Comments for the Local Government Commission (LGC) on the Morrison Low (ML) report

Summary

We consider the report to be fatally flawed and of no credible value. We ask that the LGC reject or discard its analysis and conclusions. We do not believe the report could withstand independent (of ML, AC or LGC connection or association) professional peer review without significant amendment.

We show below and conclude that the empirical data does not support a recommendation that a NRUC is not a reasonably practical option. The ML model is not a correct representation of how such a reorganisation for North Rodney could best work and is based on false assumptions.

You already have our extensive list of questions which highlight our concerns about the report and to which we have not received responses. These comments are in addition to the comments in that list of questions.

We repeat our disappointment and dismay that the report was leaked to the media and that a misleading and factually wrong statement about rate increases was subsequently headlined. The damage done to the objective evaluation of reorganisation alternatives to Auckland Council (AC) cannot be repaired. Publication has reinforced the myth prevalent in part in the public mind that the consequences of amalgamation are to be endured because the alternatives are worse.

The only responsible and credible course of action for the LGC now is to commission an independent, transparent and publicly available, professional model of our NRUC proposal.

Blatant prejudice against applicants

The consultants and LGC have not made the modeling and data in the analysis available for scrutiny by the applicants. The only data are summary numbers provided in the report and the base data provided by AC in response to the ML query on behalf of LGC.

Since AC has not provided consolidated financial data for the applicants, something that has nonetheless been done by AC at least for the Rodney Local Board area, and by ML for the options, this constitutes a deliberate bias against the reasonable analysis of the report by the applicants (who do not have the resources of the LGC) forcing them to endeavor to reverse engineer the report or undertake their own analysis. This disadvantage and exclusion is contrary to both the express reorganisation purposes of the Act and to natural justice.

We are forced to the view that the unwillingness of the consultants and LGC and AC to make the full analysis and workings of the financial modeling done for the report, and the financial analysis done for the Rodney Local Board area and its components, publicly available, will be seen as confirming that the consultants and LGC and AC are working to support the status quo and worried that public scrutiny will further expose the weakness and inadequacies of the report and the poor treatment by AC of residents and ratepayers in the Rodney and North Rodney areas.

Report assumptions

There is no credible a priori basis for the main assumption in the report - that the cost structure of AC would continue to apply in a separate NRUC or District Council. The assumption that the service quality can only be provided at AC's level of unit costs has no empirical support. The model provided by the applicant was not tested.

The assumption that the options provided by LGC can be compared with the status quo by assuming a continuation of the status quo avoids questioning the cost structure of AC's service provision - which was one of the reasons for the reorganisation application in the first place. It implies a subjective bias for the status quo and does not test reorganisation alternatives against it. In this regard, the report is a nullity.

The assumption that separating organisations necessarily adds costs (e.g. by increasing overheads) has no empirical basis and belongs in the same category of conventional myths as the view that amalgamation of organisations necessary provides efficiencies or economies of scale of scope. The consultants make no allowance for true efficiency from more focused governance and management - avoidance of wasteful spending (exampled by unnecessarily expensive provision or providing things communities don't want or derive no benefit from).

We invite ML or the LGC to provide verifiable and proven empirical evidence (not anecdotal or just examples) to refute our conclusion regarding these assumptions.

Consultants comments and observations

The comments of the consultants in the report are:

- subjective (i.e. views or conjecture stated without supporting evidence);
- in places, wrong (as in the fallacious comment that total rates needed to increase 48% to cover the shortfall in their option 4 model); and
- step outside the bounds of logic.

In our set of questions on the report we have already drawn attention to areas where the consultants' comments are subjective views not reasoned from any analysis.

If the consultants cannot correctly discriminate between general rates and total rates it casts doubt on the credibility of the rest of the report.

It is simply not credible to argue that higher levels of representation and community governance are a benefit, and then to claim that a corresponding dis-benefit is that it will encourage other local board areas to seek similar benefits. Community representation and determination of their governance are **rights**, not a **treat** or an **extra** that may be denied one because others would then have to unfairly miss out. It is akin to denying a child its right to education and food because to do so will mean other children may then also want education and food!

Cost Structure failings

The consultants assume the cost structure of AC applies to the activities in each of the options modeled in order to show that costs exceed current revenues and thus support their conclusion that Options 4 (and 6) are not “reasonably practical”.

As they provide no other reason for their conclusion, this means that if the NRUC, for example, could operate profitably at current levels of revenue it must be a reasonably practical option.

In Option 4 (which most closely represents the applicants model) no allowance has been made for the fact that costs in smaller councils are lower than in AC and therefore that is it is reasonable to expect that a NRUC will run at a lower level of unit costs than AC does.

Personnel costs overstated in ML estimate

The 2015/2016 AC accounts show that Employee Benefits make up around 23% of Group Operating Expenditure (Opex). However, AC contracts out specialized high unit cost activities to consultants - this helps to reduce the apparent high unit costs of their staff.

(Ironically it also dispels the argument that AC has material economies of scope, since contracting out the equivalent of 23% of their employee benefit costs demonstrates that they either do not have the skills in-house or do not need to have them in-house).

Allowing for spending on consultants and excluding depreciation and finance costs from Opex, personnel costs make up 36% of Opex. If it is recognized that construction costs also have a personnel component, then a proportion of depreciation should also reflect provision for that personnel component. This takes the personnel percentage of Opex (excluding finance costs) to 42%.

Using ACs FTE numbers (9,870 for 2016) we see that the direct employee benefit costs per FTE are around $81,000. Adding in consultants’ fees and members’ fees takes the cost to $100k per FTE.

Also, AC’s complexity actually adds cost in dealing with planning, management and controls across diverse multiple Local Boards and organizational functions and CCOs. It can be reasonably assumed that a proportion of the FTE’s AC needs can be eliminated in a scaled down more focused UC for a particular area and communities. The advantages of efficient specialized firms or CCOs can be sought on a shared or contract basis to eliminate the perceived disadvantages of not have the scale to employ dedicated specialists for sophisticated activities. We can then reasonably assume that AC’s people costs are up to 20% higher than in smaller more rural areas (further analysis should establish the appropriate percentage). Since this make up around 40% of the costs we can expect a reduction of (20% of 40%) 8% of total AC based expenses before finance costs. (Using the ML number of $77.0m, less the estimated finance costs (see below) of $11.8m = $65.2m). 8% of $65.2m gives a $5.2m reduction from the consultants’ model estimate of Opex before finance costs and reducing waste are considered.

Finance costs overstated.

ACs finance costs for 2015/2016 were $417m. On a pro rata Rating Unit (RU) basis this would imply financing costs of $11.8 have been imputed for Option 4. [ML do not provide their numbers]. This seems to align reasonably well with a share based on assets. Although the asset base and assumptions regarding which assets are imputed financing costs for NR is not stated by ML, a split based on earlier supplied AC numbers of $1.3billion for NR against a PPE for AC of $41.156billion would give an even higher allocation].
This level of finance charge is unreasonable since:

1) AC's financing costs are 4 times the nearest most indebted Council (i.e Christchurch), 10 times the average of other large cities and 200 times the small council average;
2) most of the AC borrowing since consolidation has been for Auckland (not NR);
3) the debt of the Rodney District Council before amalgamation was for projects which did not directly benefit NR and whose assets are not a part of the proposed NRUC; and
4) since AC has been taking more revenue out of NR than it has been spending back in the community since amalgamation, we consider that a pro rata share of AC debt is unreasonable.

In the absence of compelling evidence from AC to the contrary, we contend that the financing cost attributed to Options 4 or 6 should be no more than the small council average, i.e. $ 2.2m. This reduces the Opex estimated by ML by a further $9.6m.

Effect on financial model

Taking $5.2m and $9.6m off the ML estimate of $77m for Opex leaves $62.2m. Even before any allowance for reducing waste, we can see that against an estimated revenue base of $65.2m this is a very practical option.

Reducing waste

Focused delivery of products and services to communities that want and need them results in higher productivity or eliminating waste. Plenty of anecdotal evidence from local people supports the claim that local provision can be at lower costs than AC provision, or that over lavish proviso can be avoided because the community does not actually need "iconic" or "AC branded" activities or structures. Every 1% improvement is $0.77m in lower estimated Opex in the ML modeling. Given the overstatement in personnel costs and finance costs reduce the Opex estimate to $62.2 m, a reasonable 2% reduction in unit costs across the UC by reducing wasteful spending reduces expenses to $60.7m and allows a rates reduction of 15% to achieve breakeven. That does not seem beyond the bounds of "reasonably practical". At the very least LGC should model that as a possible outcome.

Revenue vs expenses (comparisons from other councils)

It is standard practice in valuation models to use a standard from across the industry as a comparative for modeling the potential or forecast performance and value of the business for a new owner.

ML have not done that - they have taken the worst and most non-standard model they could, i.e. AC, as their standard, added costs, and then compared that back to the standard.

Actual general and targeted rates revenue for North Rodney in 2015/2016 was $30.9m (from AC figures) and total revenue is estimated (by ML) at $63.5m.

Our model council, TCDC, has a cost per RU of $2,963, and $3,552 when its share ($407 per RU) of Waikato Regional Council costs re included.

If we assume a cost structure of the 44 district councils less than 50,000 population (i.e not cities) the average total expenditure per rating unit is $3,628. Notwithstanding the efficiency of UCs, if we allow for regional costs at the Waikato level, this increases to $4,035.

Applying $3,552 to 15,238 RUs for North Rodney we get a total expenditure of $54.1. At the other extreme, using the average expense per RU for Unitary Councils (excluding AC) of $4.168 provides a total expenditure of $63.5m.

The conclusion from a comparison of similar councils is that to balance likely expenses, total rates might have to either decease by between 30% and nothing, and the expected outcome (based on the average) is a decrease in rates of 7%. (summarized in the Expense Reassessment Table below).

We submit this does not support a conclusion that a NRUC is not a reasonably practical option. Rather it supports a conclusion that LGC should commission a proper modeling of our proposal.

Expense Reassessment Table			
	Expenses	Revenue	Rates Change to breakeven
	$million	$million	%
Rates		30.9	
Other revenue		32.6	
Total Revenue		63.5	
Expenses:			
ML Estimate	77.0		43.7%
less reductions for:			
Lower Personnel and related costs	5.2		
Fair finance costs	9.6		
Reducing waste by 2%	1.5		
Reassessed Expenses	60.7		**-9.1%**
Using TCDC costs (including regional costs)	54.1		**-30.4%**
Using an average of Councils <50,000 plus regional costs	61.4		**-6.8%**
Using an average of UCs costs (excluding AC)	63.5		**0%**

Northern Action Group (Inc.)
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