LOCAL GOVERNMENT NSW

LGNSW SUBMISSION

Local Water Stability – dividend eligibility criteria, calculation methods and other requirements

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LOCAL GOVERNMENT NSW

Local Government NSW (LGNSW) is the peak body for local government in NSW, representing NSW general purpose councils and related entities. LGNSW facilitates the development of an effective community-based system of local government in the State.

OVERVIEW OF THE LOCAL GOVERNMENT SECTOR

Local government in NSW employs more than **55,000 people**

Local government in NSW looks after more than **$136 billion of community assets**

Local government in NSW spends more than **$1.9 billion each year on caring for the environment, including recycling and waste management, stormwater management and preserving and protecting native flora and fauna**

NSW has 450 council-run libraries that attract more than **34.8 million visits each year**

Local government in NSW is responsible for about **90% of the state's roads and bridges**

NSW councils manage an estimated **3.5 million tonnes of waste each year**

NSW councils own and manage more than **600 museums, galleries, theatres and art centres**

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Introduction

Local Government NSW (LGNSW) is the peak body for local government in NSW, representing NSW general purpose councils, county councils and related entities. LGNSW facilitates the development of an effective community-based system of local government in the State.

LGNSW has been an active participant in the Town Water Risk Reduction Program (TWRRP) since its inception in February 2021. Cr Bill West, Mayor of Cowra, has represented LGNSW on the TWRRP Stakeholder Advisory Panel supported by LGNSW staff. LGNSW staff have also participated in working groups.

LGNSW responds from the perspective that Local Water Utilities (LWUs) are owned by councils and are accountable to the elected council. Councils are ultimately responsible for the effective and efficient management of LWUs.

This submission was endorsed by the LGNSW Board in February 2023.

1. Background

The Department of Planning and Environment (DPE) partnered with other agencies, LWUs and councils with the objective of enabling LWUs to manage risks and priorities in town water systems more strategically and effectively and, as a result, reduce risks to regional NSW communities over time. LGNSW has supported the program.

The program has delivered a number of initiatives including, an improved regulatory and assurance framework and the development of 12 guidance documents including one on dividend payments.

DPE issued a consultation paper on dividend methodology on 11 November 2022 and has conducted targeted consultations with key stakeholders, including LGNSW, the NSW Water Directorate and the LGNSW Joint Organisation LWUs Working Group. LGNSW welcomes the opportunity for the sector to provide additional comment in response to the consultation paper.

2. General Comments

LGNSW welcomes the review of the local water utility dividend eligibility criteria, calculation methods and other requirements. LGNSW supports the removal of any unnecessary and artificial barriers to the payment of tax equivalent dividend payments or payments from surpluses to general purpose councils or constituent councils of a county council.

LGNSW recognises that robust *'governance or regulation of dividends can aim to remove any unnecessary regulatory impediments to paying dividends, while seeking to ensure that local water utility dividend payments do not come at the expense of efficient pricing or appropriate service levels to customers'. (p. 10).*

LGNSW appreciates that the review is not intended to compel LWUs to pay dividends or to specify the level of dividends. This is important. LGNSW maintains that these matters must be determined by the individual councils who own the LWUs.

LGNSW recognises that dividends are important and agree they can potentially:

- enhance transparency and hence accountability around the performance of the utility's management in maximising efficiencies

- allow the council to determine how to best use its return on investment rather than simply retaining it in the water utility
- promote efficient financing of capital expenditure.

LGNSW recognises the requirement for LWUs as designated Category 1 local government businesses, to comply with National Competition Policy (NCP), which involves an expectation to generate a return on capital. It is also recognised that council/LWUs have further obligations under the National Water Initiative (NWI).

LGNSW also recognises that NCP requires LWU finances to be ring fenced from councils' general purpose funds however, this does not mean LWUs are independent of councils. LWUs report and are accountable to the councils that own them.

3. Response to Consultation Paper Questions

1. Why has your local water utility not paid a dividend from its surpluses? What determines whether it pays a dividend and, if so, how much?

Refer response to Q.2.

2. Why do only a few local water utilities pay dividends from surpluses?

Section 2.2 of the Consultation Paper clearly identifies the key reasons why the majority of councils don't pay dividends:

- the local water utility does not generate a surplus from its supply of water and/or sewerage services
- the local water utility (and its council shareholder) may prefer to retain earnings in the water utility to finance future capital investment (instead of debt financing) and/or mitigate any future price increases or revenue volatility
- the dividend eligibility criteria, cap on dividends and/or other requirements may impede dividend payments, either because:
  - the local water utility does not comply with the eligibility criteria
  - the compliance or regulatory burden of the eligibility criteria, cap on dividends and/or the other requirements may be considered too great.

Other factors that could be added to this list include:

- a lack of understanding of NCP and its requirements
- a lack of familiarity with the concept of dividend payments from council operations. Very few other council operations provide the opportunity for dividend payments.
- a culture of perceived LWU autonomy from councils.

The point that councils and LWUs prefer to retain earnings to finance capital investment rather than resort to borrowings, is particularly pertinent. It is widely recognised that councils are averse to debt across all of their operations and generally have very low levels of debt. Some still maintain a zero debt policy. Debt aversion is deeply entrenched in local government and is reinforced by the common public perception that a council is performing poorly if it incurs any debt. Debt can also be politically sensitive for local government.

However, debt aversion is not the exclusive domain of local government. It reflects the pervasive obsession with debt reduction and credit ratings by successive State and Federal governments over decades.

LGNSW supports the prudent use of debt by councils, particularly to fund long term infrastructure. However, it is recognised that entrenched perceptions of debt are difficult to shift in the short to medium term.

3. What, if any, implication does this have for our review of dividend requirements?

It emphasises the need to:
- Simplify the dividend payment process and remove the artificial or ill-defined barriers that currently exist
- Raise awareness of the opportunity for the payment of dividends and the potential benefits
- Increase understanding of NCP and its implications in relations to policy and practices
- Provide reassurance that the proposed changes will not compromise service levels, efficient pricing and planned capital expenditure needs of LWUs
- Recognise that many councils and LWUs will continue to build reserves to fund future infrastructure investment rather than resort to borrowings.

Dividend requirements and principles

4. What principles should be used to guide dividend requirements for local water utilities in NSW?

LGNSW agrees that dividend requirements should not seek to prescribe the level of local water utility dividend payments, nor should they impose unnecessary restrictions, impediments or regulatory burden on the payment of dividends.

LGNSW agrees that the following principles should apply to the payment of dividends by LWUs:
- efficient pricing
- service quality objectives.

LGNSW agrees in principle with the consultation paper conclusion that *"If efficient pricing and appropriate service levels are assured through the regulation and governance of local water utilities, thereby ensuring that dividend payments cannot come at the expense of these outcomes, we consider there is no need for restrictions on local water utility dividend payments (p.12)".*

However, it is recognised that many councils would also require the following criteria to be satisfied:
- an operating surplus
- adequate reserves to meet identified capital expenditure requirements.

5. Should there be a cap on tax equivalent dividend payments, or should the cap be removed?

The cap is an artificial and arbitrary constraint that should be removed. Ideally, the tax equivalent payment should have a factual basis. It should reflect, as closely as possible, the real level of taxes that would apply to an efficient and profitable privately owned LWU of a similar size. It should be scalable based on revenue or size (e.g. number of assessments). Councils and LWUs are not well qualified to determine the appropriate tax equivalent payment on a case by case basis. It is suggested that DPE provide a benchmark based on an average LWU that would provide a basis for estimation.

LGNSW also questions labelling tax equivalent payments as a dividend. The terminology is inappropriate and misleading. Dividends are, or at least should be, performance based. This would be the broader public interpretation. They should just be referred to as tax equivalent payments and recognised as an NCP requirement that is independent of the discussion of dividends. This is also consistent with the terminology used in the 'Regulatory and assurance framework for local water utilities.'

6. If there should be a cap on tax equivalent dividend payments, why and what should be the cap?

No. Refer response to Q.5.

<u>Dividends from surpluses</u>

7. Can the current criteria for dividends from surpluses be improved? If so, how?

LGNSW supports the potential criteria presented in section 5.1.2 of the Consultation Paper:

"Before taking a dividend payment from the surplus of the council's water supply and/or sewerage business, the local council must be able to demonstrate:

- *there is a surplus in its water and sewerage business*
- *the water and sewerage business has efficient pricing in place (prices recovering efficient costs, including developer charges) and is providing adequate levels of services to water and sewerage customers*
- *the financial reports of the business (water supply and/or sewerage) are a true and accurate reflection of the business, and that common costs (including overheads) are allocated in a reasonable way to the water and/or sewerage business*
- *the operational performance of the business (water supply and/or sewerage) is of a reasonable standard and meets the needs of customers".*

8. What are your views on the potential eligibility criteria presented in this Paper?

As per Q.7. – supported in principle.

9. Should the eligibility criteria consider any other factors, such as operational performance; what do you think about that?

As per Q. 7.

10. How could compliance with the eligibility criteria be best demonstrated?

As per Q. 7. e.g:
- surplus
- financial audit
- satisfaction defined performance criteria.

11. Should the current caps and restrictions on dividends from surpluses be removed?

LGNSW agrees that the caps should be removed. There is no basis for caps if eligibility criteria are met.

12. Should revenue from developer charges be included in operating income when calculating a local water utility's surplus?

LGNSW supports consistency with the NSW Local Government Code of Accounting Practice and Financial Reporting. Developer contributions for operating purposes should be included in operating income.

13. Should individual county councils be given flexibility as to how dividend payments are allocated across their constituent councils?

Yes. County Councils should be able to determine whether they pay dividends and if they choose to do so, how that dividend will be allocated across their constituent councils. For example, dividends could be allocated equally among constituents or they may be allocated on the basis of the number of assessments in each constituent council area.

14. What method or methods should a county council be able to apply when allocating dividends among its constituent councils, if such methods are to be specified in the Guidelines?

Refer response to Q.13.

15. Should there be any additional dividend requirements for county councils?

LGNSW defers to County Council water utilities on this question.

Information/reporting requirements

16. Can the current information/reporting requirements be improved to promote efficient dividend outcomes?

The current requirements appear to be appropriate. No additional requirements appear to be required to accommodate the proposed changes.

17. If individual county councils are given flexibility as to how to allocate dividend payments across their constituent councils, what if any assurance or reporting requirements should apply to these payments?

The only additional requirement to that of a council would be a simple statement from the county council explaining the allocation method and amounts and supporting it as fair and reasonable.

4. Conclusion

LGNSW is pleased to have the opportunity to make this submission to the Town Water Risk Reduction Program and looks forward to further consultation in the next stages of the review process.

For further information and enquiries:

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