

Financial Model Terms of Reference

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Introduction

Once again, we have another IPART review looking for solutions to problems that have not been properly diagnosed.

If Council financial sustainability, performance and service value for money is a problem, then the starting point should be to identify the cause.

There is no evidence that these problems have been caused by insufficient funding or revenue – yet IPART constantly conducts reviews focused on funding and revenue which inevitably lead to higher rates.

There is also no evidence that budgeting, local government accounting, financial performance reporting etc are a root cause of these problems. Sure, these processes can probably be improved, but the excessive focus on such matters in the draft Terms of Reference suggests predetermined non controversial “soft” recommendations on processes that do not get to the heart of the problem.

The elephant in the room is management performance in the local government sector – and this feeds into ongoing problems in efficiency, productivity, culture, and prioritisation. There will be no substantial improvement until this is addressed – yet the Terms of Reference once again dodge the issue.

Regulatory processes are also adding to the problems – particularly IPART’s own processes which create perverse incentives rewarding poorly performing Councils with higher rates. A bail out culture has been created which removes the incentive for reform.

Given that OLG and IPART as regulator and pricing regulator have contributed to the problem, they should be organisations of interest for a genuinely independent review. Not the organisations conducting the review and setting the Terms of Reference.

The review should be undertaken by a genuinely independent body – which neither State Government nor IPART are.

Suggestions for Inclusion in Draft Terms of Reference for Financial Model Review

1 Quality of Management across the Local Government Sector

Councils tend to recruit to senior positions from within the Local Government sector. There is a limited supply of high calibre candidates within the sector and mediocrity can rise to the top. This also means senior management experience is limited (by definition) to the non commercial sector and non commercial financial disciplines.

Encouraging applications for senior roles from outside the sector, including the private sector, would increase access to a wider range of skills and financial disciplines. It would also likely lead to change and innovation within the sector which is much needed.

2 Excessive and growing Executive salaries in Councils – none of which is performance related.

Executive salaries have been growing substantially at the same time as Council performance has been deteriorating.

In 2021, a new CEO was appointed on the Central Coast on a salary higher than the NSW Premier – none of which was performance related. He has done little to improve performance despite increasing rates revenue (general rates and water rates) by 30% in his first three years.

To some extent this is related to point one above in that there are too few high calibre candidates available to meet demand – thereby bidding up salaries. Encouraging applications from outside the sector will increase supply.

To incentivise better Council performance, Executive salaries should also be performance related to targets. This should not, however, lead to further increases in salaries. The performance related component should be a percentage of existing salaries, not an added component on top.

3 The need to improve efficiency and productivity in local government

Improvements in efficiency and productivity would lead to better financial performance and service delivery.

Yet, Councils rarely set SMART targets on efficiency and productivity.

IPART has not helped by setting the productivity factor at zero in its rate peg methodology.

IPART also has no method for measuring Council productivity – relying on cherry picked anecdotes from Councils themselves when assessing the productivity criterion in special

variations. If IPART were to develop a credible measure for productivity in local Councils, this could drive improvements.

4 Organisational culture across the sector and how to invigorate it

A more performance related and customer orientated culture could improve value for money for ratepayers. There is also a need to encourage innovation. To some extent, this is also dependent on attracting better management to the sector. State Government could help, however, by funding “culture change” projects supported by external consultants.

5 Allocating resources in accordance with strategic and community priorities

Given the wide range of functions Councils undertake (some of them discretionary rather than mandatory), Councils would provide better value for money if they focused on doing core business well, rather than wasting resources on less important matters.

All businesses and households have to make difficult choices when setting budgets. Councils often give the impression they can avoid such choices by treating the ratepayer as a magic money tree.

Councils need to improve their methodologies for identifying priorities, and their resource allocation in accordance with these priorities.

6 The role of IPART itself as a pricing regulator that has created a “bail out” culture leading to average rate increases in NSW double the rate of CPI inflation between 2010 and 2020.

Average rates across NSW rose 3.8% between the 2010/11 and 2020/21 compared with average CPI inflation of 1.9% over the same period. The annual rate peg approved by IPART was significantly higher than CPI at 2.5% and special variations increased the rate burden further.

IPART has unwittingly created a “bail out” culture whereby Councils find it easier to lobby IPART for higher rates than improve their own performance and productivity. They can then evade accountability to their communities by attributing the rate hikes to decisions by IPART rather than themselves.

This “bail out” culture has spawned an industry of consultants who know how to “game the system” with respect to special variation applications and produce these applications for Councils charging large fees (ironically) to the ratepayer for their services.

7 The need to remove perverse incentives in IPART processes, e.g., the special variation criteria such as “financial sustainability” that reward inefficient and poorly performing Councils with higher rates.

IPART processes, OLG regulations (and IPART’s interpretation thereof) all serve to promote perverse incentives and moral hazard.

Two examples. First, the Special Variation criteria are heavily weighted towards “financial sustainability” based on the Operational Performance Ratio (OPR). Poorly managed and inefficient Councils tend to have low or negative OPRs. The criterion rewards inefficient and poorly managed Councils with rate hikes (which they then attribute to IPART rather than themselves to evade accountability).

Second, IPART’s new rate peg methodology bases employee costs on the Local Government Award rather than average pay increases across the public sector. This removes the incentive for Councils to control salary increases because whatever salary increases they negotiate are passed straight through to ratepayers.