number of councillors than comparable areas in Sydney.

TABLE 7. GOVERNANCE COSTS BY OPTION (2014)

Options	No. of councillors	Governance costs	Per capita cost
Option 1 – status quo: Three separate councils	9 (Manly) 9 (Pittwater) 10 (Warringah)	As per current governance costs (Total of $15.85 million for all three LGAs, of which $2.6 million is Warringah)	$64
Option 2 – Northern Beaches Council	13	$3,425,500	$14
Option 3 – New Council: combine Manly and Warringah	10	$2,635,000	$14
Option 4 – New Council: combine Pittwater and Warringah	10	$2,635,000	$13
Option 5 – Two new councils formed by dividing Warringah Between Pittwater and Manly	10 10	$5,270,000	$21

Source: SGS estimates based on advice from Warringah, 2015. Per capita estimate uses 2014 ERP estimate. All councillors are part time.

Transition period

In addition, it is assumed that cost savings only commence three years from now (FY 2015) in FY 2018. This encompasses a transition period where council cost structures gradually move to merged structures where economies of scale apply.

Merger costs

There are likely to be transition costs to change systems and processes following merger. SGS undertook a number of case studies to understand the findings of mergers for councils in the UK, New Zealand and Queensland. Cornwall Council (UK) was one of the case studies that helped understand the costs and savings of mergers. Merger costs for this case study and others are summarised in the table below.

The costs range from $3.5 million to $8.8 million in Western Australia, an average of $8.1 million in Queensland (with significant variation between mergers), and $24 million in Canada. It is clear that there is significant variation in merger costs, reflecting the uniqueness of each case. For this study, we use the Cornwall Council (UK) estimate since it is scalable. That is, the merger cost is directly related to the operating budget of the council, and can better reflect individual circumstances[6]. Nonetheless, given the uniqueness of each case, undertaking a detailed assessment of merger costs would be advisable once the merger option is finalised, to consider the nature of service levels, assets, standards and systems of the partner councils. We believe that the Cornwall case study is a reasonable example of merger cost estimates for a high level study of this nature.

For this study, we only consider transition costs associated with systems and processes. That is, merger costs are estimated at 1.4% of base case operating expenditure for each option, based on the Cornwall case study example[7]. This assumption translates to $3 to $5.5 million (10 year present values) for the options considered, and occurs over the first two years Note that option 5 has higher merger costs resulting from dividing one council and integrating it into two existing councils, based on two sets of boundary changes.

[6] In addition, the other estimates encompass a range of components, and the share composition of each is not apparent.

[7] This is based on consultation case study with UK's Cornwall Council completed by SGS in 2014. The SGS study findings are not public.

Costs associated with redundancies are excluded in this study. This is because we assume that natural staff attrition (and any actual savings[8]) in the first three years would offset any redundancy costs during the first three years of the analysis. The study has also not considered any incentive funding from the government which is currently on offer for voluntary mergers.

TABLE 8. MERGER COST ESTIMATES – CASE STUDIES

Location	Period	Amount description	Included aspects	Number of LGAs	Source[9]
Used in this study					
Cornwall, UK	2008-2009	2.8% of operating expenditure (£42 M)	50% redundancies, 50% systems and processes	7	SGS study (2014)
Other sources					
Queensland	2008-2009 over 10 year period	Final assessed claim approx. $194.8M total for 24 councils, avg. $8.1 per council (Original claim by councils range$1.2M - $21.5M)	Approx. 50% Infrastructure, 30% Wages, Salaries, Redundancies, 20% Systems, Process & Operations.	24	Queensland Treasury Corporation (2009)
Western Australia	2008 over 4 year period	$8.8M	Change Management, Relocation, Policy & Regulation, Civic/Community and Operating Processes	3	Bob Davis, City of Greater Geraldton (2013).
	2008 over 4 year period	$3.5M		2	
Halifax, Canada	1996 n.f.d	$24M (one off transition) + Ongoing transition costs	One off costs not stated. Ongoing costs include IT, wages and salaries	Unspecified	McKinlay Douglas Ltd (2006)

Source: Collated by SGS and Warringah Council.

Operating expenditure projections and growth assumptions

Expenditure savings are assumed to grow in line with projected Long Term Financial Plan (LTFP) growth rates for the base case operating expenditure. This growth rate is calculated for each option, based on the combined projection for operating expenditure under the base case of each option (i.e. no merger), and then applied to savings per annum by service area. These base case projections were compiled by Warringah Council, using the publicly available LTFP data for each council.

The annual average LTFP growth rates for each option are shown below:

Option two: 3.84 percent
Option three: 4.13 percent
Option four: 3.99 percent
Option five: 3.84 percent

[8] Even though we assume that there would be no savings, there is likely to be *some* savings during that period. This is reasonable since detailed information regarding redundancies has not been made available.

[9] McKinlay Douglas Limited. (2006). L*ocal government structure and efficiency*, a report prepared for local government New Zealand, Tauranga: Author.; Queensland Treasury Corporation (2009), *Review of local government amalgamation costs funding submission – final summary report*, Brisbane: Author; and Davis, B. (2013). *Some insights from experiences of the City of Greater Geraldton: Amalgam of City of Geraldton, Shire of Greenough and Shire of Mullewa* [PowerPoint slides]. Presentation to City of Melville on 16th August 2013.

In contrast to the operating expenditure by service area used in the high level regression analysis, the operating expenditure projection does not include any asset depreciations. This is to exclude any non-cash items but also to avoid inconsistencies in methods used by each council in evaluating asset depreciations. Likewise, any net gains/losses on asset disposals have been excluded from the projection. However, no publicly available figures are reported on the break-down of the depreciation by service. As a result, the depreciation has not been excluded in any operating expenditure figures by service.

Discount rate

The discount rate is used to measure the present value of future flows of money and takes into account not just the time value of money, but also the risk or uncertainty of future cash flows. This is used in Discounted Cash Flow (DCF) analysis as a way to translate future cash flows to the present. A high discount rate reduces the present value of future flows, while a low discount rate increases the present value.

A nominal discount rate of 5.5% per annum is used in the cash flow model, as all cash flows are in nominal terms. This discount rate is based on a nominal investment rate, which represents an expected rate of return on liquid assets held by councils. We adopt a higher rate than the population growth rate used in the previous study because LTFP growth rates (which have both real and nominal (inflation-related) components) are used in this study.

Comparing service costs pre and post-merger

As discussed, a key source of financial savings from a merger accrues from savings in service expenditure. In order to model these efficiencies, total services costs prior to a merger are compared with total service costs post-merger.

The table below shows total service expenditure by service area for each option prior to merging. That is, the service expenditure of each council (obtained from financial reports) is summed to form the total expenditure under each option prior to merging.

TABLE 9. PRE-MERGER SERVICE EXPENDITURE ($ THOUSANDS) 2013/14

Pre-merger service cost	Option 1	Option 2	Option 3	Option 4	Option 5
Governance (excluding local boards)	$15,849	$15,849	$5,208	$13,276	$15,849
Administration	$48,231	$48,231	$33,529	$34,138	$48,231
Public order and services	$15,363	$15,363	$10,742	$11,331	$15,363
Health	$3,167	$3,167	$2,875	$2,371	$3,167
Environment	$64,774	$64,774	$49,120	$50,813	$64,774
Community services and education	$19,084	$19,084	$16,702	$13,068	$19,084
Housing and community amenities	$18,707	$18,707	$12,721	$16,351	$18,707
Water Supplies	$37	$37	$0	$37	$37
Recreation and culture	$46,952	$46,952	$37,050	$38,237	$46,952
Construction	$5,233	$5,233	$5,233	$2,314	$5,233
Transport and communication	$15,223	$15,223	$11,990	$12,270	$15,223
Economic affairs	$6,270	$6,270	$1,381	$5,003	$6,270
Total service cost ($ thousands)	**$258,890**	**$258,890**	**$186,551**	**$199,209**	**$258,890**
Total service cost per capita ($)	**$1,048**	**$1,048**	**$1,000**	**$969**	**$1,048**

Source: SGS, 2015; complied from 2013/14 financial reports. Based on advice from Warringah Council, note that per capita expenditure for Warringah does not include the expenses of other councils that relate to Kimbriki Resource Recovery Centre. This

The table below shows total service costs by service for each option post-merger. The total costs are combination of services that adopt the reference council per capita costs (six areas in blue), and services that retain the old per capita costs (remaining six areas). This implies that the reference council's systems and services standards are applied.

Warringah is in a special situation as the landholder and major shareholder of the region's waste management facility – Kimbriki Resource Recovery Centre; entailing some consolidated costs which are then charged to the other shareholder councils (Mosman, Manly and Pittwater).

In this report Warringah's expenditure figures includes the Kimbriki-related costs for servicing only its own residents and businesses, to ensure equal comparison with other councils. Where Warringah is the reference Council (Options 2 to 4), the running of the centre is assumed to adopt its systems and processes. Similarly, where Pittwater and Manly are reference councils (Option 5), their costs of running the centre are used for the northern and southern areas respectively.

Services subject to economies of scale are highlighted in blue, while the remainder are those that are not.

TABLE 10. POST-MERGER SERVICE COSTS ($ THOUSANDS) 2013/14

Post-merger service cost	Option 1	Option 2	Option 3	Option 4	Option 5
Governance (excl. local boards)	$15,849	$3,426	$2,635	$2,635	$5,270
Administration	$48,231	$33,047	$24,973	$27,511	$71,226
Public order and safety	$15,363	$11,409	$8,621	$9,498	$21,292
Health	$3,167	$3,167	$2,875	$2,371	$3,167
Environment	$64,774	$59,781	$45,175	$49,766	$72,960
Community services and education	$19,084	$19,084	$16,702	$13,068	$19,084
Housing and community amenities	$18,707	$18,707	$12,721	$16,351	$18,707
Water Supplies	$37	$37	$0	$37	$37
Recreation and culture	$46,952	$48,178	$36,407	$40,107	$45,831
Mining, manufacturing and construction	$5,233	$5,233	$5,233	$2,314	$5,233
Transport and communication	$15,223	$15,366	$11,611	$12,791	$15,260
Economic Affairs	$6,270	$6,270	$1,381	$5,003	$6,270
Total service cost ($ thousands)	**$258,890**	**$223,705**	**$168,334**	**$181,451**	**$284,336**
Total service cost per capita ($)	**$1,048**	**$906**	**$902**	**$882**	**$1,151**

Source: SGS, 2015; complied from 2013/14 financial reports.

The table below shows total cost savings moving from pre-merger to post-merger cost structures. This is calculated as the difference between Table 9 and Table 10. It is worth noting that in options 2 and 4 where Warringah is the 'reference council', there are negative savings in recreation and culture, and transport and communication. This is because Warringah's per capita expenditure for these areas is higher than the other LGAs considered in those options. This is likely due to differences in service levels between councils. For instance, Warringah's service level for recreation is much higher than the other councils as it provides 86% of the region's sports fields, and regional facilities such as Brookvale Oval, Warringah Aquatic Centre and Warringah Recreation Centre, whilst holding only 60% of the region's area and population[10].

Similarly, the reference councils for option 5 have higher per capita expenditure than Warringah for most services. This drives the negative savings (losses) in that option.

TABLE 11. POST MERGER COST SAVINGS ($ THOUSANDS) 2013/14

Cost-savings by service area	Option 1	Option 2	Option 3	Option 4	Option 5
Governance (excl. local boards)	$0	$12,424	$2,573	$10,641	$10,579
Administration	$0	$15,184	$8,556	$6,627	-$22,995
Public order and safety	$0	$3,954	$2,121	$1,833	-$5,929
Health	$0	$0	$0	$0	$0
Environment	$0	$4,993	$3,945	$1,047	-$8,186
Community services and education	$0	$0	$0	$0	$0
Housing and community amenities	$0	$0	$0	$0	$0
Water Supplies	$0	$0	$0	$0	$0
Recreation and culture	$0	-$1,226	$643	-$1,870	$1,121
Mining, manufacturing and construction	$0	$0	$0	$0	$0
Transport and communication	$0	-$143	$379	-$521	-$37
Economic Affairs	$0	$0	$0	$0	$0
Total cost savings ($ thousands)	**$0**	**$35,185**	**$18,217**	**$17,759**	**-$25,446**

Source: SGS, 2015.

[10] This is based on advice from Warringah Council.

Baseline results

The following table shows the present value of expenditure savings by service function and merger costs, using a nominal discount rate of 5.5 per annum. Note that option 5 has higher merger costs resulting from dividing one council and integrating it into two existing councils, based on two sets of boundary changes. The results represent savings across the region in total. Where there is a council not joining a merger (Options 1, 3 and 4) it is assumed that their operating costs do not change.

TABLE 12. NPV ($ THOUSANDS) OF COST SAVINGS BY SERVICE AREA– BASELINE

	10 year present values at 2015				
	Option 1	**Option 2**	**Option 3**	**Option 4**	**Option 5**
New expenditure					
Merger cost (total over 2 years)	$0	-$3,819	-$2,770	-$2,945	-$5,455
Expenditure savings					
Governance	$0	$83,921	$17,828	$72,641	$70,938
Administration	$0	$102,567	$59,285	$45,243	-$155,910
Public order and services	$0	$26,709	$14,693	$12,516	-$40,176
Health	$0	$0	$0	$0	$0
Environment	$0	$33,727	$27,337	$7,151	-$55,722
Community services and education	$0	$0	$0	$0	$0
Housing and community amenities	$0	$0	$0	$0	$0
Water Supplies	$0	$0	$0	$0	$0
Recreation and culture	$0	-$8,283	$4,457	-$12,762	$7,340
Construction	$0	$0	$0	$0	$0
Transport and communication	$0	-$964	$2,624	-$3,559	-$342
Economic affairs	$0	$0	$0	$0	$0
Total savings	**$0**	**$233,859**	**$123,453**	**$118,284**	**-$179,328**
% of option's base case	**0%**	**9%**	**7%**	**6%**	**-7%**

Source: SGS, 2015.

These post-merger cost savings for 2014 (refer Table 11) are modelled over the next 10 years. The modelling approach implemented implies that each of the combined councils broadly adopts levels of service, systems and processes in place at the reference council. As such, the result above would best represent a reference council model for mergers. As noted earlier, the merger costs for each option occur over the first two years. The costs shown the table above (ranging from $3-$5.5million) are the total (present value) of expenditure over two year periods.

Amongst the four merger options identified, option 2 (Warringah, Pittwater and Manly) is likely to generate the most cost savings, which amount to around $234 million over 10 years, in present value terms. This is followed by options 3, which is expected to generate $123 million savings. Under both options 2 and 3, majority of cost savings occur in the administration, followed by environment and public order and services. The losses realised in Option 5 would be collectively shared by the two new councils.

Comparison of Option 2 results with previous study

The 2013 SGS study found that Option 2 (Northern Beaches Council) generates savings of $257.5 million (present value at the time) over 10 years. The difference between the 2013 study and this study ($233.8 million) is around 10 percent (or 23.7 million) and attributable to the following changes in the current study:

- This study **uses Long Term Financial Plan (LTFP)** growth assumptions, in contrast to the previously study which used population growth only. LTFP growth includes a real (population related) and nominal (inflation related) component. These growth rates are used in the Discounted Cash Flow (DCF) model. The LTFP has a higher annual average growth rate of 3.84 percent compared to population growth rate of 0.58 percent.
- A **higher nominal discount rate** of 5.5 percent is used. This is due to the use of LTFP growth rates which have both a real and nominal components. The discount rate is used to measure the present value of future flows of money and takes into account not just the time value of money, but also the risk or uncertainty of future cash flows. The higher discount rate reduces the present value of future cash flows.
- This study uses **updated FY 2014 per capita service costs**. In contrast, the previous study uses FY 2012 figures. Over the two year period, there have been changes to each Council's operations, and resident population. These have resulted in each Council's per capita expenditure being different[11] from the previous study. For instance, the current study shows a loss of around $9 million in Recreation and culture, and transport and communication. These service areas yielded savings in the previous study.
- For the sake of a simple comparison that does not pre-empt solutions for community governance, **local community boards are not considered** here. In the previous study, this resulted in around $15 million (present value) of additional expenditure for the Northern Beaches Council.
- **Merger costs are included** in this study. In contrast to the 2013 study, an estimated $3.8 million (present value) of additional expenditure has been included for this Option.
- This study adopts a **different treatment of administration costs**. In the previous report, Warringah Council provided SGS with information regarding senior management, and this was separated out of administration expenditure, which resulted in unchanged senior management expenditure when comparing the base case with Option 2. This implied that the current study has higher administration savings than the previous work.

It is clear that some of the above assumptions result in higher savings, while others yield lower savings, compared to the previous work. Collectively, these differences in assumptions drive the difference in savings. The preclusion of local community boards and the use of FY 2014 per capita expenditure are two of the key differences between the two studies. However, the results for Option 2 are *broadly* comparable, because both studies utilise the reference council modelling methodology which presumes that all councils adopt the reference council systems and processes.

[11] Per capita expenditure values have decreased by 4% for Warringah, but increased by 6.29% and 3.26% for Pittwater and Manly respectively. Note that this could be due to change in either expenditure or population (or both).

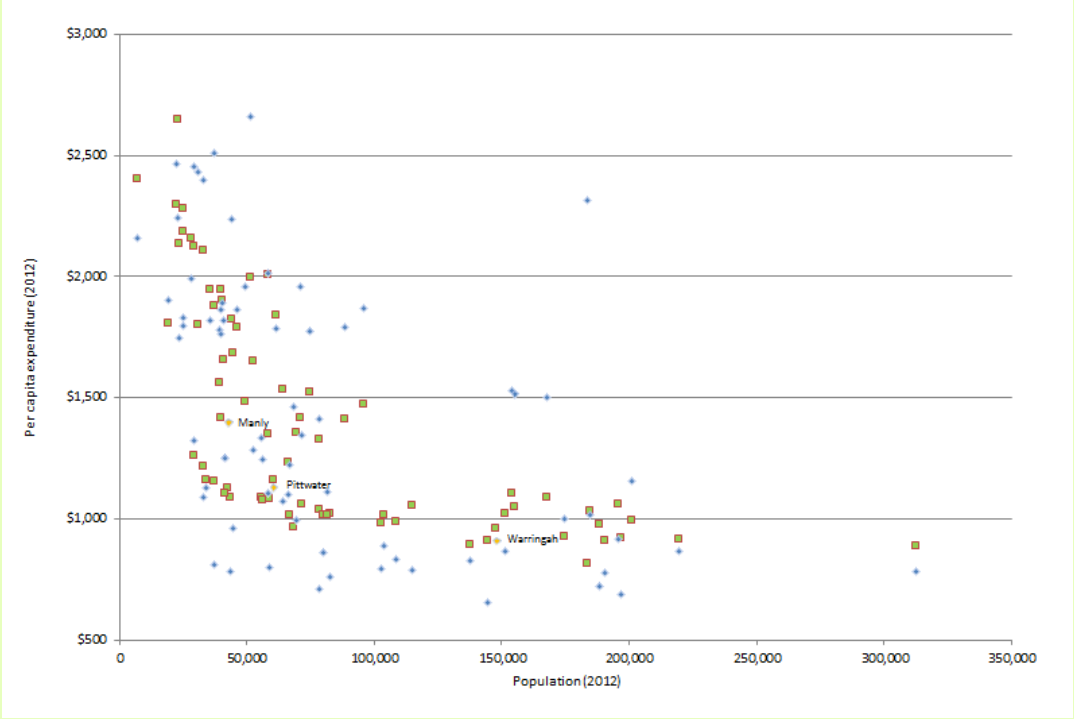
Sensitivity testing results

Sensitivity tests to the modelling results above have been completed, based on the alternative service expenditure savings estimated using an econometric model.

Econometric model of economies of scale

The table below plots total service expenditure per capita for 82 councils in NSW against total population within each council area in 2012. This shows that per capita service expenditure is higher for councils with smaller populations, but lower for councils with higher populations. That is, councils with larger populations are able to service their populations at a lower average cost (i.e. economies of scale).

Figure 2. Economies of scale – econometric model (based on 2012 data)



Source: SGS, 2014. The model is estimated using FY 2012 data, and using 82 observations for Metropolitan, Metropolitan Fringe, and Regional Town/City Councils. All data is sourced from DLG comparative Local Government reports. Note there that since the majority of Councils do not provide water and sewerage services, the model predictions (in green) are for Councils without these services.

The green dots are model predictions, while blue are actual data. The predictions are based on an estimated Ordinary Least Squares (OLS) regression[12] model of the following form:

Total service cost per capita =	**8.64524**	**-0.376113x Ln (Population)**	**+ 0.206081**	**x Ln (Road metres)**	**+ error**
R-square 0.60	***	***		***	

It is noted that economies of scale are unlikely to be linear, and may exhibit threshold effects once a critical limit is reached. For this reason, a natural log function is chosen to reflect the tapering off of per capita service costs at higher population levels. As indicated by the sign and p values (stars), the estimated coefficient on the natural log of population is negative and statistically significant. This implies that on average population levels have an impact on service expenditure per capita, and that relationship is inverse (higher population is associated with lower per capita costs).

[12] The OLS estimation uses hetroskedasticity-robust standard errors, variant HC1. Diagnostic tests indicate that the residuals are normally distributed, and that hetroskedasticity is present (which has been corrected for).

However, the R-squared (which is a measure of how well the model explains the data) measure is relatively low at 60 percent. This is to be expected since the service expenditure could be a function of other factors that are not included in this model. For example, the variation in per-capita service costs could be explained by the fact that a particular type of service (e.g. child care) is directly delivered by some, but not other councils. However, the model is sufficiently described, given its aim is to test the hypothesis of economies of scale in the context of aggregate service expenditure.

Note the purpose of the econometric model is not to ascertain the service expenditure of the combined council under different options (refer to baseline savings in Table 12 for this), but to predict the per-capita expenditure level in a larger council using population as a proxy for the council's output (average efficiency calculation below).

In this sensitivity testing, the operating expenditure per capita post-merger is based on the average estimate from the economies of scale econometric model (see Figure 2).

Service cost savings are then derived by comparing total costs prior to merging with the predicted total costs from the model. This scenario reflects the *average* efficiencies that *may* be achieved through merger options and reflects the potential efficiencies relating to a larger council. On average, the model predicts that the larger the new council, the greater the expected savings.

The following table shows the present value of service cost savings by option using average efficiencies estimated from the econometric model. Financial savings after fully addressing current asset backlogs and borrowing is also reported[13].

TABLE 13. NPV ($ THOUSANDS) OF AVERAGE EFFICIENCIES (COST SAVINGS)

	10 year present values at 2015				
Average efficiency (scale economies)	**Option 1**	**Option 2**	**Option 3**	**Option 4**	**Option 5**
Total net expenditure savings	$0	$272,907	$135,122	$75,987	$88,686
Savings as a % of base case	0%	11%	7%	4%	3%
Savings after addressing asset backlog and debt	n.a.	$204,241	$99,710	$25,699	$20,020

Source: SGS, 2015.
Note that since Option 5 has two councils, we derive an estimate for each council and then present the aggregate result here.

The sensitivity testing shows that option 2 is likely to result in the highest financial savings (of $273 million) over 10 years from average efficiencies (generated by scale economies). This is around 11 percent of the Warringah, Manly, and Pittwater operating budget over the next 10 years (in present value terms).

In comparison, option 5 is expected to generate average efficiencies of $44 million (over 10 years) for each of the two councils (north and south). This estimate is lower than option 2 because the population in each council (north and south) for option 5 is lower. That is, they operate as separate entities which results in lower scale-related average efficiencies.

[13] See Section 2.3 for information on asset backlog and debt under each option.

2.3 Asset renewal and debt repayment

The potential cost savings from a merger would provide opportunities to fund the asset renewal gaps and to reduce debt (in addition to fund changed service levels which would be a policy decision for any future council). The following section discusses the capacity of each option to fund these items.

Asset backlog

Based on special schedule 7 of the 2013/14 financial statement, published by each Council, Warringah Council has gathered the estimated asset backlog as of 30 June 2014. The table below indicates the estimated asset backlog for each council. As of 30 June 2014, both Warringah and Pittwater had an asset backlog of $17 million, while Manly had a backlog of $0.4 million.

For the sake of comparison, asset backlogs levels (for FY 2011/12) from the previous SGS study (2013) are also reported below. This shows that while Warringah's backlog has remained relatively stable and consistent, there are significant differences in the Pittwater (reduced by $65 million) and Manly (reduced by $8.4 million) backlog estimates over a short period of two years. The lower estimate for Pittwater results in lower backlog levels for options that include Pittwater. This is why the backlog for option 3 is nearly half that of option 2.

TABLE 14. ASSET BACKLOG

	Cost to bring assets up to satisfactory level FYE 2014	Cost to bring assets up to satisfactory level FYE 2012
Warringah	$17,021,000	$18,126,000
Pittwater	$17,959,000	$82,715,000
Manly	$400,000	$8,864,000

Source: SGS calculations, 2015, based on Council's financial statement for the year ended 30 June 2014.

The following table shows the total asset backlog for those councils under each option. The total gap ranges from $17.4 million to $35.4 million.

TABLE 15. ASSET BACKLOG AND RENEWAL GAP BY OPTION, AS OF 30 JUNE 2014

	Cost to bring assets up to satisfactory level
Option 1	$35,380,000
Option 2	$35,380,000
Option 3	$17,421,000
Option 4	$34,980,000
Option 5	$35,380,000

Source: SGS calculations, 2015

The following table shows that even after topping up the asset backlogs above, there would be an additional surplus of $198 million under option 2, $106 million under option 3 and $83 million under option 4. Note this is based on the baseline cost savings described earlier.

TABLE 16. ADDITIONAL SURPLUS OVER 10 YEARS AFTER ADDRESSING ASSET BACKLOG - BASELINE

	Additional surplus (NPV) - $000	
	Due to cost savings	After the asset backlog top-ups
Option 2	$233,859	**$198,479**
Option 3	$123,453	**$106,032**
Option 4	$118,284	**$83,304**
Option 5	-$179,328	**-$214,708**

Source: SGS calculations, 2015, based on Council's financial statement for the year ended 30 June 2014.

Debt repayment

In addition to filling the asset renewal gaps, the merged council may also spend the additional surplus on early repayment of the current debts.

Table 17 shows the total external debts borrowed by each council. Warringah has only borrowed $13,000 as of 30 June 2014, while Pittwater and Manly have borrowed more than $33 million combined.

For the sake of comparison, debt levels (for FY 2011/12) from the previous SGS study (2013) are also reported below. This shows that while Warringah's debt has reduced by $752,000 to a low $13,000, debt levels at Pittwater (reduced by $7.1 million) and Manly (reduced by $5.7 million) have reduced significantly over a short period. The lower debt level for Pittwater in particular, results in lower debt levels for options that include Pittwater. As was the case with asset backlogs, option 3 debt-level is lower than option 2 for this reason.

TABLE 17. BORROWINGS OF EACH COUNCIL

Councils	Borrowings FYE 2014	Borrowings FYE 2012
Warringah	$13,000	$765,000
Pittwater	$15,295,000	$8,115,000
Manly	$17,978,000	$12,291,000

Source: Council's financial statement for the year ended 30 June 2014.

Table 19 shows the current borrowings held by all councils combined under each option. According to this table, the combined council/s would have $33 million debts under options 1, 2 and 5.

TABLE 18. TOTAL BORROWINGS OF EACH OPTION, AS OF 30 JUNE 2014

Councils	Combined borrowings
Option 1	$33,286,000
Option 2	$33,286,000
Option 3	$17,991,000
Option 4	$15,308,000
Option 5	$33,286,000

Source: SGS calculations, 2015, based on Council's financial statement for the year ended 30 June 2014.

After asset backlog top-ups and debt repayment, options 2 and 3 are still expected to generate a net surplus of around $160 million and $88 million respectively.

TABLE 19. ADDITIONAL SURPLUS OVER 10 YEARS AFTER ASSET BACKLOG TOP-UPS AND DEBT REPAYMENT - BASELINE

	Additional surplus (NPV) - $000		
	Due to cost savings	After the asset renewal top-ups	After the asset renewal top-ups and repayment of debts
Option 2	$233,859	**$198,479**	**$165,193**
Option 3	$123,453	**$106,032**	**$88,041**
Option 4	$118,284	**$83,304**	**$67,996**
Option 5	**-$179,328**	**-$214,708**	**-$247,994**

Source: SGS calculations, 2015, based on Council's financial statement for the year ended 30 June 2014.

2.4 Preferred option

The following table summarises the differences between the options, and identifies key drivers of the financial savings for each option across the region.

TABLE 20 COMPARISON OF OPTIONS FOR REGIONAL SAVINGS

Options	Baseline financial savings over 10 years (present value)	Net surplus after addressing backlog and debt, over 10 years (present value)	Key driver
Option 1 – status quo: Three separate councils	$0	n.a.	There is no change to current council finances, operations, assets, and debts.
Option 2 – Northern Beaches Council	Savings of $233.8 million	Savings of $165 million	The establishment of a new entity which adopts the systems and processes of a better performing (least per capita cost) council.
Option 3 – New Council: combine Manly and Warringah	Savings of $123.5 million	Savings of $88 million	Savings for the region from this Option is lower than Option 2, because operations at Pittwater remain unchanged (and does not generate any savings). It is higher than Option 4, since Manly expenditure is higher than Pittwater, and thus achieves greater savings by adopting Warringah's approach.
Option 4 – New Council: combine Pittwater and Warringah	Savings of $118.2 million	Savings of $68 million	In 2 of the 12 service areas Pittwater has lower costs than Warringah, but since the difference between Warringah and Pittwater is smaller than Manly and Warringah (Option 3), savings are lower. It is also assumed that Manly operations remain unchanged.
Option 5 – Two new councils formed by dividing Warringah between Pittwater and Manly	Loss of $179.3 million	Loss of $248 million	The loss is due to the new council being driven by Manly and Pittwater per capita expenditure (representing their systems and processes) which is higher than Warringah. Merger costs are also higher.

It is clear from the financial analysis that Option 2 (creation of one new Northern Beaches Council comprised of Warringah, Pittwater and Manly local government areas) is the preferred option from a strictly financial perspective. The 2013 study also showed this as a preferred option arising from the multi-criteria analysis, based on social, strategic, operational and financial factors.

The current appraisal shows that this option is likely to achieve a total financial saving of $234 million (in present value) over 10 years[14]. This is a saving of around 9 percent of the combined current expenditure of the three Northern Beaches councils (base case of this option). Even after funding the current asset backlog and borrowings, Option 2 is expected to generate a net surplus of $165 million.

On other hand, Option 5 is likely to result in a net loss of $179 million over 10 years, compared to the base case (or Option 1). Once asset backlog and debts are addressed, this loss would increase to $248 million.

[14] The 2013 SGS study found that Option 2 generates savings of $257.5 million (present value at the time) over 10 years. The difference between the 2013 study and this study is around 10 percent, and attributable to the following changes in the current study – the use of LTFP for growth assumptions, use of FY 2014 updated per capita service costs, use of 5.5 % nominal discount rate, removal of advisory boards, introduction of merge-costs, and changed treatment of administration costs (senior management was not separated in this study). However, *broadly*, the two results are comparable.

It is important to note that this study is based on a series of assumptions and criteria which would need to be clarified and adjusted in partnership with any merger Council once additional information and further detail (for example about governance arrangements) is available.

The analysis is an approximation only. The intent is to identify a preferred option and to provide a solid basis for future discussions.

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