Review of the Beattie Rickman Report on the Proposed Amalgamation of the Waitomo and Otorohanga Districts

Report to the Local Government Commission

Capital Strategy Limited

October 2003

CapitalStrategy
From concepts to solutions

Contents

Authors:
John McCardle and Tony Pollitt

Capital Strategy Limited
517 South Titirangi Road
PO Box 60 029
Titirangi, Auckland
Phone: (09) 817 7665
Fax: (09) 817 7660

1. Introduction

1.1 Independent Review

Capital Strategy Limited ("CSL") has been engaged by the Local Government Commission ("LGC") to conduct an independent peer review of the Beattie Rickman ("BR") reports entitled: "*Financial Analysis for Review of Otorohanga & Waitomo Districts*[1]."

CSL, prior to this engagement, had not completed any work for the LGC. We have had no dealings with BR until this assignment, nor have we completed any work for either of the Otorohanga District Council or the Waitomo District Council.

We provided a copy of our report to Beattie Rickman to provide the firm with the opportunity to comment on the results of our analysis and the conclusions we have reached. Beattie Rickman raised no significant items in relation to the report.

1.2 Scope of Project

The LGC specified the scope of the review as follows:

- Whether BR's assumptions applied to determine the financial costs and savings were appropriate (comprehensive and reasonable), taking into account the high level nature of the financial analysis.
- Whether the transition costs and total estimated savings can be reasonably arrived at, based on the assumptions applied.
- Whether BR's financial calculations and assumptions are free of error to a reasonable degree of certainty.

While BR's report looked at two re-organisation options (an Otorohanga and Waitomo re-organisation; and an Otorohanga, Waitomo and Waipa re-organisation), the scope of this report applies to the Otorohanga and Waitomo re-organisation option only.

1.3 Methodology

Capital Strategy:

- Met with Geoff Balme of BR to:
    - Question and discuss the basis of assumptions used.

[1] March 2003 and August 2003. Note: Where page numbers are referenced in this report, they relate to BR's August 2003 report.

    - Have him show us the source data and how it flowed into their reports.
    - Discuss the basis of calculation of individual cost savings and transition costs in BR reports.
- Considered whether the assumptions made by BR were appropriate.
- Conducted our own analysis, based on each Council's 2002/03 Annual Plans, to determine whether the information in BR's reports had been accurately and validly sourced.
- Produced a financial model to assist in the analysis of the estimated savings and costs.

2. Review

2.1 Assumptions

2.1.1 Local Government Commission

The LGC set the following underlying assumptions:

"…The union of the Otorohanga and Waitomo Districts to form a new district

- *The Council would be based in Otorohanga, with a service centre in Te Kuiti*
- *Community Boards would be constituted for the Otorohanga, Te Kuiti and Kawhia townships, each with 5 elected members and 1 appointed member.*
- *8 members, including the Mayor, would be elected to the Council…."*

We have taken these above assumptions as a given.

2.1.2 Beattie Rickman

BR stated the following further underlying assumptions in their analysis:[2]

"We have made the following other material assumptions:

- *LTFS documents include all expenditure required to maintain Council's assets and services except for those specifically disclosed, e.g. unfunded depreciation.*
- *Community Board remuneration for the Te Kuiti Community will be the same as currently paid to the Otorohanga Community Board, which will remain unchanged under both options 1 and 2.*
- *Staff redundancy payments would average 6 months of salary.*
- *Following an Otorohanga and Waitomo reorganisation the present Waitomo Administration Building and associated land would be sold.*
- *Transition costs are paid, and sale proceeds for surplus assets are received, one year out.*
- *Annual savings will be achieved in perpetuity.*
- *Cash flows are discounted to present value at a real discount rate of 4.75%.*
- *All figures are GST exclusive.*

Our brief focussed on the financial implications of a reorganisation and as such did not require us to consider the wider economic or social impacts on the communities in the districts that might result from reorganisation, e.g. the economic and social consequences of job losses off-set by the economic benefits from any reduction in rates and charges…."

[2] Page 9

CSL Comment

These assumptions are reasonable given the high level nature of the review.

Other material assumptions implicit in the report are considered in the following sections.

2.2 Calculation of Estimated Cost Savings and Transition Costs

2.2.1 Staff Related Savings

BR Estimates

- BR prepared an assumed organisation chart for the new proposed organisation. It has 55 positions following consideration of potential reductions in positions across the two Councils.
- BR ranked costs and staff numbers across Councils of a similar size.

CSL Comments

We have checked the estimated total employee savings of $706,000 against the source data and a confidential version of the report that specified individual positions involved. We are satisfied that these savings reconcile.

A conservative approach appears to have been adopted by only identifying savings where there is a clear duplication of roles as a result of amalgamation. In all cases an allowance appears to have been made for increased emoluments for appointees in the newly defined positions in the new organisation

We concur with BR that the use of rankings of costs and staff numbers across Councils of a similar size provides only a general indication of relative efficiency as the mix of services and communities will be quite different at an individual Council level[3].

The approach of drafting an organisation chart as the basis of assessing staff related cost savings is a sound approach; and the numbers in this chart aligns in general terms with staff numbers in the “league table” comparison completed by BR. We have not reviewed or audited the figures in the BR comparison of 25 Councils.

2.2.2 Governance

The costs associated with governance (section 6.3*(i)*) are largely driven by the LGC assumptions.

[3] Page 1, section 6.2, paragraph 3

It makes sense to use the Higher Salaries Commission determination as BR had applied.

The other direct cost savings in the governance area seem fair and reasonable.

2.2.3 Inframax Income

We agree with BR's treatment of income from Inframax Construction Limited, in that this should be treated as a revenue or income item applied to income and not capital purposes. This corresponds with normal accounting treatments (Accounting Standard SSAP8).

2.2.4 Information System and Computer Costs

An IT cost saving of 25% seems to be a conservative estimate, but for the purposes of a high level review it is probably fair and reasonable to use.

If the amalgamation occurs, we would suggest that this area in conjunction with terminal costs (page 16*(iii)*) receive early focus.

2.2.5 Corporate Support Costs[4]

The estimated costs and cost savings for audit, insurance, valuation services, and legal expenses seem fair and reasonable. BR had assumed that an in-house legal service is retained on reorganisation. It could be expected that a cost saving of the order of $10,000 as estimated could occur through reduced duplication regardless of whether the provision was in-house or sourced externally.

In terms of legal services we consider that if an amalgamation proceeds, that a value for money assessment be carried out on the pros and cons of internal versus external legal advice.

2.2.6 Administration Building

<u>BR Estimates</u>

- Conservative sales proceeds of the Waitomo administration building of $450,000.
- The government valuation by Quotable Value is $570,000, and there was an independent confirmation of the recorded market value of $700,000.

[4] Page 17

<u>CSL Comments</u>

We have not checked these figures. Although it could be expected that the building would sell for about the assessed current market value, or at least at a premium to the government valuation, adoption of a conservative sales value for this review is prudent as the assumption is that the sale would occur within one year and the nature of the building may limit the potential range of buyers.

In our view, the BR estimates for other building related savings (page 18) seem fair and reasonable.

2.2.7 Roading Subsidies

BR provided us with a copy of a communication from Transfund identifying a reduced level of Transfund roading subsidy of $62,000.

2.2.8 Other Savings

A cost saving of $20,000 for consumable items based on the estimated staff reductions seems conservative.

2.2.9 Transition Costs

We consider the BR estimate for redundancy provision of $300,000 would be adequate for the potential reduction in staffing across general staff. It is possible that this provision may not be fully utilised if staff leave by attrition during the amalgamation period and therefore don't receive redundancy, or if certain staff are not entitled to a full 6 months redundancy payment.

This provision is probably sufficient to also meet redundancy payments for one of the CEOs. The adequacy of this provision would however depend on whether or not the CEO that was made redundant had a significant remaining period on his or her employment contract. If the new Council decided to advertise, and appointed a new external candidate, then both existing CEOs could be made redundant as a consequence of amalgamation. We do not have details on these employment contracts such that we are able to form a view on an appropriate provision in this area.

Other transition costs (redundancy support, recruitment and change management; financial information, strategy documents and records; corporate, regulatory and environmental policies; rebranding, miscellaneous capital expenditure and a contingency provision) outlined by BR (pages 19 and 20) seem fair and reasonable.

2.1.10 Strategy Documents and Financial Systems

BR Estimates

BR estimated $50,000 for combining financial information, strategy documents including the LTFS (and the LTCCP), Funding Policy and Treasury Management Policy and other records.

CSL Comments

We understand that both Councils operate the same financial systems (Napier Computer Systems) which would make the combination task a relatively straightforward one. While there may be some transitional issues to resolve if there are different data structures and chart of accounts, this should involve minimal cost.

We consider, however, that this category of transitional cost is probably understated by approximately $50,000. We estimate that a total cost of up to $100,000 would be required to meet project management costs, financial and systems advice, copy-writing, printing, etc, in the first year.

We also consider that the LTCCP should not be referred to as a transitional cost in the above assumptions. This could be started in the 2004/05 year for adoption prior to 30 June 2006.[5]

Although BR referred to costs associated with the Local Government Act 2002 ("LGA 2002") (page 8 of their report), they did not include any cost savings on the basis that these would not constitute savings of costs already incurred.

We consider that there would be additional ongoing annual cost savings of approximately $50,000. Cost savings would arise from the need to produce only one LTCCP and Annual Plan (rather than one for each Council); from reduced duplication and economies in preparing assessments of water and sanitary services, a waste management plan, and in involving Maori tribal authorities in decision-making processes particularly where decisions relate to water bodies or waterways.[6]

Larger Councils will have a greater capacity to resource from within its own staff the increased consultative and reporting requirements required in the LGA 2002.

[5] LGA 2002: *280 Long-term council community plan for period beginning on 1 July 2006:* Every local authority must adopt under section 93 a long-term council community plan for a period beginning on 1 July 2006.

[6] LGA 2002: *285 First assessment of water and sanitary services:* Every territorial authority must, not later than the close of 30 June 2005, make its first assessment under section 125 (which imposes a requirement to assess water and sanitary services).

LGA 2002: *286 Waste management plan*: If, at the commencement of this section, a territorial authority does not have in force in respect of its district a waste management plan adopted under section 539 of the Local Government Act 1974, that territorial authority must, in the period beginning with the passing of this Act and ending with the close of 30 June 2005, adopt a waste management plan under that section

2.3 Discounted Cash Flow Analysis

Discounted cash flow analysis (DCF) is a method of analysing the impact of cash flows over time. Net Present Value (NPV) is one of the techniques that can be used.

BR included in their report a calculation of the net present value (NPV) of future cash savings from the proposed amalgamation.

NPV calculations are a valid and useful method of showing the accumulated benefit of a series of future savings, while recognising that the value of money in future is less than in the hand today.

We consider, however, that a NPV analysis beyond a period of 10 years for a proposed amalgamation of local authorities has little validity, for the following reasons:

- Individual Council LTFS/LTCCPs do not extend beyond 10 years, and the precision of estimates in the latter part of the 10 year period reduces.
- In general, the impact of discount factors used in such calculations is such that the impact of savings in the years beyond year 10 quickly reduces to become immaterial.
- It is impossible to forecast in perpetuity what the role and functions of local government will be.

We believe ratepayers are more likely to understand, and will wish to focus on, their individual annual level of saving. Ratepayers will want to know the annual effect on their rates bill.

While it is useful to include in the report, for the public at large DCF analysis is a complex concept.

We suggest that the key emphasis instead be placed on a combination of year one savings (including the offsetting impact of transition costs) per average rateable property, and annual savings per rateable property for year 2 and subsequent years.

Based on the figures in the BR report year one savings are estimated to be $95.90 (including the offsetting impact of transition costs) per average rateable property, and annual savings per rateable property for year 2 and subsequent years of $112.69. The year one, and subsequent year, savings are significant and ongoing. For an average ratepayer, with all future costs remaining unchanged, the annual savings would accumulate over a 10 year period to $1,110.

BR's letter to the LGC (12 September 2003) identified an error in their August 2003 report for the 10 year NPV figures.

We have performed our own calculation of the NPV of the estimated net savings contained in BR's August report. The NPV of these savings for 10 years, at a discount rate of 4.75%, is $7,727,864, or an average of $865 across the 8,936 rateable properties. Our calculation agrees with the corrected numbers in BR's letter.

The discount rate in the NPV is based on the weighted average cost of capital ("WACC"). The WACC[7] for a Council will depend on the cost of debt and equity. BR have based their assumption of 4.75% on the average of the opportunity cost to a ratepayer of investing in a diversified portfolio (with returns of approximately 5%) and a real pre-tax interest rate of 4.5% based on the Council cost of borrowing. For the purpose of this review, in our view these assumptions are reasonable.

Because the calculation of a Council WACC involves a subjective judgement on the cost of equity and the proportions of equity and debt, it is useful to carry out a sensitivity analysis to see the impact of using a higher discount factor. A higher discount factor will also have the effect of reducing the benefit in today's dollars. If the average of the current borrowing rate of the two Councils was used (8.5%) as the discount factor, in this case the 10 year NPV would be $6,469,029. This would correspond to a saving of $724 per rateable property on average in today's money. Again, it would be better to simply focus on the actual net savings in year one, and subsequent years.

2.4 Adjusted Cost Savings

Based on our analysis, and the adjustments that we consider are necessary, we have tabulated below the resulting impacts in each year:

Year ***($000)***		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
BR estimated cost savings	*1007*										
CS adjusted cost savings		1057	1057	1057	1057	1057	1057	1057	1057	1057	1057
BR transition costs	*600*										
CS adjusted transition costs		650	-	-	-	-	-	-	-	-	-
Sale of assets	*450*	450	-	-	-	-	-	-	-	-	-
Net savings	*857*	857	1057	1057	1057	1057	1057	1057	1057	1057	1057
Average saving per rateable property (8936)		$96	$118	$118	$118	$118	$118	$118	$118	$118	$118

[7] The cost of capital is used as the discount rate in an NPV calculation.

3. Conclusions

In Capital Strategy Limited's opinion:

- The assumptions applied by Beattie Rickman to determine the financial costs and savings were appropriate (comprehensive and reasonable), taking into account the high level nature of the financial analysis.
- The transition costs and total estimated savings can be reasonably arrived at based on the assumptions applied, except that:
    - the transitional costs in year one are probably understated by $50,000 for project management and other costs to integrate strategy documents and financial systems
    - the redundancy provision may be understated in relation to one or both existing CEOs being made redundant, subject to the provisions and duration of their employment contract
    - there would be a further $50,000 ongoing annual cost saving arising from lack of duplication and economies in meeting the new consultative and reporting requirements in the Local Government Act 2002.
    - The net impact of these above changes would be:
        - a reduced saving in amalgamation in year one of $50,000 due to higher transition costs offset by increased savings of $50,000 in relation to compliance with the LGA, i.e. a neutral effect
        - a further annual saving of $50,000 for subsequent years (savings in relation to the LGA)
        - Therefore the conclusion arising from the Beattie Rickman report that there are significant cost savings in year one and subsequent years arising from amalgamation remains valid.
- Beattie Rickman had acknowledged an error in the 10 year NPV calculation in their August 2003 report. This error does not affect the conclusion in the BR report that there would be material cost savings from an amalgamation.
- The focus should be placed on the material estimated annual cost savings in year one and subsequent years per ratepayer, rather than on the use of an NPV calculation.
- If a NPV calculation is to be used, the period should be for no more than 10 years. This corresponds to the statutory disclosure period in the Local Government Act, and also the period applied by both Otorohanga and Waitomo District Councils.