



WALGA

WORKING FOR LOCAL GOVERNMENT

Improving Financial Sustainability for Local Government

A Guide for Elected Members

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Local Governments in WA play a major role in the economy, providing more than \$3.9 billion in services to the community, and managing an asset base worth more than \$45 billion.

However, the sector faces a significant challenge in funding these activities given constraints on its ability to raise revenue.

Financial sustainability is therefore an important priority for the sector.

This document provides information on key financial management topics to assist Councils to make informed budget decisions and to build and maintain financial sustainability. Please read it, discuss the issues it raises with your colleagues and staff and feel free to contact the Association for further advice.

Use of Financial Indicators in Local Government

Maintaining financial sustainability is important for all Local Governments to ensure they can deliver services and infrastructure for their communities and minimise the burden on rate payers.

Financial indicators are a useful way to assess a Local Government's overall financial performance and draw attention to matters that might warrant improvement. Financial indicator results over several years highlight the direction an organisation is travelling in and where it will end up if it takes various alternative financial strategy paths. This can help both decision-makers and stakeholders to more readily comprehend current financial circumstances and the need, affordability and implications of various alternative revenue raising and expenditure options.



KEY POINTS

Financial indicators are a useful way to assess a Local Government's overall financial performance and to guide decision making.

Local Governments are required to report against seven key financial indicators.

The operating surplus ratio is arguably the most important indicator, as it determines whether the Local Government will be financially sustainable and able to maintain services on an ongoing basis.

Financial indicator targets must be considered in the context of each individual Local Governments' unique circumstances as different operating environments require different financial strategies.

Ensuring that financial decisions are made in a way that will meet the key financial targets over the medium to longer term is an important responsibility of Councils.

Any decisions that will have a significant detrimental impact on the financial indicators may need to be re-examined or deferred until the Local Government's financial situation has improved.

Legislative Requirements

It is a legislative requirement that Local Governments report against several key financial targets.

Regulation 50 of the Western Australia Local Government (Financial Management) Regulations requires Local Governments to publish results in their annual financial report for seven financial indicators, for the current and preceding two years.

These indicators are listed in the table across.

Indicator	Definition
1. Current ratio	Current assets minus restricted assets relative to current liabilities minus liabilities associated with restricted assets
2. Asset consumption ratio	Depreciated replacement cost of depreciable assets relative to current replacement cost of depreciable assets
3. Asset renewal funding ratio	Net present value of planned capital renewals over 10 years relative to net present value of asset management plan estimated required capital expenditure over 10 years
4. Asset sustainability ratio	Capital renewal and replacement expenditure relative to depreciation
5. Debt service cover ratio	Annual operating surplus before interest and depreciation relative to principal and interest
6. Operating surplus ratio	Operating revenue minus operating expenses relative to own source operating revenue
7. Own source revenue coverage ratio	Own source operating revenue relative to operating expense



While financial indicators provide a useful guide about a Local Government's financial performance, they must be interpreted with caution.

Financial indicator targets must be considered in the context of each individual Local Governments' unique circumstance as different operating environments might warrant different financial strategies. For example, a Local Government that needs to provide infrastructure to satisfy expected long-term population growth could justifiably utilise higher levels of debt than one with a declining population. Further, some Local Governments have far more assets relative to income than others, and therefore asset management performance is likely to be more important both in terms of maintaining preferred service levels and financial sustainability.

Setting and Interpreting Financial Indicators

The most appropriate financial indicators or benchmarks will for Local Governments not necessarily be the same as those most suitable for other levels of government or for private entities.

This is because Local Governments often are very asset-intensive in their service provision and generally have relatively high long-run certainty in their future revenue provision. Similarly, there are structural differences between Local Governments in Western Australia, which also need to be taken into account in assessing performance against financial indicators and comparing individual Council's performance.

Almost invariably, the most critical financial performance indicator for Local Government is the operating surplus ratio, which measures whether underlying long-run revenue (net of capital related revenue such as grants for capital works) is expected to exceed underlying long-run operating expenses (including reliably based depreciation). Local Governments need to generate operating revenue sufficient to at least offset their operating expenses on average over the medium to longer-term. If this can be achieved, then it is likely that the Local Government will be financially sustainable and be able to maintain services on an ongoing basis.

By contrast, if a Local Government currently has a significant underlying operating deficit, it is likely to face substantial future financial challenges and may be required to reduce service levels over time if it can't turn its position around.

A Local Government's performance against other financial indicators should be considered in the context of the operating surplus ratio. In some circumstances, low score results for other unrelated financial indicators may be less of a concern, so long as the Council has a satisfactory operating surplus ratio. Further, the operating surplus ratio will provide an important starting point for other financial decisions, for example raising debt.

Whilst Local Governments are required to report actual performance for the mandated indicators in their annual financial statements, they should also consider reporting indicator results based on 'underlying' performance.

Underlying performance shows what the result would be abstracting any material temporary or timing-related variation in results. A recent example relates to Commonwealth Financial Assistance Grants, where the timing of payments to Local Governments have been brought forward in recent years. This has had the effect of distorting the results for some indicators when an individual year is considered in isolation. If these factors are not removed, this can generate a misleading picture of a Local Government's financial situation. Highlighting expected trend performance across several years can also help to identify likely material results and consequences.

Local Governments should also provide further explanatory notes in situations where a calculated indicator result may not be an accurate representation of actual performance. For example, a Local Government's aggregate assets may currently be relatively new, and therefore optimal asset renewal needs over the next decade based on a well-developed asset management plan may be materially below the long-run average. This would generate a low score for the asset sustainability ratio and suggest that the Local Government is under-investing in infrastructure maintenance and renewal, even though the level of spending is appropriate given the age of the asset. Similarly, a Local Government may have a lower debt service cover ratio by virtue of their decision to pay back a loan within a shorter timeframe.

The State Government's *My Council* website looks to use these indicators to develop a financial health indicator for each Local Government. The 'benchmark ratio' for each indicator is given a score of 7 and the maximum score of 10 is awarded if the 'high ratio' result is met or exceeded. The minimum score is 0 and this is awarded for indicator results at or below the 'low ratio'. In arriving at an overall 'financial health' score for a Local Government its result for each indicator is given a score out of 10 and then weighted based on the perceived value of the indicator's importance in assessing a Local Government's financial health. As outlined above, these results should be interpreted with caution given that there may be other factors which influence the outcome.

Using Financial Indicators

Ensuring that financial decisions are made in a way that will help to meet the key financial targets over the medium to longer term is an important responsibility of Councils.

These targets should form the basis of a Local Government's Long Term Financial Plan (LTFP). Maintaining these targets can guide and assist in ensuring the financial sustainability of a Local Government and its capacity to meet the level of services preferred by the community on an ongoing basis.

In making significant financial decisions it is important that Councils have regard to the resulting impact on financial indicator scores and their associated targets. Any decisions that will have a significant detrimental impact on the financial indicators may need to be re-examined or deferred until the Local Government's financial situation has improved.

The Role of Debt in Local Government

Debt can be a useful tool to assist Local Governments to manage timing mismatches between spending needs and income. However, research by Deloitte Access Economics shows that Western Australian Local Governments collectively have low levels of debt relative to their circumstances.

While the use of debt is not appropriate in all circumstances, it can be an important tool to assist with prudent and strategic financial management.

It is understandable that Local Governments sometimes fear the consequences of greater use of debt. However, these risks can be mitigated if debt is used in accordance with soundly-based financial targets and well-developed and financially sustainable strategic Asset Management Plans (AMP) and Long Term Financial Plans (LTFFP).



KEY POINTS

Borrowings are a useful financing tool that allow timing mismatches between outlays and available funds to be overcome.

Provided a Local Government can maintain a projected satisfactory underlying operating surplus ratio in its forward financial estimates, it should not fear raising debt if this is necessary to undertake justified works.

Borrowings are not likely to be appropriate for a Local Government that faces significant financial sustainability challenges – typically, those which are facing an ongoing underlying operating deficit.

The key to being able to assess the need for and affordability of raising borrowings for capital works is developing and regularly updating appropriate financial plans including a LTFFP and AMP.

In considering when to use borrowings and the associated costs, Local Governments always need to examine whether the cost of raising debt and its purpose is affordable, inter-generationally equitable and provides value for money on a long-term basis.

Excessive use of debt will not arise if there is a commitment to base revenue-raising, and expenditure and borrowing limit decisions on sound financial targets and well-developed and financially sustainable strategic Asset Management Plans and LTFFP.

Why Borrow?

Debt can be a useful tool to manage timing mismatches between spending needs and income.

It can be particularly beneficial for Local Governments, whose incomes are often reasonably stable and predictable but their outlays can vary significantly between periods, primarily because of fluctuations in capital expenditure. This is because Local Governments are asset intensive in nature, and typically have a very large stock of longlived infrastructure assets relative to their income.

Without debt, or funding from external sources (such as grants from other levels of government or developer contributions), it is impossible for a Local Government to fund the acquisition of new assets and warranted asset renewal over time, without a significant burden on rate payers. If Local Governments didn't borrow, they would effectively be dependent on grants for asset acquisition or would need to fund asset provision from accumulated savings. This would effectively require ratepayers to pay more than the cost of services they receive.

Use of debt can therefore assist in addressing equity concerns, and ensure that ratepayers and service recipients who benefit from new assets meet their cost rather than such assets being effectively funded by an earlier generation of ratepayers.

When to Borrow?

It is important to recognise that borrowings are not income, and cannot be used to fund a project. Instead, borrowings are a financing tool that allow timing mismatches between outlays and available funds to be overcome.

Ultimately, all costs still need to be paid for by income. Borrowings are therefore not likely to be appropriate for a Local Government that faces significant financial sustainability challenges – typically, those which are facing an ongoing underlying operating deficit (i.e. net of material one-off or timing factors). In this case, raising borrowings will not address concerns about the underlying financial sustainability of a Local Government, and may in fact exacerbate existing concerns through the imposition of interest obligations and additional operating costs associated with new infrastructure.

In order to be able to sustain service levels, Local Governments need to generate operating revenue sufficient to at least offset their operating expenses on average over the medium to longer-term. Provided a Local Government can maintain a projected satisfactory underlying operating surplus ratio in its forward financial estimates it should not fear raising debt if this is necessary to undertake justified works (e.g. peaks in capital expenditure).

It is likely that the asset renewal needs of some Local Governments could be at least partially addressed by making greater use of debt. If a Local Government is in a sound financial position it may be able to maintain a satisfactory ongoing operating result even with greater borrowings to address priority needs.

It is important to bear in mind that in many instances, a major project funded as a result of raising borrowings will add to a Local Government's long-run operating costs. New additional capital works will likely lead to higher operating costs such as depreciation, operations and maintenance. On the other hand, renewing assets will generally not lead to higher depreciation as an old replaced asset would have already been depreciated. Ongoing maintenance costs from renewing assets may fall.

Good Forward Planning is Necessary to Inform Debt Decisions

The key to being able to assess the need for and affordability of raising borrowings for capital works is developing and regularly updating appropriate financial plans including a LTFP and AMP. Both of these documents are now legislative requirements and are important tools to guide annual budgeting and forward financial decision-making, and can help Local Governments to determine when borrowings are appropriate.

A LTFP includes estimates of expected future income and costs, and key financial data (financial indicator projections), which can be used to assess the likely impact of additional borrowings. A well-developed LTFP can ensure debt levels are kept within an appropriate range. In addition, because a LTFP will include future cashflow projections, it can help determine the point in time when a borrowing should be raised, the period over which it can be repaid and the optimal pattern of repayment. Modelling different options and scenarios in preparing a LTFP can help a Local Government determine the impact on long-term sustainability of raising more borrowings to undertake various works.

AMPs give an indication of outlays required and the likely appropriate timing to renew and replace assets to maintain preferred service levels. If this forecast expenditure was included in a LTFP it would show whether such outlays were affordable (that is the impact on the long-run operating result) or whether some further adjustments in future proposed revenue or expenditure was necessary. The LTFP would also show whether borrowings would be necessary to accommodate these and other forecast expenditure.

The Cost of Debt

In considering when to use borrowings Local Governments need to examine whether the cost of raising debt and its purpose is affordable, inter-generationally equitable and provides value for money on a long-term basis.

Local Governments need to weigh up the cost of raising borrowings immediately instead of using its own monies on hand to accommodate major capital outlays. There is a direct cost associated with raising debt (through interest expenses), as well as an opportunity cost associated with using internal funds, through interest revenue foregone.

Because interest rates on borrowings are typically higher than interest rates for investments for comparable periods and risk, Local Government should look to 'internally borrow' and only raise debt when cashflow needs dictate.

For those Local Governments where it is preferable to raise additional borrowings, in many cases this will not have a material impact on their operating costs. At present, the gross interest costs of the whole Western Australian Local Government sector only represent around 1% of total operating expenses.

In terms of the structure of loans, Local Governments have traditionally borrowed money at fixed interest rates over fixed terms, which provides certainty regarding future repayments.

One option to minimise net interest costs and interest rate risk exposure that Local Governments could consider is to split the loan amount over different timeframes and interest rate options. For example, a Local Government could consider raising some borrowings over shorter periods and some over longer periods, and some with fixed interest rates and others with variable interest rates. Variable interest rate loans have the advantage of enabling Local Governments to pay down debt more when they have uncommitted cash that would otherwise be invested.

Ideally loans should be paid off as quickly as possible, depending on future cash flow and financial sustainability considerations, as this will save on interest expenses. From an inter-generational equity perspective, however, prime consideration should be given to generating and maintaining a satisfactory operating result and then determining loan repayment arrangements that have regard to future forecast cash flow needs and availability.

Managing Debt

It is simply not practicable for many Local Governments to make significant improvement in their financial, asset management and service delivery performance without greater and better use of debt.

Local Government's debt levels should not be 'as low as possible' in an absolute sense but should instead be as low as possible relative to its needs and capabilities. Depending on a Local Government's circumstances it is not necessarily better to have less debt than more.

It is understandable that Councils sometimes fear the consequences of greater use of debt. Excessive use of debt will not arise if there is a commitment to base revenue-raising, and expenditure and borrowing limit decisions are based on sound financial targets and well-developed and financially sustainable strategic AMPs and LTFPs. Interest rate and loan repayment risks can also be minimised by adopting and following a locally appropriate treasury management policy, to guide the timing and structure of any borrowings raised.



Local Government's debt levels should not be 'as low as possible' in an absolute sense but should instead be as low as possible relative to its needs and capabilities. Depending on a Local Government's circumstances it is not necessarily better to have less debt than more.

Financial Sustainability Strategies and Long Term Financial Planning in Local Government

Local Governments face an ongoing challenge to deliver on the community's growing demands for services. This is a particularly difficult task in an environment where revenue is constrained.

Having in place appropriate strategies to balance these competing demands is critical to ensure that Local Governments can deliver on community needs in a financially sustainable manner.

Long Term Financial Plans (LTFP) are an important tool to assist Local Governments with this task, and determine sustainable service levels, affordable and cost-effective asset management strategies and fair and appropriate revenue-raising decisions.



KEY POINTS

A LTFP is an essential tool for financial decision making. It provides information to guide decisions about the mix and timing of outlays on operating activities, renewal and replacement of existing assets, future additional assets and the associated funding implications. It can be used to assess the expected future impact of financial decisions, and to manage risks.

Local Government's requirements to prepare Strategic Community Plans and Corporate Business plans effectively require the preparation of long-term (10 year) financial plans by Local Governments as part of their Integrated Planning and Reporting responsibilities.

There are a number of considerations that need to be taken into account in developing a LTFP:

- A LTFP needs to be underpinned by a clear and documented financial strategy, based around financial indicator targets.
- The financial strategy must take into account each individual Local Government's unique circumstances and operating environment.
- A LTFP must be based on realistic assumptions.

What is a LTFP?

A LTFP is an essential tool for financial decision making. It provides information to guide decisions about the mix and timing of outlays on operating activities, renewal and replacement of existing assets, future additional assets and the associated funding implications. It can be used to assess the expected future impact of financial decisions, and to manage risks.

The *Local Government (Administration) Regulations 1996* requires each Local Government to adopt a Strategic Community Plan and a Corporate Business Plan. These plans effectively require the preparation of LTFP (10 year) financial plans by Local Governments as part of their Integrated Planning and Reporting responsibilities. A Local Government's LTFP should be consistent with its Strategic Community Plan, Corporate Business Plan and other documents prepared in association with Integrated Planning and Reporting requirements.

To assist Local Governments to prepare and make use of LTFPs, the State Government has produced various models, tools and guidelines, which are available at the Department of Local Government, Sport and Cultural Industries website.

LTFPs are particularly important for Local Governments given that they are much more asset-intensive than other spheres of government, in that they are responsible for managing far more assets relative to their annual income. These assets typically have a very long average life (often 40 years or more) before requiring replacement and can require increasing maintenance as they age, which means that the expenditure necessary to maintain service levels can increase over time.

Capital outlays to provide both new and replacement assets are often considerable and can vary markedly between years. Revenue needed to offset expenditure can therefore also vary markedly between years. This can cause uncertainty and inter-generational revenue-raising inequity regarding what's needed on a long-term basis, and reinforces the need for sound financial planning.

Developing a LTFP

A LTFP, just like the annual budget, should be developed in an iterative way. This enables a Local Government to assess the future financial implications of various options for asset investment and service levels.

The level of financial detail included in a LTFP is to a large degree a matter of user's choice. Sufficient data needs to be included to be able to generate necessary and preferred financial indicator result projections and identify the key drivers of these results. At the same time information should be kept relatively brief and as simple as possible to encourage readability of the document. The Department of Local Government, Sport and Cultural Industries has included on their website downloadable Excel model LTFP templates that are available for use by Local Governments.

There are a number of considerations that need to be taken into account in developing a LTFP:

A LTFP must be based on a clear financial strategy

A LTFP needs to be underpinned by a clear and documented financial strategy. This involves determining actions that are needed to achieve both preferred service levels and financial objectives.

Financial objectives should be expressed in terms of financial indicator targets, both of those mandated for all Local Governments to report against and any others that a Council deems to be appropriate. Achieving these targets is likely to involve trade-offs in terms of service levels and revenue raising. Through their Integrated Planning and Reporting processes, Local Governments need to choose the best balance that is affordable in the long-run and satisfies community preferences having regard to willingness and capacity to pay constraints.

The financial indicator targets set out in the LTFP should in most circumstances be based on the Local Government maintaining, or where warranted, improving its long-term financial sustainability, whilst at the same time providing preferred service levels and equitably generating appropriate levels of revenue. In order to achieve ongoing financial sustainability, it is particularly important for the financial management strategy to focus on maintaining, or incrementally moving towards achievement of, a small ongoing underlying operating surplus. If a Local Government can do this then it is also likely to be able to satisfy other reasonable financial indicator targets.

The operating result target needs to be based on accrual accounting rather than cash accounting considerations, and therefore needs to recognise depreciation as an expense. Depreciation is an estimate of the annual consumption of assets incurred in providing services. It is important that Local Governments seek to recover sufficient revenue to offset depreciation and other operating costs on average over the long-run, particularly given that the sector is asset intensive and depreciation represents a large share of individual Local Governments' total annual costs. Generating revenue to offset this means that ratepayers equitably pay their way over time for available services, and helps ensure that Local Governments have reasonable capacity to undertake asset renewal works when they are required.

A LTFP must take into account a Local Government's individual circumstances

It is important that the financial strategy takes into account each individual Local Government's unique circumstances and operating environment. The LTFP must therefore be consistent with the Local Government's Strategic Community Plan and Corporate Business Plan.

An integral part of developing a LTFP is determining proposed funding amounts necessary to meet projected outlays. Local Governments need to determine an appropriate mix of rates, fees, charges and grant revenue having regard to expenditure proposals and long-term financial sustainability, as well as the capacity of their own community to pay.

A LTFP should also include a simple narrative overview to help both decision-makers and stakeholders understand the purpose of the document and the key messages it highlights.

The LTFP should therefore help inform decisions and judgements regarding future major initiatives and proposed service levels and associated funding constraints.

A LTFP should be underpinned by realistic assumptions

A LTFP should be based on best estimates of actual forecast financial events (i.e. inclusive of one-off fluctuations). However, a Local Government should also consider compiling and documenting 'adjustments' to show underlying performance if this is likely to help highlight key information.

In establishing the LTFP, care needs to be given to the assumptions upon which forward financial projections are based to ensure they are realistic, and relevant to local circumstances. This is because excessive variation in assumptions can lead to considerable variations in future financial projections.

The LTFP needs to have regard to a Local Government's operating environment and possible future changes including the expected level of growth and associated consequential impacts. It is important that key assumptions are documented and aligned to those made in a Local Government's other Integrated Planning and Reporting documents.

In preparing a LTFP a Local Government should undertake a sensitivity analysis to consider and model the risks and impacts of variation in assumptions. Some of the possible scenarios that should be examined are as follows:

- What would be the long-run impact if anticipated growth was significantly delayed or less than forecast?
- Are significant levels of grant income assumed and how certain are they? For example, Financial Assistance Grants from the Commonwealth are backed by legislative provision and therefore relatively secure, but other programs can often be varied through budget decisions.
- What is the expected inflation rate and are there any significant sources of revenue? For example, rates income or expenses (e.g. labour costs) expected to increase by a significantly higher or lower amount?

Using the LTFP

A Local Government's Strategic Community Plan and Corporate Business Plan should be informed by the financial constraints highlighted by the LTFP and therefore may need to be subsequently updated as a result of preparation of the LTFP.

The LTFP also forms a key platform for the Local Government's annual budget process. While the starting point for the initial development of the LTFP is the current year's budget, the adopted LTFP should be used as a guide for decision-making about future budgets including service level provision, outlays, revenue raising and borrowings.

The starting point for each year's budget should be the data set out in the next year of the LTFP. The budget should be consistent with the proposed financial strategy and assumptions. Any significant variations that are made in finalising that budget should be fed back into the next update of the LTFP, particularly any flow-on implications

for subsequent years. Careful regard needs to be taken with respect to any discretionary or unavoidable material departures from proposals in the LTFP for achievement of the Local Government's financial strategy and the possible resulting implications.

If a draft version of a LTFP indicated that proposed activities over the course of future years would have an unacceptable detrimental effect on a Local Government's financial sustainability, then options to reverse this situation need to be examined.

Local Governments could consider exploring opportunities to raise additional revenue as a way to address an expected deterioration in its financial sustainability. However, a decision to increase rates (for all or some classes of ratepayers) needs to take account of the Local Government's existing relative rating levels and the financial circumstances of the local community.

A preferred option may instead be to delay proposed new, additional capital works (which are likely to add to long-run costs) or reduce some existing lower priority service levels in order to be able to continue to provide other, higher priority services on an ongoing basis. This may for example involve not renewing or replacing some old assets at the end of their service life (subject to risk considerations) or replacing them with lower cost assets that provide lower levels of service. If this is considered the best option in the circumstances, then it will also necessitate the future update of the Asset Management Plan, to ensure this is consistent with the LTFP.

By contrast, a draft LTFP showing a very sound ongoing financial performance and position would allow a Local Government to consider opportunities such as raising service levels; introducing additional activities to meet community wants and needs; or limiting future proposed increases in rates and charges.

Use in Decision Making

Councils need to have careful regard to longer-term considerations in making annual budget decisions. If they don't, they may find that they are faced with unanticipated financial challenges.

A long-term financial plan lets a Council see what its future financial scenario is likely to be. It helps it assess its capacity to do more and reduce future risks and the associated revenue raising requirements, and helps to manage risks.

If a Local Government currently has a significant under-lying operating deficit it needs to recognise the longer-term implications. Not addressing this deficit is likely to mean that it will struggle to be able to accommodate asset renewal needs in the future and that service levels will decline over time. The long-term financial plan should explore the potential to address the deficit and associated implications. Can some services be reduced? What savings would this realise? Is it practical and preferred to increase revenue? Often by looking at projections over the five to 10 year period a Council can see that small and potentially acceptable changes each year can have a significant compounding financial impact over time.

Community demands for better and additional Local Government services will always exist. It is imperative that Councils have well-developed LTFPs to help guide decision-making and protect their future sustainability and the interests of current and future ratepayers.



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