Financial Sustainability of the New South Wales Local Government Sector

APRIL 2013

FINDINGS, RECOMMENDATIONS AND ANALYSIS

New South Wales
Treasury Corporation

Acknowledgement

Completing the financial assessment of the 152 Councils in New South Wales within a 12 month timeframe was a major task which involved and required the assistance of many people.

New South Wales Treasury Corporation (TCorp) would like to thank all those who assisted us in completing this major assignment within such a tight timeframe. In particular, we would like to thank:

- The staff of all the Councils who provided much assistance in helping us understand their businesses so we could make informed recommendations and findings
- Staff from the Division of Local Government (DLG) who provided valuable background information and assistance
- Queensland Treasury Corporation (QTC) staff for sharing a lot of their knowledge with us, particularly in respect of the similar process that they had undertaken and the ongoing work in respect of benchmarking Council performance
- The many staff and contractors from TCorp for their hard work and diligence in completing this assessment process

With such a large database of information created through this process, New South Wales now has the opportunity for a greater understanding of the issues facing Councils in this State and with the input from the Independent Sustainability Review Panel, the opportunity to assist in improving the outputs of this sector.

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1. Executive Summary

1.1 Background

In December 2011, DLG appointed TCorp to assist DLG and NSW Treasury in respect of the State Government's Local Infrastructure Renewal Scheme (LIRS) initiative. The LIRS initiative seeks to address Councils' 'Infrastructure Backlog' by providing Councils with an interest rate subsidy on borrowings from the private sector to fund qualifying projects.

TCorp's role was to undertake a financial assessment and benchmarking report for each Council seeking or requiring such an assessment under the LIRS.

In March 2012, the Minister for Local Government announced the establishment of an Independent Local Government Review Panel (Review Panel) chaired by Professor Graham Sansom. The Review Panel is to develop options to improve the strength and effectiveness of local government in NSW. Included under the Review Panel's Terms of Reference, the financial sustainability of each Local Government Area (LGA) is to be considered.

Following the announcement of the Review Panel, DLG expanded the scope of TCorp's reports to incorporate additional material to facilitate use by the Review Panel, particularly in respect of the area of financial sustainability. In addition, TCorp was requested to prepare reports for all 152 NSW Councils. TCorp's scope of work excluded the 14 County Councils in NSW.

This Report sets out TCorp's findings from its work assisting DLG and the Review Panel.

TCorp's key tasks in undertaking its work included:

- Creating a definition of sustainability
- Establishing a set of appropriate benchmark indicators
- Developing an assessment methodology including a rating scale and Outlook that could be used to compare Councils against a sustainability definition
- Reviewing both historical financial results and the long term (10 year) financial forecasts of each Council

In reviewing the relevant work that had been done around Australia in recent years, TCorp determined that no concise definition of sustainability existed. Therefore TCorp developed its own definition being:

> *A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure agreed with its community.*

The definition takes into account the effect ongoing change could have on a Council's operating position and service levels over the long term.

The definition brings together what TCorp considers are the key elements of financial strength, service and infrastructure requirements, and needs of the community. TCorp considers that this definition is concise enough to be remembered, whilst broad enough to cover the key aspects.

In developing appropriate benchmark indicators to be used in the analysis, TCorp considered the work undertaken by QTC, the Independent Pricing and Regulatory Tribunal (IPART) and DLG. Based on the work previously undertaken, TCorp then compiled a list of 10 key benchmarks to use to measure performance on a common basis across all Councils.

TCorp also built on the work undertaken by QTC to create a Financial Sustainability Rating (FSR) and Outlook methodology, for the purpose of rating each individual Council. The FSR provides TCorp's assessment of each Council's current long term rating. The FSR methodology is used to individually assess Councils and categorise them into seven rating bands ranging from Very Strong to Distressed.

TCorp considers that a Council needs to be assessed at a Moderate or higher level to be acceptable in terms of their sustainability. A Moderate level FSR is on average equivalent to marginally exceeding the benchmarks utilised in TCorp's assessment process.

TCorp's assessment of the likely movement in a Council's FSR over the short term, being the next three years, is the Outlook. Councils were assigned an Outlook rating of Positive, Neutral or Negative. A Positive Outlook indicates that a Council's FSR is likely to improve in the short term, whilst a Neutral Outlook indicates that the FSR is likely to remain unchanged. A Negative Outlook indicates that a Council's FSR is more likely to deteriorate, and is a sign of a general weakening in performance and sustainability.

A Council with an FSR of Moderate and an Outlook of Negative, is assessed as being in a deteriorating position or at risk of being downgraded from Moderate to Weak. As TCorp considers a FSR of lower than Moderate to be at much greater risk of being unsustainable, Councils in this position need to be urgently considering options for addressing the areas of poor performance that are contributing to Council's assessed FSR and Outlook.

Likely causes of a Negative Outlook include:

- Forecast poor operating results
- Increasing risks from large developments being undertaken
- No apparent action being undertaken by Council to address financial pressures
- Risks associated with the current status, and potential implications for the Council's finances, of a Council's Asset Management Plan (AMP) which may not be completed to an acceptable standard

For Councils assigned a Negative Outlook, TCorp has provided some recommendations and areas of investigations to assist in improving the sustainability position. The recommendations include:

- The need to source additional revenue, such as under an SRV, to improve financial flexibility and to assist in reducing the Infrastructure Backlog
- For Councils with the borrowing capacity, consider using debt funding to reduce the Infrastructure Backlog and improve intergenerational equity
- Devising programs and strategies to contain rising costs and improve efficiencies
- Further improvement required in AMPs and integration into the Long Term Financial Plan (LTFP)
- Increasing spending on maintenance and infrastructure renewal, balancing this with the need for capital expenditure on new assets

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In undertaking its assessment of the 152 Councils in NSW, TCorp has assessed:

- The financial capacity of each Council; which included an analysis of each Council's historical results from the 2009 to 2012 financial years (Review Period)
- The long term sustainability of each Council; which included an analysis of each Council's LTFP and the degree to which Council has completed its AMP and integrated the requirements of the AMP into its LTFP
- The financial performance of each Council in comparison to a range of similar Councils when measured against the established benchmarks

TCorp has consulted with all of the Councils that it has assessed and meetings have been held with many Councils from a cross section of the DLG Groups. TCorp has also been able to highlight to Councils anomalies that existed in their LTFP whether in respect of historical performance and how that linked to forecast assumptions, or where poor financial forecasts were a result of modelling errors. Some of the issues identified included where Councils needed to revisit some of their base assumptions or capacity to deliver existing service levels.

Further details of TCorp's methodology are provided in Section 3 of this Report.

1.2 TCorp's Key Findings

From its assessment of the 152 Councils and its analysis of the outcomes, TCorp considers that the key findings are:

1. **Operating deficits are unsustainable** - The majority of Councils are reporting operating deficits and a continuation of this trend is unsustainable. In 2012 only one third of Councils (50) reported an operating surplus. Over the 2009 to 2012 Review Period, the cumulative operating deficits for all Councils in NSW totalled $1.0b

2. **2012 operating deficits are understated** - The cumulative operating deficit of all Councils in 2012 of $288m understates the severity of the current position. In the 2012 financial year the Federal Government prepaid half of the 2013 Financial Assistance Grants which most Councils declared as revenue in 2012. Removing the impact of this prepayment results in the normalised deficit for the 2012 financial year being $469m, an increase of $181m

3. **Sustainability is deteriorating** - The sustainability position is expected to deteriorate over the short term for nearly 50% of all Councils, based on current LTFP. Should the current Outlooks eventuate, 70 of the 152 Councils in NSW (46%) would be rated as Weak or lower within three years

4. **Consultation with the community is required** - Addressing the expected continued deterioration of Councils' financial positions will require an extensive consultation process with the community to consider a combination of revenue increases, expenditure reductions and service level reviews

5. **Need to prevent further deterioration** - Achieving a breakeven operating position for Councils is one factor that will assist in preventing further deterioration in the financial position of the local government sector. The achievement of a breakeven operating position would provide sufficient funds to meet future requirements for maintenance of assets and services, but it would not provide sufficient funds to address the current (2012) reported Infrastructure Backlog of $7.2b, nor any as yet unquantified asset maintenance funding gap that may exist

6. **Improved focus created by the Integrated Planning and Reporting (IP&R) process** - The introduction of the IP&R process in 2009 has increased Councils' focus on longer term planning and strategy. TCorp recognises that Councils are at different stages of implementing the full suite of IP&R requirements. Continued work on refining AMPs, and methodologies for valuing Infrastructure Backlog will improve the quality of LTFPs and assets information over time. Councils who have not as yet completed their initial work under the IP&R process, need to do this urgently to provide a clearer picture of their financial status and future financial requirements

7. **Asset management planning is improving** - Asset planning is improving but will require further (and ongoing) iterations for most Councils. Whilst the majority of Councils have now completed their initial AMP, the analysis and discussions with Councils indicates that it can take a number of iterations before a high level of certainty can be attached to the outputs of the AMP

8. **An asset maintenance gap exists** – Councils' reported expenditure on the maintenance of their assets shows an annual shortfall in spending on asset maintenance. In 2012 alone, the reported maintenance gap was $389m across the local government sector in NSW, and has totalled $1.6b over the last four years

9. **Regional performance varies** - There is a higher proportion of Councils rated as Weak and Very Weak in the north coast region and the far western region of the State, compared to other regions. Much of this variation in performance can be attributed to population density, where lower levels of population and hence lower proportional numbers of rate payers are available to meet the costs of maintaining and renewing assets

1.3 Key Recommendations for Consideration

Based on the findings from its review into the financial assessment and sustainability of the local government sector in New South Wales, TCorp's recommendations are:

1. **At least breakeven operating positions are essential** - Councils need to achieve at least a breakeven operating position on an on-going basis. The future sustainability of Councils is dependent upon generating sufficient funds to meet the costs of maintaining and renewing assets to deliver services. Councils who have been operating with deficits and are forecasting to continue to do so, are not generating sufficient funds to continue providing services and renewing assets at their current levels. These Councils need to develop options to correct this position. Such options will necessarily involve extensive consultation with their

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communities, and will need to consider options for revenue increases, reductions in expenditure, and reviews of existing service levels and standards. Surpluses generated by Councils can be used to address their Infrastructure Backlogs

2. **Pricing paths are needed for the medium term** - IPART, DLG and Councils should work together to consider the development of a medium or long term, and achievable pricing path so that Councils can achieve at least a breakeven operating position. A clear strategy across the local government sector is needed to promote future sustainability for Councils

3. **Rate increases must meet underlying costs** - Future increases in all rates and annual charges for Council services should be based on the underlying cost of delivering these services and the annual movement in the cost of these services. Where a decision by Council is made to increases rates and charges at a lower than required factor, the impacts of such actions must be clear in the context of each Council's sustainability

4. **Asset management planning must be prioritised** - Councils need to prioritise the completion and validation of their AMP and Infrastructure Backlog values so that a clear picture is available as to the total funding requirements for their assets. Without this certainty, Councils cannot accurately forecast their future funding requirements and put in place appropriate strategies

5. **Councillor and management capacity must be developed** - Councils and the DLG should continue to articulate the benefits of the IP&R process, by increasing the focus on linking long term strategies, asset management planning and long term financial forecasting to assist with decision making and promoting sustainability. Enhancing the knowledge and skills of Council management and elected officials, particularly in respect of the importance of financial and asset management, would greatly assist in this area

6. **Improved use of restricted funds** - A review of the system and guidelines for accessing restricted funds is needed. Under the current requirements, most Councils are required to hold substantial funds in reserve for specific purposes, often for lengthy periods of time. On average 50% to 60% of funds held by Councils are externally restricted. Being able to access more of these funds (eg through s 410 internal borrowing arrangements) could allow Councils to meet current asset renewal and maintenance requirements and be a more efficient use of funds

7. **Increased use of debt** - Debt is underutilised by some Councils and there are opportunities for more cost effective borrowing and debt management. Some Councils have low or zero debt, strong cash flows and outstanding Infrastructure Backlogs. For some of these Councils the use of debt can be an efficient means of addressing Backlog issues, enhancing intergenerational equity and improving asset quality and services. For many Councils with existing debt, overly conservative debt management practices are adopted which could be improved to deliver enhanced value and a lower cost of funds for Councils

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1.4 Overall Results

Table 1 below provides the current FSR distribution of the 152 Councils in NSW as determined by TCorp's assessment process.

The results show that 113 (74.3%) of the 152 Councils are currently rated Moderate or better, and 39 (25.7%) are rated Weak or Very Weak. A Moderate rating indicates that a Council has an adequate capacity to meet its financial obligations in the short to medium term (being the next five years), and to manage risks to its business. A Council rated as Moderate is likely to have recorded some minor to moderate operating deficits and it may have also recently recorded a significant operating deficit. It is likely to be able to address any unforseen financial shocks with moderate revenue and/or expense adjustments. Achieving a Moderate level FSR is considered to be the base target level for Councils and those Councils with a FSR higher than Moderate are in a much stronger position to deliver services, manage their assets and risks and address their Infrastructure Backlogs. Councils rated as Moderate will generally not have sufficient funds to address their Infrastructure Backlogs.

No Councils were assigned an FSR of Very Strong or Distressed.

Table 1 - FSR Distribution

Rating	Count	Percentage
Very Strong	0	0.0%
Strong	2	1.3%
Sound	32	21.1%
Moderate	79	52.0%
Weak	34	22.4%
Very Weak	5	3.3%
Distressed	0	0.0%
Total	**152**	**100.0%**

The map in section 4.1 shows the geographic distribution of the assessed FSR for each Council.

TCorp also prepared an Outlook rating for each Council based on the perception of the likely future movement in the FSR rating of each Council. The Outlooks were assigned based on TCorp's view of the likely movement (if any) of a Council's FSR rating over the next three years.

The Outlooks determined are shown in Table 2 below:

Table 2 - Outlook Distribution

Outlook	Count	Percentage
Positive	5	3.3%
Neutral	74	48.7%
Negative	73	48.0%

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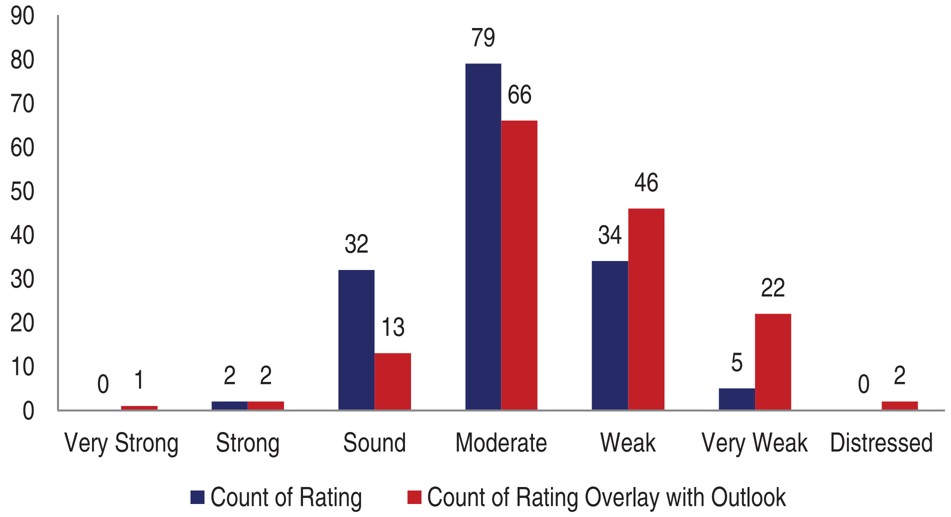
Following the determination of the Outlook, each Council has a FSR ranging from Very Strong to Distressed and an Outlook ranging from Positive to Negative.

Whilst an Outlook is not certain, if the Outlooks eventuate, only 82 Councils (53.9%) would be rated as Moderate or higher, with 70 Councils (46.1%) being rated Weak or lower, including two as Distressed.

The graph below shows the changes that would result if all the Outlooks occurred. This clearly illustrates the impact for the overall local government sector should no remedial action be taken by Councils and TCorp's perception of a general weakening trend over the short term eventuate.

Graph 1 - FSR Overlay with Outlook



The map in section 4.3 shows the geographic distribution of the assessed FSR for each Council if the Outlook occurs.

Analysis of the information to identify the causes of these forecast results reveals a number of factors that are driving TCorp's perception of the expected continued deterioration in the financial rating of many local Councils. These factors include:

- The inability of many Councils to achieve a breakeven or surplus operating position
- The introduction of the IP&R process has increased the Councils' focus on the longer term, rather than just the next 12 month budget period and this has identified longer term trends and issues
- The AMP, introduced as part of the IP&R, has required Councils to consider the whole of life costs associated with their infrastructure assets and has highlighted the costs associated with renewing assets
- The AMP has also highlighted the underspending on the maintenance of assets, which can lead to a declining quality of assets, reflected in an increased Infrastructure Backlog
- Changes in demographics where some LGAs are experiencing declining populations, whilst others are experiencing strong population growth

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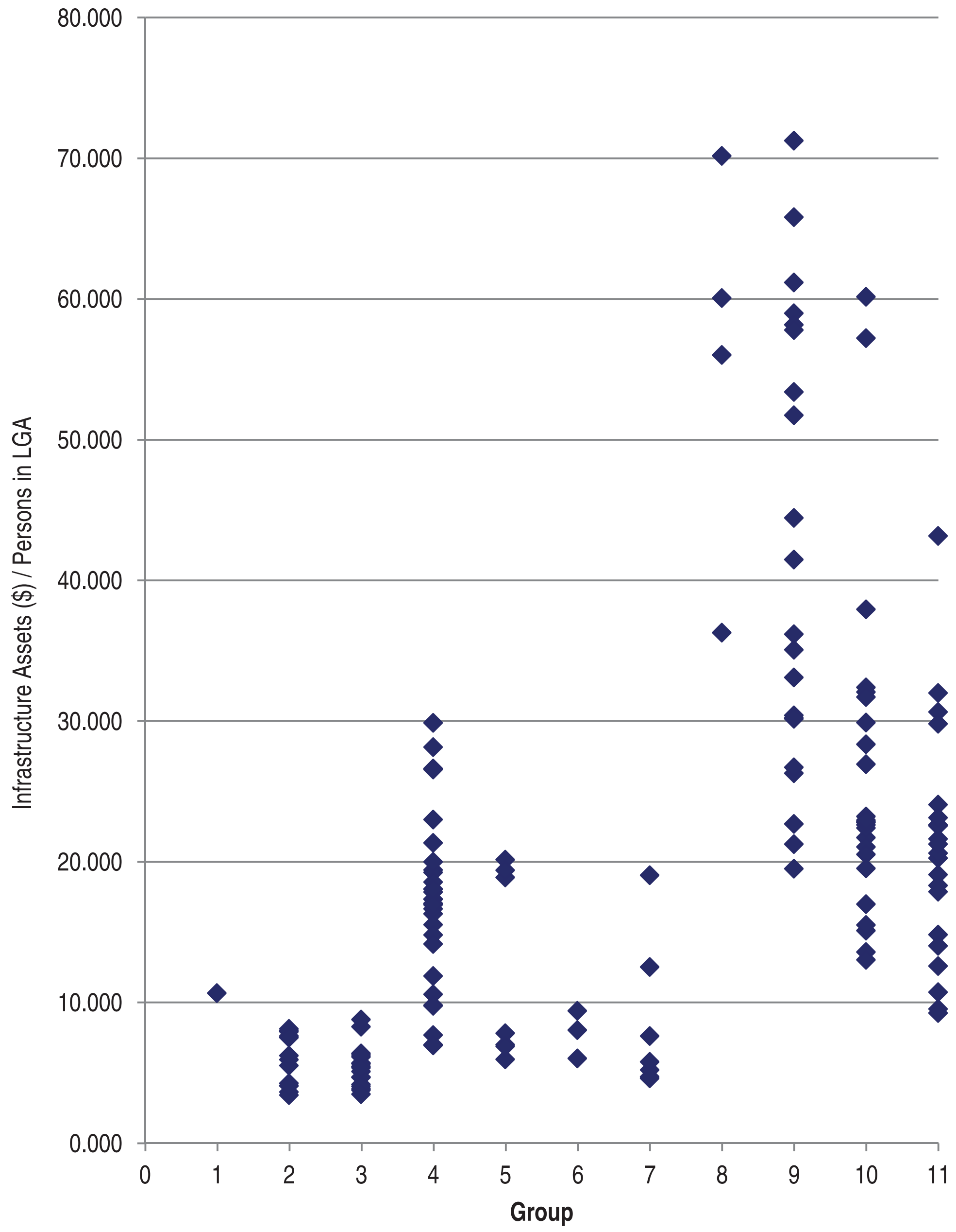
1.5 Factors Affecting Sustainability

1.5.1 Population and Demographics

The graph below shows that Councils in regional and rural areas (DLG Groups 4, 8, 9, 10 and 11) have a much higher value of infrastructure assets per person to maintain. As these Groups also have lower population densities this increases the pressure on local ratepayers to fund infrastructure.

Graph 2 - Amount of Infrastructure Assets per Person (by DLG Group)



Population density compared to the amount of infrastructure managed by a Council is an important factor in determining the sustainability of a Council. Graph 2 shows on the horizontal axis the dollar value of infrastructure assets per person in the LGA. This excludes land and property, plant and equipment. The graph shows a distinct difference between Urban Councils in Groups 1 to 7 compared to the Rural Councils in Groups 8 to 11. Urban Councils generally have less of the cost of the infrastructure burden per resident. Each resident in a Rural Council has to support a greater amount of infrastructure asset. This is generally due to the lower population density in rural areas compared to the volume of assets, particularly length of roads.

It is important to note, that Councils in groups such as 8, 9 and 10 which had the higher dollar value of infrastructure assets per resident also had the highest proportion of Councils rated Weak and Very Weak. Group 11 Councils which are rural in nature had a much lower proportion of Councils in the Weak and Very Weak categories. This Group also had a lower rate of dollar value of infrastructure assets per resident compared to the other rural Council groups.

If a Council has a higher proportion of residents compared to its infrastructure value, it is generally less reliant on external sources of funds, more financially flexible and more likely to be self sustaining.

1.5.2 Features of a Sustainable Council

While a high population density and low reliance on external sources of funds are important factors to a sustainable Council, other factors which can assist their sustainability position include:

- Quality management and staff
  - An experienced management team which understands the business and are focused on sustainability
  - Appropriately qualified engineering staff who are able to understand relevant tasks required
  - Skilled grant officers and financial reporting staff which produce quality reporting data to assist in decision making and in the application for grants
  - Ability to attract and secure quality and skilled employees
  - Rural Councils are able to use State road contracts to provide some critical mass for the Council's roadwork team and equipment. It also helps in attracting and retaining expertise in the engineering area
- A responsible Council that understands its role
  - It is important for the Council to have a long term vision particularly when it manages assets with long useful lives
  - In respect of capital expenditure, Councils should concentrate on 'fit for purpose' standards for its assets and at levels agreed with the community
- Good reporting and budgeting
  - Conservative budgeting can be used as a tool to keep pressure on operating budgets. Surpluses generated can be allocated for capital expenditure
  - Producing good quality data and reports so that a Council is able to secure its appropriate entitlement of grants, such as flood grant funding

1.5.3 Regional Factors Impacting Sustainability

In conducting the review, TCorp has identified particular geographical regions which had relatively lower FSR and Outlooks when compared to other regions. This is not to say that all Councils in these areas were lower rated, with some regions having a large range of outcomes from Sound to Very Weak. In particular, two regions stood out as having lower FSR and Outlooks.

These two regions are firstly, the coastal and near coastal areas of the north coast of NSW, where 11 Councils are rated by TCorp as being in the lowest 24 FSR rated Councils in NSW. The second region covers the most western areas of NSW where eight Councils are in the lowest 24 FSR rated Councils in NSW.

We have considered these further and identified some factors affecting these regions.

In the north coast region, many of these Councils have some or all of the following characteristics:

- Highly prone to floods and storms (which have been prevalent in recent years)
- The coastal Councils suffer from holiday peak crowds that place great pressure on facilities
- Due to the popularity of many of these Council areas for retirement, ageing populations are a significant issue
- High demand for a large variety of services due to the age mix of the local (and tourist) populations

In the western region, most of these Councils have some or all of the following characteristics:

- Declining populations
- Large land areas and road networks
- Very low population densities
- Low rate bases, so Councils are heavily reliant on government operating and capital grants
- Susceptible to the full range of natural disasters of drought, floods and bushfires

Whilst many other Councils in NSW will also have some or all of these features, they are not in general affected by these factors to the same extent as these two regions.

1.5.4 Urban Councils

Given that population density is an important factor in sustainability, a lesser portion of Urban Councils have been assigned a Weak or Very Weak rating compared to Rural Councils. However, 19.8% of Urban Councils are still considered Weak or Very Weak. Most of these Councils were in regional areas outside of Sydney. Some of the factors which contributed to a low FSR score for Urban Councils are:

- Substantial increases in employee expenses, particularly workers compensation costs and superannuation
- High Infrastructure Backlogs and an inability to reduce this in the short term
- Underspending on asset maintenance and renewal