Government of **Western Australia**
Department of **Local Government**

Rate Setting, Asset Management and Financial Sustainability

A guide for local governments • June 2013

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1 Introduction

Raising rates is an option that needs to be weighed against alternative actions that can potentially achieve similar budget outcomes.

The purpose of this paper is to allow consideration of all the options currently available to local governments when planning their budgets and setting rates in preparation for a new financial year.

Local governments typically are asset rich but income poor, with far more assets to manage relative to income than other spheres of government. Most of these assets are long-lived and require increasing maintenance as they age and eventually need replacement. Strong financial and asset management planning is therefore essential if local governments are to sustain the services that their communities want and need, and remain financially viable.

Improving the financial sustainability of local governments has been a major focus for both the Commonwealth and State Governments over recent years. It is recognised that, in most cases, local governments rely primarily for their own-source revenue on:

(1) property taxes (i.e. rates); and
(2) the sale of goods and services (i.e. fees and charges).

It is also acknowledged that, for a variety of reasons, there are constraints on local governments from broadening their revenue sources. The policy settings around local government revenue raising capacity continue to be reviewed at both a state and national level. Similarly, the restrictions on certain fees and charges that local governments can set for service delivery are also under review on a case-by-case basis.

This paper does not explore these broader questions but focuses on the mechanisms available at present to local governments to address the twin requirements of asset management and financial sustainability in their budget planning. Increasing annual rates is an understandable response to predicted shortfalls in revenue and may form part of a strategy to address asset and financial sustainability issues. However, it is an option that needs to be weighed against alternative actions that can potentially achieve similar budget outcomes with less immediate and direct negative impacts on the community.

Ultimately, assets and services are delivered to meet the needs of the community. It is essential that local governments actively engage their communities to foster a greater understanding of the costs associated with maintaining assets and delivering services. It is also essential that local governments set service delivery levels in consultation with their communities and obtain agreement on strategies that seek to address asset funding gaps through significant rates increases.

2 Integrated Planning and Reporting

Good asset management ensures that local governments have the financial capacity to deliver community priorities.

The Department of Local Government has implemented the Integrated Planning and Reporting Framework (IPR) across the State to address identified long-term sustainability issues within the local government sector. The Framework , together with the associated guidelines and Advisory Standard, was developed to assist local governments in developing Strategic Community Plans, Corporate Business Plans and associated supporting plans (Asset Management, Workforce and Long Term Financial Plans).

Local governments are required to have developed and adopted a Strategic Community Plan and Corporate Business Plan by 30 June 2013. This planning process will provide direction to councils in determining their budgets for the coming year and subsequent years.

The Strategic Community Plan results from a process of extensive community engagement that sets out the community's aspirations and service requirements. The community can contribute further to this Plan when it is reviewed every two years. A local government's approach to asset management and financial planning is therefore informed by, and in turn informs, the service requirements and service levels needed to meet community expectations and strategic priorities, as expressed in the Strategic Community Plan.

Good asset management ensures that robust Long Term Financial Plans and Annual Budgets are developed and that local governments have the financial capacity to deliver these priorities into the future.

Comprehensive asset management planning will highlight the age and condition of a local government's stock of physical assets. This should result in a determination of the financial costs associated with the maintenance and renewal of the local government's asset portfolio. The Department is aware that, as some local governments complete their Asset Management Plans and Long Term Financial Plans, they may identify significant unfunded asset gaps.

This may, in turn, reveal that some local governments are in a financially unsustainable position. Such local governments may find themselves under increased pressure to consider large rate increases in their coming budgets, specifically to meet these asset replacement and renewal gaps. These gaps have developed over time and may need to be addressed over the medium to long term.

Rate revenue is generally the largest discretionary revenue source available to a number of local governments. Within the parameters of the Local Government Act 1995, it is open to local governments to set rates to address unfunded asset gaps. However, this solution may not be sustainable and should be considered in consultation with the community.

Following large rate increases, community expectations will often be that service delivery levels will increase . The community may not be sympathetic to increased rates to pay for previously committed asset maintenance and replacement.

[1] *Integrated Planning and Reporting – Framework and Guidelines,* Department of Local Government, Western Australia, 2010

[2] *In Our Hands: Strengthening Local Government Revenues for the 21st Century* - Working Paper, Australian Centre of Excellence for Local Government, February 2013

3 Strategies for reducing unfunded asset gaps

Substantial rate increases or spending cuts may be avoided if a council's long-term finances are sustainable. The following strategies could be considered by local governments looking for ways to effectively manage their assets while still providing the level of services expected by the community.

A council's financial are sustainable in the long term only if its financial capacity is sufficient – for the foreseeable future – to allow the council to meet its expected financial requirements over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments[3]*.*

3.1 Review services provided and levels of servicing

Local governments provide services that benefit the whole community or a particular section of the community. The scope and nature of these services vary significantly between local governments.

Service delivery and service levels should be considered as part of long term financial planning and asset management. The process should identify the existing services and level of service delivery.

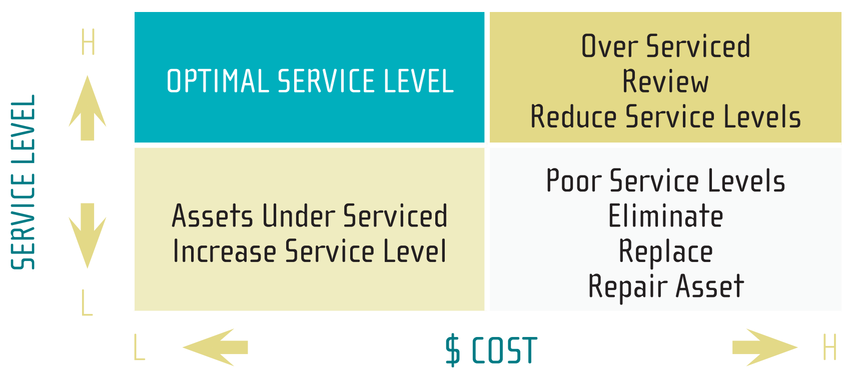
Further analysis of the services provided may identify:

- services provided that are rarely used or no longer required;
- over-servicing, for example services provided more often than required;
- services that may be provided in another way using up-to-date technology;
- services that could be more effectively provided by others;
- services that could appropriately be delivered via user pays;
- alternative service delivery models, for example leasing or shared service arrangements;
- services that do not need to be resourced at the current level; and
- services that are of low priority where consideration could be given to focus on higher priority services.

Local governments can revisit and review defined service levels to provide the community with the level of service defined in the strategic plan in the most cost effective way.

A review of level of services will place a local government within the asset management matrix.[4]

MAINTAINING ASSET SERVICE DELIVERY LEVELS



3 *The Journey: Sustainability into the Future,* WALGA Systemic Sustainability Study, 2008
4 *Asset Management - Managing Service Delivery* Department of Local Government, 2011

3 Strategies for reducing unfunded asset gaps

All councils, including those that have capacity to raise more revenue, need to equally consider whether expense reductions through efficiency improvements and service level reviews may be at least part of the answer to both their own financial challenges and to deliver optimal value to their citizens and ratepayers[5].

3.1 Review services provided and levels of servicing (continued)

In some cases, local governments will conclude that services which rely on assets that cannot be maintained and replaced affordably must be discontinued or provided by other entities.

Adjusting service delivery levels or methods can be a difficult decision for local governments. Agreeing service delivery levels with the community is essential to achieve a fit between what local governments can afford to deliver and what the community would like them to deliver.

3.2 Review, refine and verify asset management strategies and plans

Asset management is an area where many local governments may now be facing challenges in infrastructure renewal/replacement backlog.

Improving asset knowledge can provide useful data on how assets are performing, their condition and whether they are providing the required service levels.

The following strategies may provide additional information that can further refine asset management plans. Undertaking these strategies may identify opportunities for reducing costs whilst still maintaining assets to the required standard and providing the services expected by the community.

3.2.1 Verify Asset Registers

The cost of asset maintenance and renewal is directly related to the number and type of assets that a local government controls. Care should be taken to ensure that the local government's asset register (which records all assets and their location, acquisition, disposal, transfer and other relevant transactions) is up to date.

3.2.2 Conduct independent asset condition assessments (in situ inspections)

Condition of some asset classes, for example infrastructure, will vary depending on circumstances and usage. Sound assumptions can be developed and more accurate information on asset lifecycle and maintenance costs can be obtained by a physical inspection of assets and an exploration of alternative maintenance and renewal methodologies.

3.2.3 Apply differential renewal cycles for different asset classes

Different asset classes will have varying renewal cycles and this should be reflected in Asset Management Plans. In addition, an asset management system can be utilised to further break down assets into respective components to better reflect renewal cycles. For example, air conditioning in a building will have a much shorter renewal cycle than the actual building.

5 *In Our Hands: Strengthening Local Government Revenues for the 21st Century* - Working Paper, Australian Centre of Excellence for Local Government, February 2013

3 Strategies for reducing unfunded asset gaps

3.2.4 Effective Use of Data and Systems

The Department's Asset Management Framework and Guidelines notes that effective collection and analysis of asset data can assist in the development of efficient maintenance and capital works programs.

The calculation and interpretation of local government asset performance against the asset ratios, as set out in the Department's Integrated Planning and Reporting Advisory Standard , can provide good indications of the aged condition of the local government's asset stock and whether investment in maintenance or renewal is required. It can also illustrate whether the local government is under or over investing in its assets, and whether it has the financial capacity to fund asset renewal as required and can continue to provide existing levels of services in the future, without additional operating income, reductions in operating expenses or an increase in net financial liabilities.

Improving asset knowledge can provide useful data on asset performance and condition.

3.2.5 Review depreciation methodologies to better reflect actual usage

Straight line passage of time depreciation methodologies are often used to depreciate assets. However, for some assets, a different methodology such as actual usage may be a better measure. For example, a vehicle may be depreciated at a cost per kilometre to reflect consumption of that asset.

3.2.6 Identify surplus or low-use assets for disposal where appropriate

A review of assets held may identify assets that are no longer used as a result of changes in community demands. Accordingly, these assets should be disposed of.

3.2.7 Identify other service delivery options

> *Certain local government assets may be better suited to alternative ownership structures, including corporatisation or privatisation. Not only can this provide revenue for local government, but transferring the management of assets to corporate entities can provide access to new skills, asset and risk management processes, and independent strategic planning.*[7]

A review of assets may identify circumstances where services could be better provided to the community by others. Assets associated with delivering such services may no longer be required by the local government in the long term.

3.2.8 Identify assets that could be shared with other local governments or organisations

A review of assets may identify high cost/low usage assets such as some machinery that could be shared between organisations or with neighbouring local governments.

6 *Integrated Planning and Reporting Advisory Standard,* Department of Local Government, 2011
7 *Strong foundations for sustainable local infrastructure,* Ernst and Young, 2012

4 Strategies to Increase Revenue

The public good/private good characteristics of services should be considered when reviewing fees and charges.

4.1 Review fees and charges

Fees and charges represent an opportunity to recoup the costs associated with providing goods and services. Although the fee or charge imposed for some services is limited under the Act, and other relevant legislation, the setting of fees and charges is generally at the discretion of the local government. Many local government services are provided for a community benefit (e.g. recreation facilities) and full cost recovery is not applied.

Consideration should be given to the public good/private good characteristics of the services provided and used in reviewing the extent to which fees and charges recover service costs. For example, fitness facilities where an entrance fee is charged have more private good characteristics than a park where it would be difficult to limit access.

An accurate analysis of services provided and associated costs for delivery of services would provide useful information for determining appropriate fees and charges.

4.2 Rating levels

Local governments set rates within a framework influenced by political circumstances and legislative requirements. Although a local government can set rates at whatever level it deems appropriate, market forces in the form of ratepayer backlash and capacity to pay issues provide a limit on rate increases.

A compromise between service levels expected by the community and rate increases that would be tolerated is often necessary.

Even a large increase in rates for a local government with a low rate base will not generate substantial revenue.

The development or review of a local government's rate setting policy may identify rating improvement opportunities. For example, differential rating may provide an opportunity to increase rate revenue in a manner that is fair and equitable.

4.3 Optimise use of borrowings and cash reserves to fund major capital works

Many local governments are reluctant to consider relying on debt to fund major capital works. However, developing a formal financial management policy that makes optimum use of borrowings and cash reserves to fund major capital works is a mechanism for spreading the cost of significant infrastructure across current and future generations.

> *An organisation could have affordable service levels but not enough projected cash to accommodate forthcoming asset renewal. In this case it should simply borrow if necessary to accommodate this need. If it has reliably estimated long-run service level costs and generates sufficient revenue to meet such costs, then there will be periods where cashflow is in excess of asset renewal needs, enabling any borrowings previously raised to be repaid* [8].

[8] *Practice Note No.6: Long-term Financial Planning (2012)*, Institute of Public Works Engineering Australia 2012

4.3 Optimise use of borrowings and cash reserves to fund major capital works (continued)

Use of borrowing to finance upgrading or expansion of infrastructure can free up internal funding for financing the maintenance of assets. Local governments with high levels of growth may need to fund the development of infrastructure and borrow in the knowledge of future increases in rates revenue as a result of that growth. However, local governments should be careful to ensure that repayment periods do not exceed the life of the assets being financed.

Implementation of the Integrated Planning and Reporting Framework will provide local governments with a clearer understanding of their long term financial position and may provide some local governments with the confidence to make greater use of debt.

Local governments are able to borrow from the Western Australian Treasury Corporation (WATC) at rates that are generally more competitive than commercial alternatives. In order to assist local governments in accessing loan funds in the most appropriate and prudent manner, the WATC has established a *Local Government Borrowing Kit* to facilitate the loan approval process. Further information on the application process can be obtained from www.watc.wa.gov.au.

5 Conclusion

Local government financial sustainability is constrained by increased service delivery demands coupled with aging infrastructure. If this situation is left unchecked, many local governments will need to make hard choices.

Substantially increasing rates revenue quickly without agreement from the community is not a sustainable option for many local governments. Residents are sensitive to the levies imposed by all levels of government and local government is not immune to concerns about perceptions of value for money. Even with increased revenue, insufficient planning for assets and inadequate appreciation of the full whole of life costs of assets will result in long term financial challenges.

Integrated Planning and Reporting provides a means for local governments to plan and monitor assets and a means to inform local governments about the true cost of their asset maintenance and replacement commitments.

Local governments have a further responsibility to manage their assets in a responsible manner on behalf of the community when difficult decisions to ensure financial sustainability are implemented.

Debt management is viewed as both an indicator of financial performance and as a financing opportunity. Out of hand dismissal of debt as an appropriate source of funding is not a measure of prudence, but rather a failure to entertain an important opportunity for meeting defined objectives.[9]

9 *The Journey: Sustainability into the Future*, WALGA Systemic Sustainability Study, 2008

6 References

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