



Inquiry into the long-term financial sustainability of Local Government



June 2017

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The Local Government Finance Professionals

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Committee Secretary
Infrastructure, Planning and Natural Resources Committee
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Inquiry into the long-term financial sustainability of local government

The Local Government Finance Professional Inc. (LGFP) welcomes the opportunity to make a submission to the Inquiry into the long-term financial sustainability of local government.

The LGFP Inc. (the Association) represents Queensland Local Government practitioners in the fields of accounting and financial management, and has members across the full Local Government spectrum and from most Queensland Councils.

Local Government financial sustainability is the most critical issue the Association have been addressing in recent years. Therefore we have given considerable thought to this submission. However, it is unfortunate the very short opportunity to make submissions has coincided with the peak Local Government budget development period.

This submission has been authorised by the Association's Executive. We would welcome the opportunity to discuss the issues raised with the Committee so as to achieve a framework which enhances Local Government financial sustainability. For LGFP policy matters, please contact LDGP Committee member Michael Shave on 07 5329 6229 or Michael.shave@noosa.qld.gov.au. For technical matters, please contact the Association's Technical Advisor, Mr David Spearritt on 07 3113 3644 or david@orionco.net.

We have also attached a copy of the report "Factors Influencing Financial Sustainability by Local Government Segment (2012), for LGAQ, which Mr Shave and Mr Spearritt were part authors.

Yours faithfully

Natalie Kent,
A/Secretary

Cc. Deputy Premier, Minister for Transport and Minister for Infrastructure and Planning

Minister for Local Government and Minister for Aboriginal and Torres Strait Islander Partnerships

Director-General, Department of Infrastructure, Local Government and Planning

1. Key financial sustainability Issues

Local Governments manage around \$100bn in physical assets, compared with \$185bn managed by the Queensland Government. Yet Councils only have \$9bn in operating revenue (including grants) compared with the Queensland Government with \$53bn. The Commonwealth has 2.8 times the revenue as its asset base. This makes Local Government the most capital intensive level of government as well as having the tightest revenue base from which to manage its assets. This imbalance has been exacerbated in recent years by significant cutbacks in commonwealth and state government grants, as well as limits being imposed on Councils in the developer contributions they are able to levy in order to finance new infrastructure to service new developments. Many smaller Councils were only able to finance water and sewerage infrastructure with most of the funds coming from programs from SCAP. It is hardly surprising that they struggle to replace these assets when they reach the end of their lives, since they were never able to fund them in the first place.

When accrual accounting was introduced in the 1990's there was very limited information about the assets or their asset replacement needs. Depreciation was usually calculated on a straight line basis against simplistic design lives estimates. The (Local Government) Department invented the term "Funded Depreciation" as a catch-all measure to ensure Councils generated enough cash to fund the depreciation, which was assumed to equate to the asset replacement needs. The term "funded depreciation" is not part of the accounting standards and is not used in other states. It confuses two related but different concepts. Depreciation under the accounting standards is an estimate of the amount of the asset value which has been consumed in a financial year. It is not required to be funded, and does not reflect an estimate of the asset replacement needs. What needs to be funded is the identified asset replacements as outlined in the asset management plans.

In many ways, when accrual accounting was introduced, the cart was before the horse. We needed asset management systems before introducing accrual accounting which requires sophisticated asset accounting. A consequence is that much of the thinking and financial ratios are based on depreciation rather than asset renewals. Initially the QAO set the bar for asset documentation very high and qualified the majority of Council's accounts because of inadequate documentation. As a result, most Council hired expensive valuers to independently calculate the asset value and depreciation parameters. This has led to generally overstated depreciation, and inconsistent valuations, because the valuers cannot have the detailed operational knowledge of the assets in the field. Then along came QTC which declared that 43% of Councils were weak or worse, because of large operating deficits. Yet the operating deficits were often due to overstated depreciation which was required to pass audit.

There are 3 levels of financial sustainability. In the short term, Councils need to be able to have sufficient liquidity to pay their bills. In the medium term Councils need to stay solvent, by having a sustainable balance sheet, especially sustainable debt levels. Finally, to be financial sustainability in the longer term, Councils need to be able to fund the replacement of assets at the optimal time in the life cycle. Many of the ratios currently prescribed are based on depreciation rather than asset renewals as the key sustainability issue. QAO's proposal to introduce a ratio based on the proportion of the asset renewal program which has been funded is a step in the right direction. Other ratios need to be changed also.

The evolution of legislative requirements Local Government financial management has resulted in a piecemeal range of policy, planning and reporting requirements. An overarching framework is required, as well as addressing the imbalance between Council revenues and asset responsibilities.

2. Financial Planning and Long-Term Forecasting

QAO) recommended councils improve the quality of their long-term forecasts and financial planning by: developing financial plans to explain their financial forecasts and how they intend to financially manage the council and its long-life assets (Chapter 2).

2.1 LGFP Response

We partially agree with the QAO recommendation. The concept of requiring Councils to explain the forecasts and financial management strategies is sound. However, expecting perfect 'crystal ball' forecasts ten years into the future is an absurd notion. Both QTC and QAO have been highly critical of the accuracy of Council forecasts when reviewed in hindsight. Yet the much better resourced state and commonwealth Treasuries have not been any more accurate in predicting future trends. As Niels Bohr, Nobel Scientist stated "*Prediction is very difficult, especially about the future*"

The real value of long term modelling and forecasting is in highlighting the cumulative impact of a Council's budget settings and financial strategies, and showing the impact of 'lumpy' capital works programs. Councils' cannot be expected to be able to predict the 10-year future of factors outside their control. What would be more useful is stress-testing various scenarios to see how Council's finances would be impacted – e.g. if Council builds infrastructure for a certain level of growth and the actual growth in the rate base is lower or higher. For small population Councils it might be wise to stress test different levels of grants.

Financial modelling and planning is driven by the underlying assumptions which are often hard to predict, such as:

- Growth in population and rateable properties
- Wages increases rate increases (election cycle decision making) government grants
- Asset valuations, useful lives, condition assessments, and the different valuation methodologies used by various valuers
- Legislation changes (i.e. capping developer contributions, and government cost-shifting)
- Economic factors
- Funding opportunities arising outside the budget cycle

It should be noted that only Local Government is required to prepare 10-year forecasts (LTFF), but State and Federal Governments are only required to publish 4-year Forward Estimates. In our experience, Councillors are primarily interested in the impacts of the remaining electoral cycle, since this is the period they have a mandate over.

We suggest that the Local Government Regulation be amended to rename the Long Term Financial Forecast to recognise the necessary limitations to the exercise. Alternations include Estimate, Projections, Plan or Outlook. Councils should be able to emphasise the current term of office. We also suggest the QTC reviews stress test the financial outcomes with best, worst and medium scenarios.

The reliability of LTFF is significantly impacted by Capital Projects which are often dependent on external funding i.e. Grants and Partnerships. Most Council would include these Projects in their LTFF by providing revenue sources for funding shortfall and recognising Whole-of-Life Costing (WOLC) in future years. This also impacts on Rating pricing paths.

3. Asset Condition Data & Management Plans

(QAO) recommended councils improve the quality of their long-term forecasts and financial planning by maintaining complete and accurate asset condition data and asset management plans (Chapters 2, 3, and 4)

3.1 LGFP Response

In a perfect world Councils would like have “accurate condition data and asset management plans”. However, specially updating the condition assessments is a very expensive and resource-intensive exercise and dates very quickly. It is particularly difficult and expensive to inspect the condition of underground assets such as water sewerage and drainage pipes. Camera technology is improving and being used for sewer mains but is also expensive. Simpler and more cost-effective information can be gained by monitoring sewer chokes and water main bursts which indicate problem areas. It is also not necessary to have accurate and regular condition assessments of long-life assets which are not near the end of their useful lives.

Councils would be best to apply the 80/20 rule-

- Focussing on the main asset classes (water, sewerage roads bridges and buildings which could account for upwards of 80% of a Council’s asset base)
- Focussing on the specific assets which are nearing the end of their estimated or useful lives, so that plans and financing can be made to renew them at the optimal time and manner.

Ideally systems and processes could be implemented to continually update this data periodically in a cost-effective manner. For example, field staff could log any asset damage in an app on hand held devices and then updated into the asset systems. Some Councils around the world have online facilities and app to enable members of the community to notify Councils of any asset defects. Progressively updated asset condition should then enable AMP’s to be continually updated.

Best practice is where the asset data is core to Council’s operations. Unfortunately accrual accounting (requiring asset information) was mandated before Councils developed asset knowledge. In the 1990’s the QAO audits required robust proof of asset assumptions and this led to widespread outsourcing of asset valuations and condition assessment rather than developing in-house systems and knowledge. It also led to ultra-conservative asset lives estimates, which has often resulted in depreciation being overstated. This in turn makes the operating result appear worse and the asset replacement ratio also appears worse.

The capacity of indigenous, rural remote and rural regional Councils to sustain ongoing asset management systems and processes is limited. Unless support is provided via regional resourcing or via state government resources it is unlikely that asset management will improve.

This issue would benefit from government funding pilot programs to develop ongoing condition assessment tools and automatic updating of key asset management planning information. LGFP would be happy to assist.

4. Decision-Making Frameworks for Major Infrastructure Investments

(QAO) recommended councils improve the quality of their long-term forecasts and financial planning by implementing a scalable project decision making framework for all infrastructure asset investments (Chapter 2)

4.1 LGFP Response

The QAO report focuses on project decision making and asset management planning as separate issues, when in reality they are part of the same asset management life-cycle. In fact these need to be subsets of an overarching financial sustainability strategy. Each Council needs to manage the whole cycle in ways that suit its requirements, governance setup, and skill levels.

Any project decision framework needs to be adapted for each Council's governance and management approach, rather than one-size fits all. Thresholds requiring PDF's need to be tailored for the size and issues of each Council. It would not be cost-effective for PDF of every project. i.e. exclude renewal programs (like for like) where the projects are supported by robust AMPs.

Commonwealth and State Government have not led by example in this area – Grant programs are announced out of the blue and tend to override Council's priorities. Government grants need to give priority to projects which have already passed some PDF process in Council;

QTC have a PDF toolkit, however there has been limited adoption by most Councils. The framework is more suited to grant-funded projects rather than those designed to meet community aspirations. The QTC PDF is too complex for most smaller to medium Councils to use. There is also the problem that Councillors (and some staff) feel threatened by having a financial model "telling them what to do or not do" and therefore they resist implementing a tool. The decision-making tools need to be designed to enable Councillors to make informed decisions rather than being railroaded to predetermined outcomes.

Technical skills and abilities regarding the undertaking of robust PDF is again a challenge for those Council categories outside of SEQ and regional centres. Training on the importance and benefits of a PDF approach for Councillors and key executive level staff in Local Government is required as currently a significant gap exists. This may be an area where QTC could provide expertise.

Elected members and management sometimes resist a framework as it may appear to reduce their ability to add projects or make significant changes to existing projects without preparing a business case and scope. However, this will increase accountability and governance, and is intended to enable Councillors to make fully informed decisions and get better value for their communities.

Seed funding for Strategic Project Management would be useful (relying on external funding or partnership)

- a) To assist Councils to identify and prioritise strategic projects based on a benefit to the community criteria (QBL format)
- b) To prepare shovel ready strategic projects for future funding submission. This would offset design costs in the operating budget and enhance project delivery timeframes.

Local Government Finance Professionals

Rather than a PDF we should be developing Asset Management Frameworks within an overarching financial sustainability strategy, which includes:

- a) Needs identification
- b) Prioritisation model // service level impact
- c) PDF with a review
- d) Project management including variations controls
- e) Debrief /review on completion of project
- f) Capital program management (refer Q1)
 - a. Budgeted CapEx Program
 - b. Strategic CapEx Program
- g) Asset renewals programs and funding

5. Community Engagement and Future Service Levels

(QAO) recommended councils improve the quality of their long-term forecasts and financial planning by: engaging directly with their communities on future service levels (Chapters 2 and 4)

5.1 LGFP Response

Many Councils already undertake ongoing community consultation, however consultation needs to be implemented with care. Councils provide a very large range of services, and it is almost certain that poorly planned community engagement will only raise expectations for higher, unaffordable service levels which elected officials feel pressured to deliver. Ideally community engagement should be over service level priorities and the link between service levels and rates, rather than attempting to deliver more from less revenue. There is also a risk that the people who attend the consultation sessions have a vested interest in additional services to benefit themselves, and may not reflect the wishes of the silent majority.

We would support the ability of Councils being encouraged to undertake high level consultation over its key budget decisions, but this should not be prescribed by legislation. For example, a Council could have a 21-day community consultation timeframe on Council budgets and financial plans (as it is done in some States and Territories). It could be up to each Council how detailed their consultation process is, but at the end of the day a 21 day notice period and the requirement for the Council to consider and respond formally to any comments from the public could help the community understand the financial difficulties being addressed. This could also possibly be used for major projects above a certain percentage of a Council's revenue base or assets.

Commonwealth and State Government have not led by example on giving priority to community needs. Grant programs are often announced outside the budget and consultation cycle and tend to override the Council's and community's priorities and funding sources.

Other jurisdictions such as New Zealand which have attempted budget consultation have not been very successful because of these problems.

This issue would benefit from government funding pilot programs to develop service level based community engagement processes which assist Councils in determining affordable priorities. LGFP would be happy to assist.

6. Financial Sustainability Ratios & Targets

DiLGP broaden the number of ratios required to be calculated over 10 years to include the asset renewal funding ratio, once councils have improved their asset condition data (Chapter 4). DiLGP allow councils to set their own financial sustainability targets where they can justify that a different target is more appropriate for their long-term sustainability (Ch 2)

6.1 LGFP Response

The inclusion of an asset renewal funding ratio was a recommendation of the AEC/Orion review (attached). There will never be a time when asset condition data is perfect. Implementing the alternative ratio/s now would help encourage Councils to focus on the important issues. Therefore we support the adoption of a renewal funding. This should replace the current mandatory asset sustainability ratio which compares asset renewals with depreciation and is often very misleading.

Most of the current indicators are adversely affected by using depreciation rather than renewal requirements as the indicator of replacement needs. The operating surplus is based on accounting depreciation rather than renewals. Although this is appropriate for the financial statements, it is a misleading indicator of a Council's ability to fund its replacement needs. Similarly the asset sustainability ratio now mandated is a comparison of actual renewal spending versus depreciation. This puts growth Councils and those with relatively new assets unnecessarily in a poor light. Consider a \$20,000 car with depreciation of \$2,000 per year over 10 years. This current ratio would show the zero replacements during the first few years when nothing needs to be replaced as being unsustainable.

Allowing Councils to set their own targets is likely to lead to widespread confusion, make benchmarking difficult and a reduction of financial sustainability. It is misleading to assess all councils using the same set of targets. Clusters of councils depending on size, location, employment/industry base will achieve different results, but this doesn't mean they aren't sustainable, just the results may be out of line with predetermined benchmarks. Many Queensland councils have been serving their communities for decades despite having poor ratios, poor (text book) asset management practices but still have bitumen town streets, pools, sewer, water, tidy parks, tourism facilities, can pay wages, they just need to live within their modest means.

The poor choice of the current indicators is causing the pressure for varying targets. Better ratios would overcome this problem. The Net Financial Liabilities Ratio compares net financial liabilities (debt less cash) with total operating revenue. The benchmark is currently 60%. Growth Councils are likely to need a much higher level of debt than current revenue, since they are providing for a future population and rate base. Conversely, stable or declining population Councils should have a lower ratio. A more appropriate ratio is Interest Cover, widely used by the private sector and banks, as well as QTC. This simply measures an entity's ability to pay the interest from its operations. There are accepted prudent ranges for this, and QTC uses a target of 4 times (4 times the operating revenue to pay the interest).

The operating surplus ratio would also be more accurate if based on a 20-year renewals annuity rather than depreciation. A renewals annuity of the annual amount required to fund the required in the asset management plans renewals over the next 20 years.

If the Net Financial Liabilities Ratio is to be maintained, rather than our suggestion of using Interest Cover, we would support the use of varying targets for differing circumstances, such as population and growth rates. However these should be set by the Department after consultation with Councils and LGFP.

7. Organisational Governance

Department of Infrastructure, Local Government and Planning strengthen their governance role, including analysing long-term planning documents, to allow the Minister to identify councils in, or becoming, financially stressed (Ch 3)

7.1 LGFP Response

Supported in principle. This recommendation is mainly aimed at DILGP governance.

The LGFP committee has met with the Director-General and senior DILGP staff in recent months and is developing a working relationship with them. We are confident that they understand the key issues.

The role of monitoring stressed Councils has been a traditional function of the department and should be supported. The governance role should also include examining the intellectual and resourcing capacity of Councils to ensure any adverse financial sustainability symptoms are understood and assistance is provided to put plans in place (i.e. asset management planning and project decision frameworks previously mentioned).

The Local Government component of DILGP has suffered large cutbacks from whole of government cuts in recent years, and has very limited capacity itself to provide additional governance.

This issue would benefit from DILGP making use of secondments from Local Governments in order to get a better appreciation of industry issues. LGFP would be happy to assist.

8. Strategic Planning and Organisational Capacity

Department of Infrastructure, Local Government and Planning support councils to strengthen their strategic planning by building their capability and capacity to produce 10-year financial forecasts and asset management plans that can be relied on, and are integrated with their annual budgetary processes. They should be renewed and updated at least every four years (Chapters 2 and 3)

8.1 LGFP Response

All levels of government have found financial forecasting very challenging, and we believe that Local Government is no worse than other levels of government. It has been especially difficult for Councils with large resource or tourism related industries because of economic volatility. As noted in our introduction, the notion of being able to forecast such a wide variety of factors over a ten-year period is deeply flawed and set up to fail. A more useful approach is to change the legislative requirement to have a ten-year financial forecast to requiring a ten-year financial estimates/outlook/projection, with stress testing of adverse conditions.

The significant challenge will be to provide ongoing capacity to those rural-remote, rural regional and indigenous Councils which have historically and will continue to struggle to attract and retain skilled resources to undertake the required analysis, plan development and ongoing monitoring and updating. Out of the box thinking will be required to find a sustainable solution to this issue.

Growth Councils will need to review their growth assumptions much more regularly than 4-yearly (depending on regional volatility).

9. Budget Transparency

DiLGP require councils to include in their annual budget or annual report statements:

- 1. the long-term financial forecasts for at least three subsequent years after the budget year*
- 2. reporting analysis of actual to budget figures (Chapter 2).*

9.1 LGFP Response

As outlined above we prefer that Councils be required to provide a ten-year outlook rather than pretending to be able to prepare a ten-year forecast of so many variables. These should be included in the adopted budget.

Reporting analysis of actual to budget figures is not supported. We believe that reporting actual vs budget in the budget or annual report would not be cost-effective, and would delay the preparation of the budget and/or financial statements. Ideally Council budgets are progressively reviewed and changed several times per year, usually adjusted for unforeseen circumstances. This includes government grants which are announced outside the budget preparation period. Budget amendments are adopted by Council and therefore are already publicly available information.

10. Procurement Policy and Value for Money

No specific QAO recommendations

10.1 LGFP Response

We support a review of procurement thresholds, which have not been updated in over a decade. Ideally these thresholds should be scalable rather than one size across such a huge range of Councils. One option would be to base the thresholds on the Council category. An alternative would be to base the threshold on a variable such as a percentage of Council rate revenue. Any threshold which do not automatically link to Council revenues etc. should be updated annually through a Bulletin issued by the Department, as occurs with other thresholds such as National Competition Policy matters.

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11. Other Matters

11.1 LGFP Response

The most important cause of difficulties in Local Government financial sustainability relate to its limited revenue base compared with its asset responsibilities. Impact of government cost shifting and grant cutbacks have been significant in recent years. Most of the QAO recommendations will only highlight the seriousness of the problem rather than address this underlying cause of the problem.

The Queensland Government now has a healthy operating surplus and should progressively restore the capital works subsidies. One option would be to reimburse a proportion of financing costs for approved projects, which would ease the government's cash flows and achieve a similar result. Since the 1930's capital works subsidies were provided in all years except two years of WW2. In many years the subsidy was by way of financing cost reimbursement. Ideally any of capital grants reintroduction should be focussed on renewal capital work not new assets, unless their renewals are up to date.

An alternative to restoring Council grants would be for Queensland Government agencies to pay Council general rates, rather than just the service charges. The lack of payment of Council rates is based on the principle that the different levels of government should not tax each other. However this principle does not really apply to Local Government general rates. The main expenditure from general rates is on roads, which are used by government agencies and their employees in the course of their duties. By paying Council rates (or a negotiated road service charge) would help improve the ratio between revenue and assets managed, and provide operating income from which to renew the assets.

It is important to address the impact of QAO audit standards on asset accounting and AMP's. Depreciation is often overstated due to the standard of documentation required to meet audit requirements. A more pragmatic approach would encourage Councils to make use of their own data and systems and gain a better ongoing knowledge of their assets than occurs when this is outsourced. External assistance should be guiding and facilitative rather than simply creating figure to put in the financial statements for audit purposes.

The current governance arrangements do not always support financial sustainability. In earlier decades Councils could have a larger number of Councillors who were only paid meeting fees. Government regulatory mechanisms restrict the number of Councillors who are now paid substantial salaries. In recent elections, this has encouraged some members of the community to stand for election making promises of increased services and facilities and no rate increases. Once elected on such a platform of promises it any attempts to educate have limited success since it would breach their electoral mandate. Mechanisms are needed to raise Councillor awareness, as well as potential candidates of the need for financial sustainability, and the Councillors role in achieving this.

Another factor affecting Local Government financial sustainability is the short-term nature of much Council funding, such as grant programs and contracts to provide services for departments such as Transport and Main Roads. Multi-year agreements (e.g. 5 years) would improve Councils ability to forecast these revenues.