When will they ever learn? The financial implications of water ‘regionalisation’ for non-metropolitan New South Wales local councils

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Abstract: An inquiry into water and wastewater in NSW recommended the ‘regionalisation’ of water services away from local councils. However, these recommendations have yet to be implemented. This paper argues that any ‘regionalisation’ of water services will have disastrous results on the financial sustainability of local councils in non-metropolitan NSW. Since ‘bigger is not better’ in water services and the costs of ‘regionalisation’ are prohibitively high, the paper argues that the NSW state government should instead consider other methods of improving the efficiency of water and wastewater services.

Keywords: consolidation; local government; water.


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1 Introduction

On 15 August 2007, the (then) NSW Minister for Water Utilities Nathan Rees announced an Inquiry into the Secure and Sustainable Urban Water Supply and Sewerage Services for Non-metropolitan NSW. The NSW Department of Water and Energy issued a discussion paper entitled ‘Inquiry into the secure and sustainable urban water supply and sewerage services for non-metropolitan NSW’ in January 2008. The NSW Department of Water and Energy (2008, p.7) inter alia set out the ‘case for the inquiry’ by arguing that the NSW Best-Practice Management of Water Supply and Sewerage Guidelines represented the “key instrument for driving performance improvement by local water utilities”. While more than 85% of larger NSW water utilities, defined as utilities with over 10,000 connected properties, comply with these Guidelines, “compliance by smaller water utilities is significantly less”. By contrast, only 53% of “52 utilities with fewer than 3,000 connected properties” comply fully with the Guidelines [NSW Department of Water and Energy, (2008), p.8]. On the basis of this information, the NSW Department of Water and Energy (2008, p.7) argued “it is the smaller and marginally viable local water utilities that have the greatest need for adopting the guidelines to ensure long-term business sustainability”. In other words, the NSW Department of Water and Energy (2008) propagated the view that ‘bigger is better’ in water and wastewater services in non-metropolitan NSW.

The Terms of Reference of the Inquiry into the Secure and Sustainable Urban Water Supply and Sewerage Services for Non-metropolitan NSW had two main objectives:

- to identify the most effective institutional, regulatory and governance arrangements for the long term provision of water supply and sewerage services in country NSW
- ensure these arrangements are cost-effective, financially viable, sustainable, optimise whole-of-community outcomes, and achieve integrated water cycle management.

However, while the Terms of Reference provide a set of broad criteria which the Inquiry must invoke, they offer no further detailed guidance regarding the different ‘institutional, regulatory and governance arrangements’ that should be considered by the Inquiry. This was problematic since numerous alternative institutional arrangements are possible.

In an effort to address this shortcoming in the Terms of Reference, the Local Government and Shires Association of New South Wales and the NSW Water Directorate commissioned an options paper on the Inquiry into Secure and Sustainable Urban Water Supply and Sewerage Services for Non-metropolitan NSW prepared by Davis et al. (2008).

In the Options Paper, Davis et al. (2008, p.3) identified nine possible institutional possibilities. However, in a critical caveat to their discussion, they observed that “in view of the sheer geographic size of NSW, the fact that there are currently so many water and sewerage providers involved, and the diversity of physical, demographic and economic situations that apply; it seems unlikely that any one option will suit all circumstances state-wide”. This implied that the range of options presented was “based on the premise that there may well be two or more options which are ultimately implemented in parallel, to suit local circumstances”. In other words, the options paper is at pains to stress that a ‘one-size-fits-all’ approach is inappropriate in the NSW water and wastewater milieu.

The nine different models set out by Davis et al. (2008, p.3, Table 1) included retention of the status quo, but ruled out full privatisation. These nine different policy
models embraced the following possibilities: ‘a regional ‘mandatory’ alliance’; ‘county councils: service provision only’; ‘county councils: asset ownership’; ‘council-owned regional water corporations’; ‘state-owned regional water corporations’; ‘regional council aligned to catchment or sub-catchment’; ‘regional, NSW-wide agency: ‘country water’ model’; ‘disaggregated model: bulk supply, distribution and retail’; and the ‘status quo’.

In its final report, entitled ‘Report of the independent inquiry into secure and sustainable urban water supply and sewerage services for non-metropolitan NSW’, made public in December 2008, the Inquiry considered the nine different models proposed by Davis et al. (2008). It recommended that ‘three organisational structure options be considered for the future delivery of water supply and sewerage services’. These options were the ‘binding alliance’, ‘council-owned regional water corporations’ and ‘current arrangements for certain existing general purpose councils and county councils’ or the status quo [NSW, (2008), p.67]. It should be noted that the NSW (2008, p.68) added the caveat to its recommendation that “the county council model should only be considered for future aggregations if it is the preferred model of all constituent councils and that it can be demonstrated that the impacts on councils’ viability, economies of scope, employment and local communities can be adequately managed”.

For the analytical purposes of this paper, the nine options offered by Davis et al. (2008), as well as the three actually recommended by the NSW (2008), can easily be reduced to two main models for economic investigation; ‘small’ local entities and larger ‘regional’ entities. If significant scale economies and/or scope economies attach to water and wastewater activities, then this obviously suggests that ‘bigger is better’ in economic terms and large entities ought to be favoured, as a general rule, by policy makers. Conversely, if no substantial scale economies and/or scope economies attach to water and wastewater activities, then this plainly suggests that ‘bigger is not better’ in economic terms and small entities ought to be favoured, as a general rule, by policy makers.

Whether or not scale and scope economies exist in water and sewerage operations is an empirical question. Unfortunately, in the Australian context very little evidence is available on the question. However, the Independent Inquiry into the Financial Sustainability of NSW Local Government’s (‘Allan Report’, 2006) Final Report, Are Councils Sustainable? investigated this matter. In Chapter 10 ‘Council Governance and Management’, the LGI (2006) directly considered the problem of the optimal structural arrangement for water and sewerage utilities in NSW. On the question of scale economies in water and wastewater services, the LGI (p.265) observed that “expert opinion was negative, due to the fact that water pumps and sewerage treatment works are locally based with short networks”. However, “if within a reasonable distance of a water-rich council there were councils that were water poor, it could be to their mutual advantage to establish a joint water reticulation authority”.

Three further papers considered the questions of scale economies in water and wastewater provision outside of metropolitan areas. Woodbury and Dollery (2004) investigated the relative efficiency of wastewater providers in regional NSW. The results indicated that considerable potential for performance improvement of the utilities was available. Byrnes et al. (2009) found a significant disparity in relative efficiency scores between wastewater utilities in NSW and Victoria, with the latter more technically efficient when compared to utilities in NSW of a similar size. However, this was due to superior governance arrangements and not scale economies. Byrnes et al. (2010)
estimated the relative technical efficiency of urban water utilities in regional NSW and Victoria and found Victorian water utilities exhibited a higher degree of managerial efficiency.

Given the absence of scale economies in water services, the ‘Allan Report’ (2006, p.265) instead recommended a ‘shared service approach’ to improving efficiency. In particular, since “the problem of hiring suitably qualified staff in the regions is becoming increasingly acute”, adjacent local councils could share skilled professionals, although “provision of the service could still be the responsibility of each council, and the attendant revenue streams could still accrue to each council”. In addition, the Report noted that “there are other ‘back office’ costs that may be cut using a jointly owned shared services centre or outsourcing to a third party”.

However, while the efficiency characteristics of these two methods of structuring water and wastewater services represent a vital consideration for the Inquiry, its Terms of Reference obliged it to investigate other dimensions of the problem, including the potential impact of structural reform on local council finances. In order to address this important question, we examine the direct economic consequences of the removal of water and wastewater utilities from non-metropolitan local councils in NSW.

This paper will thus explore the financial contribution that water and sewerage services make to the financial sustainability of non-metropolitan councils in NSW, not only by providing additional and vital revenue to these councils, but also by assisting councils to generate scale economies and scope economies in the provision of the broader range of general local government services provided by local councils. In addition, we consider the effects of a ‘regionalisation’ of water and sewerage services on the operations of councils and their ongoing capacity to provide a broader range of local government services.

The paper is divided into six main parts. Section 2 provides a review of local government sustainability in NSW against the broader backdrop of Australian local government financial sustainability. Section 3 considers the role that water services and sewerage services play in the overall operations of local government in non-metropolitan NSW. Section 4 analyses the efficiency of corporate overheads in NSW local government. Section 5 discusses the likely effects of removing water and wastewater services from local government ownership and control in local organisational and local capacity terms. The paper ends with some brief concluding remarks on the potential policy implications flowing from a ‘regionalisation’ of water and sewerage services in non-metropolitan NSW local government in section 6.

2 Financial sustainability in NSW local government

Before the effects of a potential ‘regionalisation’ of the provision of water and sewerage services in non-metropolitan NSW are considered, it is worth briefly noting the existing state of financial stress in NSW local government since this will provide an indication of the local government sector’s capacity to absorb a further loss of revenue and functions from its operations.

Over the recent past, a large number of official inquiries’ reports, including the ‘Hawker Report’ (2003), the South Australian Financial Sustainability Review Board
(2006), the ‘Allan Report’ (2006), the WALGA (2006) and PricewaterhouseCoopers (PWC) (2006) national inquiry, have all found that Australian local government is currently under intense financial pressure. Quite apart from the increasing costs of service provision, local councils face rising expectations from their respective communities to deliver both more and better quality services, including those beyond the traditional focus of local government. State and federal governments’ expectations of local government have also never been greater, with municipal authorities increasingly forced to implement the policy objectives of these higher tiers of government (CGC, 2001). At the same time as councils are grappling with these increased expectations, as well as the resultant cost-shifting expenditures associated with their implementation, they have limited means of raising sufficient revenue to meet the higher expectations, they struggle to maintain sustainability in their operations, and they are attacked on the efficiency of their operations (Johnson, 2006).

It is thus clear that Australian local government is currently under intense financial pressure. It has the additional problem of controlling large amounts of local infrastructure that will need replacing or renewing in the very near future (see, for example, CGC, 2001; ‘Hawker Report’, 2003; LGI, 2006; PWC, 2006). The gap between what local communities and other levels of government demand from local councils, together with the asset renewal requirements confronting many councils, and the funds that local government can raise to meet these demands, is growing at an alarming rate.

Table 1 provides a useful illustration of the extent of the financial sustainability problem facing Australian local government, with an estimated 35% of the 700 municipalities in the Australian local government sector classified as being ‘non-sustainable’. At the heart of this problem is an estimated $2.16 billion per annum required to fund the gap to clear both the estimated assets backlog and to cover the annual ‘under-spend’ on asset renewals, representing around 9% of total revenue [PWC, (2006), pp.11–12).

In its Final Report, the PCW (2006, p.13) observed that local councils classified as ‘rural remote’ and ‘rural agricultural’ had ‘more pronounced viability problems’ when compared to their metropolitan counterparts. Moreover, these non-metropolitan councils “often battled against lack of scale and extra funding for renewal of existing community infrastructure is required for most”.

In the context of NSW local government specifically, the ‘Allan Report’ (2006, p.7) found local councils have an infrastructure renewal backlog in excess of $6 billion, which is expected to grow to almost $21 billion within a 15 year period if not addressed urgently. The ‘Allan Report’ further estimated that it will require around $900 million a year to address this backlog. The ‘Allan Report’ (2006, p.71) also established that the extent of cost shifting, when extrapolated, amounted to $430 million per annum or 6.9% of ordinary revenue before capital items. In addition, the ‘Allan Report’ (2006, p.24) found that the operating result before capital items was negative. Indeed the Access Economics Report undertaken for the ‘Allan Report’ (2006, p.17) argued that, excluding commercial activities, local councils on average had an operating deficit of almost 5% of their total own-source income. Moreover, only one in four NSW councils are currently running operating surpluses for their general government activities [Access Economics, (2006), p.19], while half are running adjusted operating deficits in excess of 10% of their own-source revenues [LGI, (2006), p.279]. Figure 1 highlights the extent of the individual operating surplus ratio for each NSW council.
## Table 1

<table>
<thead>
<tr>
<th>Access economics and MAV financial sustainability summary results</th>
<th>Backlog in infrastructure renewals (Sm)</th>
<th>Underspend on existing infrastructure renewals per annum (Sm)</th>
<th>Est. funding gap per annum (Sm) (to cover backlog and annual underspend) to be generated via savings or extra revenue grants</th>
<th>Est. funding gap per council per annum (Sm)</th>
<th>% of councils unsustainable</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW (152 LGBs – access)</td>
<td>$6,300</td>
<td>$500</td>
<td>$200</td>
<td>$5.9</td>
<td>25%</td>
</tr>
<tr>
<td>SA (66 LGBs – access)</td>
<td>$300$¹</td>
<td>$20</td>
<td>$40</td>
<td>$0.8</td>
<td>38%</td>
</tr>
<tr>
<td>WA (142 LGBs – access)</td>
<td>$1,750</td>
<td>$110</td>
<td>$220</td>
<td>$1.5</td>
<td>68%</td>
</tr>
<tr>
<td>Vic (79 LGBs – MAV)</td>
<td>$800$²</td>
<td>$81</td>
<td>$203</td>
<td>$2.6</td>
<td>10%</td>
</tr>
<tr>
<td>Total NSW/WA/Sa/Vic</td>
<td>$9,156</td>
<td>$711</td>
<td>$1,362</td>
<td>$3.1</td>
<td>35%</td>
</tr>
<tr>
<td>(441 LGBs: 63% of LGBs, 76% population and 73% of local xad km)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Low case national estimate</td>
<td>$12,012</td>
<td>$922</td>
<td>$1,826</td>
<td>$2.6</td>
<td></td>
</tr>
<tr>
<td>(700 LGBs) (apply WA, Vic, SA average result per council to 259 councils in Qld, Tas and NT)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mid case national estimate</td>
<td>$14,533</td>
<td>$1,129</td>
<td>$2,163</td>
<td>$3.1</td>
<td>35%</td>
</tr>
<tr>
<td>(700 LGBs) (apply WA, Vic, SA average result per council to 259 councils in Qld, Tas and NT)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High case national estimate</td>
<td>$15,305</td>
<td>$1,190</td>
<td>$2,281</td>
<td>$3.3</td>
<td></td>
</tr>
<tr>
<td>(700 LGBs) (apply WA, Vic, SA average result per council to 259 councils in Qld, Tas and NT)</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Notes: ¹Access estimate for SA based only the backlog developed over last ten years and full backlog will be higher.
The estimated funding gap to clear both the backlog and to cover the annual underspend on renewals is $3.1 million per council per annum or $2.6 billion nationally.

Source: PWC (2006, p.11)
When will they ever learn?

Figure 1 Operating surplus ratio,* by Individual NSW Councils (see online version for colours)

<table>
<thead>
<tr>
<th>Year</th>
<th>Access Economics</th>
<th>Published</th>
<th>Published</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>-6.2%</td>
<td>-6.5%</td>
<td>-6.2%</td>
</tr>
<tr>
<td>2002</td>
<td>-5.1%</td>
<td>-5.3%</td>
<td>-5.1%</td>
</tr>
<tr>
<td>2003</td>
<td>-4.3%</td>
<td>-4.5%</td>
<td>-4.3%</td>
</tr>
<tr>
<td>2004</td>
<td>-3.5%</td>
<td>-3.7%</td>
<td>-3.5%</td>
</tr>
<tr>
<td>2005</td>
<td>-2.8%</td>
<td>-3.0%</td>
<td>-2.8%</td>
</tr>
</tbody>
</table>

Note: *Operating surplus (adjusted onto a basis involving depreciation on council assets valued at closer to current cost) as a percentage of total own-source operating revenues.


Figure 1 tracks NSW local councils’ operating surplus ratio over the five year period ending in fiscal year 2004/05. By contrast, Figure 2 indicates that while the ratio has improved in recent years, it is still negative. The conclusion that follows inexorably from this analysis is that this situation is not sustainable in the long term.

In its analysis of the problem, the ‘Allan Report’ (2006, p.26) concluded that “the most vulnerable councils are rural ones whose small population densities mean that they do not have the financial capacity to maintain let alone renew their road infrastructure”. It is interesting to note that, for this group of councils, the ‘Allan Report’ (2006, p.27) maintained that “simply amalgamating them will not generate the savings needed for meeting their infrastructure obligations”. For the remainder of NSW local councils, the ‘Allan Report’ (2006, p.26) argued that to achieve sustainability in NSW local government will require “a combination of fiscal measures including rate deregulation, increased state and Commonwealth grants, greater application of user pays, increased operating efficiencies and increased borrowings”.

Figure 2 Operating surplus ratio* (see online version for colours)

Notes: *Operating surplus as a percentage of total own-source operating revenues. Both ‘published’ operating surplus ratios are based on published depreciation figures. The ‘Access Economics’ ratio is based upon estimates of annual depreciation were council assets valued at closer to current cost.

Source: Access Economics (2006)
The LGI (2006, pp.104–105) also reported that a number of non-metropolitan smaller rural councils with low populations and large spatial areas had become heavily dependent on grants for their very survival. Figure 3 provides an overview of this situation, where councils with generally low rate bases, due to their low socio-economic demographic composition, or due to the limited number of persons residing in their local government area, are forced to a greater reliance on rate revenue to support their operations. This situation need not necessarily be regarded as a ‘problem’ since it is precisely considerations of this kind that led to the formation of state local government grants commissions in the first place; the view then taken that all Australians should enjoy some minimum level of local service provision, regardless of the financial circumstances of their particular local council.

Figure 3  Distribution of revenue from all grant sources for NSW councils 2002–2003 (see online version for colours)

Figure 3 paints a somewhat dismal picture of the current state of local government finance in NSW, and a particularly disturbing future for non-metropolitan councils in the state, if the issues outlined in the various sustainability reports are not addressed as a matter of urgency.

3  Water and sewerage services in non-metropolitan NSW council financial sustainability

In NSW, local councils are prohibited from using the revenue generated from water supply and sewerage disposal activities for purposes that fall outside of these functions. Put differently, a given local council is prevented from using income produced from its water service and sewerage operations to fund activities falling under its general fund, such as local swimming pools, halls, libraries, road maintenance, and the host of other
local services provided by local councils. In fact, councils are required to keep completely separate its general fund operations from its water and sewerage fund operations. To this end, separate audited financial statements (or special purpose financial statements to be precise) are required to be prepared for the council water and sewerage ventures. At first glance, it could therefore be argued that the removal of the separate business activities of water and sewerage functions from the council’s general activities should have a minimum effect on the overall operations of councils.

However, in reality, quite the contrary holds true. Water and sewerage functions are fundamentally important to the ongoing financial sustainability of many rural and remote local authorities, regardless of their characteristics, including population size and spatial area. This is a result of the vital contribution that the water and sewerage undertakings make to fund the corporate overheads of the overall operation of each council.

To further appreciate the importance of the financial assistance rendered by water services and sewerage operations, it is worth noting that in NSW all local councils provide a wide range of services to their local communities, from town planning, waste management, libraries, aged care, youth services, emergency services, to parks and sports fields. Each function has its own revenue stream, which together with the municipalities general purpose revenue, and enable local councils to provide these and many other services. Underpinning each of these services are crucial ‘back-office’ functions which provide a variety of corporate support services to each of these activities. These corporate support services include the following: information technology, human resource management, payroll, revenue collection and management, accounts payable, purchasing, stores, customer service, financial management, statutory reporting, records management, risk management, and GIS support.

In addition to these ‘back-office’ functions, a council must also provide various technical services to its specific functions, including survey and design, construction, environmental services, specialised plant and equipment, mechanical support, asset management, and management support. Each of these corporate and technical support services activities employs staff, often a large number of people, depending on the size of the council, that work seamlessly across all activities and services provided by the local council.

It must be stressed that each of the numerous corporate and technical services that are provided by a local council are individually unaffordable. Put differently, each service in the general range of services provided could not economically obtain these corporate and technical services in its own right. However, collectively they can finance the overheads in question. Under the governance of a single local government authority, services can achieve sufficient scale economies and scope economics in their delivery to make payment towards overheads adequate to cover the requisite ‘back-office’ and technical service functions required.

Many of these services exhibit a degree of fixed costs, both in the short and long term. For instance, some information technology costs, such as finance systems and servers, etc., are fixed (at least in the short to medium term) regardless of whether the council’s income (or expenditure) varies across different financial calendars. We can place this argument in the specific context of local water and wastewater service provision. That is, a reduction of income (and expenditure) of say 15% due to the ‘regionalisation’ of water and sewerage services will not lead to, for example, a reduction in server costs or financial software. The cost of these items will still need to be funded from the remaining income of the council.
Even at the operational level, a council can also achieve significant economies of scope by the switching its multi-skilled work force between its different functions. For instance, an excavator and its operator can be used for both general road works and for digging trenches for water and sewer piping. This achieves greater utilisation of plant for both activities and thus reduces overall costs to the council and its ratepayers.

Multi-skilling and workforce diversification has assisted many rural councils attract and retain skilled staff by offering a variety of experience and career development opportunities, which would not otherwise be available. This competitive advantage in recruiting staff will be even more crucial if the labour market tightens in future and the skill shortage deepens.

A significant problem for local councils in non-metropolitan NSW involves attempting to separate the council employees associated with providing corporate and technical support to water and sewage activities from the provision of the council’s many other services, particularly in the short term. This is largely due to the multitude of staff involved and the fact only a small part of the workload of many employees can be attributed to the provision of a council’s water and sewerage function. In theoretical terms, this stems from the fact that, for example, in small councils which often employ a single specialist engineer and other comparable technical staff to handle not only water, but many other functions as well, these factors of production cannot be accurately functionally decomposed or ‘unbundled’ without inordinately high transactions costs. Nor would it be sensible from the point of view of the technical efficiency of the organisation.

It would thus be difficult to reduce staffing numbers and other corporate and technical costs in the short term. This leaves local councils with no option but to reduce other services, at least until it can restructure its operations in the long term. For instance, a senior engineering manager may spend 10% of his or her time on water and sewerage issues, with the remaining 90% allocated other local government activities. A contribution would thus be made from the water and sewer fund to the council’s general fund of 10% of the manager’s time in order to fund that proportion of the engineering manager’s time spent on water and sewerage issues, with the remainder funded from the general revenue of the council. Following any ‘regionalisation’ of non-metropolitan water and sewerage services, the council now has to fund 100% of the engineering manager’s costs from its general revenue (rather than only 90%).

It must be stressed that it is seldom feasible to ask the engineering manager to work 10% less and suffer a 10% pay cut to ensure that the council is not financially disadvantaged. In effect, in the short term, the 10% that the manager was working on water and sewerage issues (and paid for by the water and sewerage fund) will then have to be picked up by reducing other local government services to fund the entire position.

This example encapsulates the difficulties of adjusting to the loss of revenue and loss of contribution to corporate overheads. While the council may have identified that, for example, three full-time equivalent employees may no longer be required as a result of any ‘regionalisation’ of non-metropolitan water and sewerage services, the reality is that the three full-time equivalent employees are drawn from as many as 15 different staff members, providing just as many separate corporate and technical support services to the water and sewerage operations, making it all the more difficult to offer redundancies as a
short term solution to reduced funding. In a nutshell, the council cannot offer the human resource manager, the payroll officer and creditor’s clerk a redundancy to reduce its cost base as a result of losing its water and sewerage function; it still needs these officers to service the balance of the council’s operation.

The policy implication of this argument is straightforward: In the medium to long term, a council will be left with no choice but to restructure its organisation and reduce its staffing levels and expertise to match the reduced revenue stream resulting from the ‘regionalisation’ of water and sewerage services or find a substitute for this lost revenue.

4 Local council corporate overheads

Section 3 argued that non-metropolitan councils in NSW relied on their water and sewerage functions to contribute to the corporate overheads of the overall council operation. The next step in our analysis of the economic impact of a ‘regionalisation’ of water utilities is to review the corporate overheads of local councils and compare them with general accepted benchmarks to determine their relative efficiency and appropriateness.

As part of the ‘Allan Report’ (2006), a study was commissioned to consider the percentage of council overheads when compared with their total operating revenue and staffing numbers. The study used ‘corporate overheads percentage benchmarks’ developed by the NSW Council on the Cost and Quality of Government (CCQG, 2004) as the basis for comparing local government overheads. The CCQG (2004) assessment sought to determine the relative split between ‘front-line’ service delivery and ‘back-office’ support services. The CCQG used staffing numbers to determine the relative size of the agency (as opposed to revenue). Table 3 illustrates the results of the CCQG analysis of overhead costs for NSW state agencies. This indicates that overhead costs reduce as staffing levels increase, displaying the possible existence of scale economies and/or scope economies. More specifically, the CCQG investigation revealed that based on staffing numbers, the corporate overhead ratios of agencies reviewed varied between 6% and 27% with the average result being 17%. When considering on an expenditure basis, corporate overhead ranged from 7% to 39%, with an average overhead ratio of 18%.

Table 2 Desirable corporate overhead percentage benchmarks for general government agencies

<table>
<thead>
<tr>
<th>Number of FTE’s</th>
<th>Size of agency</th>
<th>Benchmark minimum</th>
<th>Benchmark maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 25</td>
<td>Micro</td>
<td>20%</td>
<td>25%</td>
</tr>
<tr>
<td>26–100</td>
<td>Very small</td>
<td>14%</td>
<td>16%</td>
</tr>
<tr>
<td>101–350</td>
<td>Small</td>
<td>12%</td>
<td>14%</td>
</tr>
<tr>
<td>351–1,000</td>
<td>Medium</td>
<td>10%</td>
<td>12%</td>
</tr>
<tr>
<td>1,001+</td>
<td>Large</td>
<td>8%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Source: CCQG (2005) with supplementary data on micro provided by Premier’s Department
It is also apposite to consider the observations of a report commissioned by the ‘Allan Report’ (2006, p.21) to measure the ‘back-office’ overheads of a representative sample of 58 councils (DG & AB Maxwell, 2006). This study found that these costs represented a mere 10% of a typical council’s operating cost. This is thus well within the best-practice benchmark of between 10% to 16% set by CCQG. Moreover, the study found that corporate efficiency of councils decreased as employee numbers increased, in a dramatic contrast to what the CCQG (2004) found for NSW state agencies.

**Table 3** Corporate overheads cost ratio for a sample of 58 NSW councils, 2004–2005 financial statements

<table>
<thead>
<tr>
<th></th>
<th>Very small</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of councils</td>
<td>22</td>
<td>22</td>
<td>12</td>
<td>2</td>
<td>58</td>
</tr>
<tr>
<td>Minimum</td>
<td>2%</td>
<td>5%</td>
<td>4%</td>
<td>Sample too small</td>
<td>3%</td>
</tr>
<tr>
<td>Maximum</td>
<td>17%</td>
<td>19%</td>
<td>19%</td>
<td>19%</td>
<td></td>
</tr>
<tr>
<td>Mean</td>
<td>9.09%</td>
<td>10.50%</td>
<td>11.67%</td>
<td>10.38%</td>
<td></td>
</tr>
<tr>
<td>Medium</td>
<td>9.5%</td>
<td>10%</td>
<td>13.5%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>95% confidence level for range</td>
<td>7.86%</td>
<td>9.34%</td>
<td>8.91%</td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>9.29%</td>
</tr>
</tbody>
</table>

*Source:* DG & AB Maxwell (2006)

The ‘Allan Report’ (2006, p.252) observed that Table 3 suggested that “corporate efficiency in the very small, small and medium councils out-performed the state government benchmarks (and even more so most state agencies results)”. In addition, the ‘Allan Report’ (2006, p.21) observed that “councils have lean corporate support structure, a good pointer to the general state of cost efficiency of an organisation”. Furthermore, the “corporate efficiency of NSW councils of all sizes, population and locations is at least comparable to, and possibly better than, equivalent-sized state government agencies” [LGI, (2006), p.252].

### 5 Effects of removing water and sewerage from local government

Thus far, this paper has sought to identify the areas in which councils will be damaged if the ‘regionalisation’ of non-metropolitan water and sewerage services occurred. Section 5 seeks to quantify these expected losses and place them in perspective relative to the other sustainability issues facing NSW local government.

Water and sewerage functions represent a significant component of councils existing operations, representing some 23% (or $742.1 million) of its operating revenue. In some cases, these services represent as much as 35% of a council’s revenue. Figure 4 shows the contribution that water and sewerage revenues make to the total operational income of local councils across non-metropolitan New South Wales.
The water and sewerage functions of a council also contribute to an improvement of the consolidated operating result (before capital items) of a local council. This is the result of most water and sewerage activities being provided on a cost-recover basis and achieving a small surplus whereas, as we have seen earlier in the paper, the general operations of local government have tended to be run in deficit. Table 4 highlights the extent of the operating deficits reported by councils and shows that, on a consolidated basis, the operating surplus ratio would be expected to deteriorate significant following the removal of water and sewerage services (i.e., commercial services) from non-metropolitan NSW councils.

Table 4 Operating ratio* 2004–2005

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>General government activities</th>
<th>Commercial activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW councils</td>
<td>−3.0%</td>
<td>−4.5%</td>
<td>6.5%</td>
</tr>
<tr>
<td>NSW state sector</td>
<td>1.5%</td>
<td>4.6%</td>
<td>−4.7%</td>
</tr>
</tbody>
</table>

Notes: *Operating surplus before capital revenues as a percentage of total own-source operating revenues.

For NSW councils, the operating surplus ratio is based upon estimates of annual depreciation where council assets are valued at closer to current cost, similarly to the basis used for state government agencies.

*For the state, excludes the state government-owned financial corporations.

Source: Access Economics

In their submission to the ‘Allan Report’, the Local Government Auditors Association of NSW [LGAA, (2005), p.2] argued that, in respect of the extent of operating deficits across NSW councils, “our assessment of most NSW councils is that they have either reached or are near the point where the operating revenue within council’s general fund is fully committed to recurrent expenditure and there is very little flexibility left in the budget”. The LGAA (2005, p.2) added that ‘there are a plethora of reasons given for this including rate pegging, rising costs (insurance in particular), increasing community
expectations, ‘unfunded mandates’ and dollar-matching grants that entice councils to take
on projects that both become recurrent and which, but for the grant funding, the council
might not otherwise have prioritised’. In other words, the removal of water and sewage
functions from councils will amplify their underlying operating deficit (before capital
items) which will further undermine their long term financial sustainability.

The fundamental issue at stake, in a financial sustainability sense, is the quantum of
the corporate and technical support services provided by a council’s general operation to
its water and sewerage ventures. Figure 5 shows the amount of these charges recovered
by each council from its water and sewerage funds.

Figure 5  Amount of management costs per council (see online version for colours)

As we can see from Figure 5, the total management cost of operating non-metropolitan
water and sewerage schemes in NSW amounted to $146.3 million and ranged from
$20.4 million to $25,000 for individual councils.

Figure 6 indicates the amount of these management costs as a percentage of total
operating revenue of the councils’ water and sewerages.

This potential loss of revenue represents some 20% of the total rate revenue of
these councils, or 5% of total ordinary income or 71% of their general-purpose
commonwealth-provided financial assistance grant (general component only). For
individual councils, the water and sewerage management costs range from less that 1% of
total ordinary revenue for a number of councils, to a maximum of 11% for Gosford
Council. The range of these costs in relation to rate revenue commenced at 2% for
Weddin Council to 46% at Cowra. Comparing the water and sewerage management costs
to the respective councils’ general portion of the financial assistant grant, these ranged
from 2% at Weddin to 328% at Gosford.

What are the policy implications of this analysis? In essence, it is no exaggeration to
stress that the ‘regionalisation’ of non-metropolitan water and sewerage services in NSW
will have a severe financial effect on the operations of many of the councils.
It may be objected that using water revenues to ‘cross-subsidise’ other municipal activities (or indeed vice versa) is unacceptable on efficiency and equity grounds. For example, it can be argued that from a public policy perspective, ‘cross-subsidisation’ of this kind amounts to arbitrarily taxing water and wastewater users, who thus bear a disproportionate share of corporate services, in order to provide other local public goods. It may be further objected that to contend that water and wastewater consumers should simply pay these extra charges so that the overall financial viability of councils is not threatened is illegitimate. After all, it may be contended, why should a large family which uses comparatively more water pay more taxes for the provision of corporate services which also support road construction, libraries and the myriad of other local government services? In essence, this line of reasoning hinges on the old axiom that ‘two wrongs do not make a right’ in public policy or any other terms.

In an idealised ‘first-best’ world, it is difficult to rebut objections of this nature since numerous standard public policy remedies could be used to tackle the problem of local government financial un-sustainability without cross subsidisation, such as ensuring the taxation base of local government is adequate or alternatively increasing the size of intergovernmental transfers to financially weak local councils (see, for example, Bailey, 1999). However, once we depart from this hypothetical state of affairs and enter the ‘second-best’ arena of ‘hard choices’ which characterises NSW local government, it becomes unwise to insist on first-best economic policymaking, given that few of the optimal conditions for ‘first-best’ policy making exist (see, for instance, Lipsey and Lancaster, 1957). For example, over the past three decades the NSW government has imposed ‘rate-pegging’ on councils which limited property tax increase to levels below the consumer price index, let alone the higher but more realistic construction and wage indexes (Dollery and Wijeweera, 2010). This has had dire effects on local government finance, but nonetheless has had such popular appeal that both sides of state politics support its continuation. Similarly, ‘cost-shifting’ from state and federal government onto local councils, in the form of unfunded mandates, partly funded additional responsibilities and continually rising prescribed service delivery standards, represents a significant ongoing impost on local government and continues to distort local government expenditure (Dollery et al., 2008). It should also be pointed out that the vast majority of local government services are funded from general revenue, rather than hypothecated revenue, which could give rise to numerous equity objections since obviously residents do not use these services in the same proportions.

Analogous other ‘n-best’ pragmatic policy considerations apply to NSW local government. In the first place, since local councils are creatures of NSW government
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statute, with no independent constitutional standing, if state government intervention in water and wastewater service delivery cripple or even bankrupt financially unsustainable local authorities, then the NSW government must assume responsibility for the provision of at least those services essential for health and wellbeing of the affected local communities. There are thus solid practical grounds for state government policy makers to avoid policy measures which could cause damaging consequences along these lines.

Secondly, it is commonly held on equity grounds that in developed economies all residents should enjoy some minimum level of basic local public service provision as part of citizenship rights, regardless of their individual financial circumstances or the fiscal condition of the local authority responsible for their local government area. Indeed, the extensive Australian system of intergovernmental grants to local government, including Commonwealth Financial Assistance Grants, explicitly aims at equalising the financial capacity of local authorities to the extent that they are able to deliver specified minimum service standards to residents, despite any adverse effects this may have on efficiency (see, for instance, Mathews and Jay, 1972; Mathews, 1982; Worthington and Dollery, 1998, 2000).

It is thus argued in this paper that although in strict first-best theoretical terms cross-subsidisation of municipal services to cover corporate service costs cannot be defended on efficiency grounds, given the absence of many of the conditions necessary for optimal first-best policy making in NSW local government, second-best policy solutions must be sought. Accordingly, against the background of widespread financial un-sustainability in NSW local government, it is held that the ‘quarantining’ of water and wastewater revenues through the ‘regionalisation’ of water and wastewater services is not justified if acute fiscal distress in local government is an inevitable consequence.

6 Concluding remarks

This paper has argued that water and sewerage functions are critical to the long-term financial sustainability of non-metropolitan NSW councils. An important reason for this is that income from these functions enables country councils to attract a variety of skilled staff that would not otherwise be available. These functions also make a significant contribution towards the cost of a council’s corporate and technical support services. Water and sewerage services thus significantly enhance a local council’s ability to achieve scale and scope economies in its overall operations. All this makes a substantial contribution to financial sustainability.

We have sought to demonstrate that local government will have great difficulties in responding to the loss of its water and sewerage services in the short term and many local authorities may not be able to adjust, in some areas, even in the long term. In other words, if a local council loses its water and sewerage functions, it will not simultaneously decrease the cost base that supports these functions. Indeed, many of these costs cannot be reduced at all in the short term and must thus be covered by councils’ existing revenue streams or by reducing service levels in other activities. As we have seen, Australian local government faces severe financial pressure and significant questions are being asked over the sector’s ongoing financial sustainability. Similarly, serious questions should be asked by the NSW government, before it implements the ‘regionalisation’ recommendations of the Inquiry into the Secure and Sustainable Urban Water Supply...
When will they ever learn?

and Sewerage Services for Non-metropolitan NSW, over the ability of non-metropolitan councils to absorb these costs without significantly reducing services, at least in the short term.

The effect on each local council will differ depending on the particular circumstances of that council. It hardly needs emphasising that local government is an industry characterised by considerable diversity in many respects and thus the method employed to address the financial problems that will result from any ‘regionalisation’ of water and sewerage services must be tailored to meet the individual factors confronting different councils. A ‘one-size-fits-all’ solution will not work and will leave a number of councils in severe financial distress.

If the ‘regionalisation’ on non-metropolitan water and sewerage services was to occur, then suitable compensation packages would need to be negotiated with affected councils. This should include the consideration of paying an annual dividend back to each local council as compensation for a reduction in the contribution these services previously made to the councils corporate and technical support costs, which could be determined as a return on assets that the council has provided to the new regional authority. It should be noted that this compensation stipulation was also recommended in the Inquiry into the Secure and Sustainable Urban Water Supply and Sewerage Services for Non-metropolitan NSW. As an alternative policy remedy, any new regional water and wastewater authority could pay for the cost of the assets that the new authority has acquired, thus allowing the affected councils to invest the proceeds and use the returns to provide for the lost revenue. A third policy option for compensating the councils affected would require an increase in general rates of 20% (or $146.3 million) or an increase in the general portion of its financial assistance grant of 71% to reimburse councils for the loss of revenue and to enable them to maintain their existing range of local government services.

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Notes
1 We are indebted to an anonymous referee for raising this argument.