ESSENTIAL SERVICES COMMISSION OF SOUTH AUSTRALIA

Advice

Local Government Advice

Framework and Approach

August 2022

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Glossary of terms

Commission	Essential Services Commission, established under the *Essential Services Commission Act 2002*
CPI	Consumer Price Index
Draft F&A	Local Government Rates Oversight Scheme: Draft Framework and Approach
F&A	Local Government Advice: Framework and Approach (this document)
LG Act	*Local Government Act 1999*
LGA	Local Government Association
LGFMG	Local Government Financial Management Group
LGGC	Local Government Grants Commission
LGPI	Local Government Price Index
LTFP	Long-term financial plans
IAMP	Infrastructure and asset management plan
The Scheme	Local Government Advice Scheme
SMP	Strategic Management Plan

1 Executive summary

On 30 April 2022, amendments to the *Local Government Act 1999* (the **LG Act**) came into operation (**the amendments**). Those amendments introduced an advisory scheme aiming to give ratepayers confidence that the rates they pay are set at the level necessary for their council to provide the services they value. The Essential Services Commission (**Commission**) is the advisory body. The State's 68 councils are subject to the scheme.

The amendments gave the Commission discretion in relation to scheme design and implementation. The Commission consulted on a proposed framework and approach and, after taking into account comments received, has resolved a final Framework and Approach as set out in this document.

The Framework and Approach builds on documents that councils are already required to have under the LG Act: their long-term financial plans (**LTFP**) and their infrastructure and asset management plans (**IAMP**). The focus of the scheme is that the Commission must advise on material changes made or proposed to be made to councils' LTFPs and IAMPs (and a council's reasons for those changes), if any, and revenue sources outlined in the LTFPs. These are referred to in the LG Act as '*Relevant Matters*'. The Commission also has discretion to advise on other issues concerning LTFPs or IAMPs.

The legislation provides for two methods for the Commission to receive the information on which its advice will be based. The first method is by way of a schedule determined and published by the Commission under which councils are required to provide information on *Relevant Matters*. The other is a power to require a council to provide information that the Commission reasonably requires to provide the advice.

It is an advisory scheme, rather than a compulsive one. The scheme provides advice only, with decision making in the hands of the councils. This means that the Commission cannot require councils to follow the advice. However, the scheme requires both the Commission and councils to publish the advice and, if a council wishes to respond to the advice, that council must publish that response in its annual business plan.

Advice provided under the scheme therefore has broad benefits: it will inform councils' decision making and will also provide to ratepayers and other interested stakeholders an independent consideration of a council's plans, thereby adding value across local communities. In this way the scheme will achieve its purpose of giving confidence to ratepayers about the setting of their rates.

1.1 Scheme design principles and concepts

Seven principles guided the Commission in the Framework and Approach design:

Table 1: Principles

Principle	Reason
Principle 1: Monitoring, not regulating	The scheme relates to monitoring, not economic regulation. As such, the design focuses on providing evidence-based and useful advice. The objective being, through time, to develop a record of a council's performance, relative to its long-term planning, and its response to advice, as the basis for changing behaviours and outcomes over time. The scheme does not provide the Commission with powers to enforce compliance measures, set service standards or regulate any council's rates. In those respects, it differs from other States' council rates regulation frameworks, such as those in Victoria and New South Wales.

Principle	Reason
Principle 2: Long-term planning focus	While councils can provide a diverse range of services, they are generally delivered through infrastructure and operations that require long-term planning. In relation to existing infrastructure assets, in the absence of significant shocks outside of a council's control, its long-term plans would not be expected to exhibit significant variation through time (replacement/renewal expenditure should not materially vary due to political cycles, or short-term transient operational or financial concerns). For new assets, it is important that these are planned for, implemented and managed on that same long-term basis.
Principle 3: Materiality	Focus will be given to key overarching targets and measures. Otherwise, the underlying analysis may become unduly complex/disaggregated, with key observations diluted through unnecessary detail.
Principle 4: Simplicity	The scheme will be as simple as it practically can be and be capable of being applied across the diverse range of councils within South Australia.
Principle 5: Leveraging existing information and evidence	The Local Government Grants Commission (**LGGC**) collects data and the Local Government Association (**LGA**) provides guidance material regarding financial and service sustainability. As such, a significant amount of underlying information and a standard accounting framework exists - this will underpin the analytical framework. In accordance with the legislative framework, if demonstrable gaps in information become apparent that are of relevance to the operation of the scheme, it may be necessary to collect further information in relation to this.
Principle 6: Consistency of application	The scheme will be applied consistently across councils in terms of the underlying processes and analytical framework. Advice across councils will only be similar if all the inputs into the analytical framework (both quantitative and qualitative) result in similar advice being warranted.
Principle 7: Transparency	The implementation of the scheme requires transparency in processes and approach. Each council will be provided with the information and calculations upon which the advice relating to it has been based.

In addition to the design criteria, the core concept is that councils should operate on a long-term financially sustainable basis, for the benefit of ratepayers. The Commission will apply the nationally agreed definition of financial sustainability for the local government sector, which is:

> *A Council's long-term financial performance and position is sustainable where planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services.*

The Commission considered that concept in the context of three elements (the sustainability elements), developed by the local government sector, which are:

Program stability: This relates to the provision of reliable quality services over time, and requires a stable and consistent set of actions, from the perspective of day-to-day operations and infrastructure management.

Rate stability: This relates to charging ratepayers reasonably to fund the services, underpinned by the program of works noted previously (program stability). Rates should be stable, noting that stable does not mean fixed but rather the absence of large or unplanned year-on-year variances.

Intergenerational equity: This relates to fairly sharing services and the associated cost between current and future ratepayers. It requires adopting sound long-term financial management principles, particularly in relation to the balance between debt and cash in financing service delivery.

The sustainability elements should already be applied in practice. They encapsulate financial and service sustainability, cost control and affordability in a way which can be measured consistently on both a forward- and backward-looking basis, given their connection with the model accounting framework adopted. This provides a picture of how a council proposes to manage its ongoing financial and service sustainability, in the context of its past decisions, and the role that general rates, affordability and cost control will play.

1.1.1 The advice

In a four-yearly cycle for each council, the Commission will address the *Relevant Matters*, which are:

- material amendments made or proposed to be made to the council's LTFP and IAMP and the council's reasons for those amendments
- revenue sources outlined in the funding plan (being a component of the LTFP) and
- any other matter prescribed by the regulations.

This will be informed by each council’s own performance and financial trends, producing trend-based advice that will:

- support councils to make decisions relating to their annual business plans and budgets in the context of their LTFP and IAMPs, which together are foundational documents that set out how councils propose to manage their financial position and performance over the longer term, and
- assist councils to make appropriate decisions on the level of financial contributions to be made by ratepayers for the provision of services and infrastructure within the context of their LTFPs and the financing options available to councils (such as the use of borrowings or reserves).

In preparing this trend-based advice, the Commission will inform itself by reference to historical information (from 2011-12 onwards) that councils are already required to have under the Act, and to existing practices, procedures and protocols. In particular, it will have regard to three financial indicators specified in the *Local Government (Financial Management) Regulations 2011*: the operating surplus ratio, the net financial liabilities ratio and the asset renewal funding ratio. Since 2011, councils have been required to refer to these three indicators in their plans, annual budget, mid-year budget review and annual financial statements.

2 Introduction

Through amendments to the *Local Government Act 1999* (the **LG Act**), which came into operation on 30 April 2022, the South Australian Government has enacted a Local Government Advice Scheme (**the scheme**). The scheme involves the provision by the Commission of advice to councils in relation to their strategic management plans.

The scheme will benefit ratepayers by supporting councils' decision-making processes, affording ratepayers increased transparency and greater confidence that council operations are being undertaken on a long-term financially sustainable basis.

Importantly, the scheme implicitly recognises the ability of councils and their ratepayers to make decisions on the level and scope of services that the community might desire and for which it may be willing to pay. The advice to be provided under the scheme will provide independent and transparent information on matters which will be key to those discussions and decisions. The advice will also provide to ratepayers and other interested stakeholders an independent consideration of a council's plans, thereby adding value across local communities.

Equally importantly, the scheme and the advice under it are not in the nature of an 'audit' or any similar concept. Those are distinct activities for different and distinct purposes, with a backwards-looking focus; this scheme is for the purposes outlined above and, as explained in this document, is forward-looking in nature. Nor is the scheme regulatory in nature: it is an advisory scheme, rather than a compulsive one; councils are not required to follow the advice.

Under the LG Act, the Commission is responsible for developing and administering the scheme. In March 2022, the Commission commenced public consultation, through a Draft Framework and Approach document (**Draft F&A**), on how it proposed to undertake those statutory tasks. The Draft F&A focussed on explaining how the Commission proposed to understand and analyse strategic management plans so it can give the advice.

This paper sets out the Commission's final Framework and Approach (**F&A**) (refer Chapter 5), including responses to the submissions received through the consultation process and an explanation of any amendments made to its approach to developing and administering the scheme (refer Chapters 3 and 4).

2.1 Scheme overview

Under the scheme set out in section 122 of the LG Act, a council must, on or before 30 September in the relevant financial year for the council, provide to the Commission all relevant information on the following matters (the *Relevant Matters*) in accordance with guidelines determined by the Commission (if any):

- material amendments made or proposed to be made to the council's long-term financial plan (**LTFP**) and infrastructure and asset management plan (**IAMP**) and the council's reasons for those amendments
- revenue sources outlined in the funding plan (being a component of the LTFP) and
- any other matter prescribed by the regulations.

Following the provision of information by a council, the Commission, on or before 28 February in the relevant financial year for the council:

- *must* provide advice to the council on the appropriateness of the *Relevant Matters* (as defined above) in the context of the council's long-term financial plan and infrastructure and asset management plan (as this is a mandatory requirement it may be seen as the Commission's primary scheme statutory function under section 122(1f)(a) of the LG Act), and
- *may*, if the Commission considers it appropriate having regard to the circumstances of a particular council, provide advice in relation to any other aspect of the council's long-term financial plan and infrastructure and asset management plan (as this is a discretionary requirement it may be seen as the Commission's secondary scheme statutory function under section 122(1f)(b) of the LG Act).

In providing advice under section 122(1f)(a), the Commission:

- *must* have regard to the following objectives:
  - the objective of councils maintaining and implementing long-term financial plans and infrastructure and asset management plans, and
  - the objective of ensuring that:
    - the financial contributions proposed to be made by ratepayers under the council's long-term financial plan and infrastructure and asset management plan are appropriate, and
    - any material amendments made or proposed to be made to these plans by the council are appropriate.
- *may* have regard to any information or matter the Commission considers relevant (whether or not such information or matter falls within the ambit of the matters defined as *Relevant Matters*).

A council must ensure that the advice provided by the Commission under the scheme, and any response of the council to that advice, is published in the council's annual business plan (both the draft and adopted annual business plan) in the relevant financial year and each subsequent financial year (until the next relevant financial year for that council).

The *Relevant Financial Year* is the year in which a council goes through the scheme. The first cycle of the scheme is four years long, with around 17 councils going through the scheme annually, based on the current Schedule.

The scheme also provides two methods for the Commission to obtain information it requires.

First, under section 122(1e) of the LG Act, a council must provide to the Commission all relevant information on *Relevant Matters* on or before the end of September in a year when it goes through the scheme (and, if the Commission has made guidelines, then the council must follow those guidelines in doing so).

Second, under section 122(1j), the Commission can require a council to provide information in that council's possession, where the Commission reasonably requires that information for the performance of its functions.

In both instances, whether making guidelines or requiring other information, the Commission will give careful consideration to whether the information concerned is reasonable in terms of its primary and secondary scheme statutory functions.

2.2 Financial sustainability – LTFPs and IAMPs

The nationally agreed definition of financial sustainability for the local government sector is:

> *A Council's long-term financial performance and position is sustainable where planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services.*

The Commission considered that concept in the context of three elements (the sustainability elements), have been developed by the local government sector, which are:

Program stability: This relates to the provision of reliable quality services over time, and requires a stable and consistent set of actions, from the perspective of day-to-day operations and infrastructure management.

Rate stability: This relates to charging ratepayers reasonably to fund the services, underpinned by the program of works noted previously (program stability). Rates should be stable, noting that stable does not mean fixed but rather the absence of large or unplanned year-on-year variances.

Intergenerational equity: This relates to fairly sharing services and the associated cost between current and future ratepayers. It requires adopting sound long-term financial management principles, particularly in relation to the balance between debt and cash in financing service delivery.

The sustainability elements should already be applied in practice. They encapsulate financial and service sustainability, cost control and affordability in a way which can be measured consistently on both a forward- and backward-looking basis, given their connection with the model accounting framework adopted. This provides a picture of how a council proposes to manage its ongoing financial and service sustainability, in the context of its past decisions, and the role that general rates, affordability and cost control will play.

The LG Act provides for a cycle of planning, aimed at embedding financial sustainability into a council's planning processes. It requires that a council must ensure the sustainability of its long-term financial performance and position.[1] Councils also need to have a Strategic Management Plan (SMP), including a LTFP and an IAMP, with both covering a period of at least ten years.[2] A council's Audit Committee must provide input to any review of SMPs.

Regulation 5(1) of the *Local Government (Financial Management) Regulations 2011* requires that a LTFP must include:

- a summary of proposed operating and capital investment activities presented in a manner consistent with the note in the Model Financial Statements entitled *Uniform Presentation of Finances*, and
- estimates and target ranges adopted by the council in each year of the LTFP, with respect to an operating surplus ratio, a net financial liabilities ratio, and an asset renewal funding ratio, presented in a manner consistent with the note in the Model Financial Accounts entitled *Financial Indicators*.

Further, the LTFP must include a statement[3] setting out the purpose of the LTFP, the basis on which it has been prepared (including key assumptions) and the key conclusions which may be drawn from the estimates, proposals and other information in the LTFP.

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[1] Section 8.
[2] Section 122 (1a)
[3] This statement must be expressed in plain English and must avoid unnecessary technicality and excessive detail.

The LG Act requires an annual review of LTFPs.[4] As part of that review, a council's Chief Executive Officer must prepare a report on the council's financial sustainability.[5]

IAMPs are to be updated within two years after each general election of the council.[6]

2.3 Draft Framework and Approach

On 31 March 2022, the Commission published a *Local Government Rates Oversight Scheme: Draft Framework and Approach* (**Draft F&A**) for an eight-week consultation period, ending 27 May 2022. That document set out the Commission's:

- understanding and interpretation of the legislative framework enacting the scheme
- proposed analytical framework and approach for implementing the scheme
- proposed approach to information collection and information provision guidelines, and
- indicative cost estimates for administering the scheme, and options for recovering those costs.

The Commission also published a Schedule, which identified the year that each council would go through the first four-year cycle of the scheme (the *Relevant Financial Year* for each council).

Elements of the Draft F&A have already been updated during the process of preparing this F&A, reflecting the Commission's own work during that time. This includes having itself accessed historical financial and operational data (rather than requiring councils to do so) where that is available on the public record (e.g., council and other public websites) and commencing work with individual councils in anticipation of the scheme's commencement.

One further change, discussed with councils during the consultation process, is the name of the scheme. During the development of the scheme, it was generally referred to as a 'rates oversight' regime – and the Commission adopted that term for the Draft F&A.

It was noted during consultation that this term does not reflect the provisions of the scheme as set out in the LG Act. The Commission has therefore decided to change the term for its new role to 'Local Government Advice'. This change is reflected in this F&A and in the Commission's communication materials.[7]

2.4 Submissions

The Commission received 27 submissions to the consultation: one from the Local Government Association (**LGA**), one from the Local Government Financial Management Group (**LGFMG**), 24 from individual councils and one from a private individual.

Submissions expressed concerns that:

- the proposals in the Draft F&A are beyond the scope of that envisaged for the scheme under the LG Act
- the proposals are onerous on councils in terms of information provision and the use of council resources

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[4] Section 122 (4)(a)
[5] Section 122 (4a)(a)
[6] Section 122 (4)(b)
[7] See, for example, the local government advice page on the Commission's website, which, along with information on the Commission's other advisory role (to Government), can be accessed via the 'Advice' tab on the home page of the Commission's website at www.escosa.sa.gov.au

- the proposals do not add any value to existing requirements and processes, and
- the Commission's proposed costs under the scheme are greater than expected.

These, and other specific concerns regarding the Draft F&A's proposals are discussed in detail in Chapter 4.

In summary, many of the matters raised focussed on a particular view of the legal operation and effect of the scheme and the Commission's powers under it. The Commission has considered the reasoning underpinning that view and, for the reasons set out in Chapter 4, it does not accept it.

2.5 Next steps

Having considered submissions and finalised the F&A, the Commission's focus moves to practical implementation of the scheme. Since the commencement of the relevant section of the LG Act in April 2022 (after the release of the Draft F&A), the Commission has collected much, but not all, of the historical quantitative information from 2011-12 onwards that it needs from councils' websites and other public sources, collating those for use in analysis for the preparation of advice.

It has also commenced discussions with individual councils, focussing on those for whom 2022-23 is the *Relevant Financial Year*, and it will continue to do so. The Commission thanks councils for the practical and pragmatic approach demonstrated in those discussions to date. Having obtained much relevant data and information already, the Commission will now work with individual councils on scheme implementation issues, including identifying any data or information gaps and verifying the data already obtained.

3 Background

This Chapter outlines the proposals and methodology set out in the Draft F&A, to provide context for the discussion of stakeholder submissions and the Commission's response to these in Chapter 4. In developing the proposed framework, the Commission had regard to a set of seven principles.[8]

3.1 Identifying risks, behaviours and establishing the baseline

The Draft F&A proposed that, in forming its advice, the Commission would assess the LTFP and IAMP, and any material changes proposed, with respect to cost control, affordability and sustainability risk. This is because any council will find it challenging to develop a robust long-term financial and service sustainability strategy if the costs associated with the services it delivers, given the infrastructure used to deliver them, do not reflect its ratepayers' financial capacity.

This notion of risk relates to a council's behaviour. The LTFP and IAMP forecast a council's intentions, which is its planned behaviour, while historical information provides evidence of actual behaviour. Further, historical behaviour directly influences the LTFP and IAMP because it affects their respective starting points. Given this, to advise on the *Relevant Matters* as required under the scheme, the Commission explained how it would establish and interpret a set of baseline information, which would allow it to understand the origins of a council's current LTFP and IAMP and any material changes it might propose to those.

3.2 Existing financial indicators

The draft proposals and methodology built upon existing practices and information. It was noted that the LGA considers that performance, relative to the definition of financial sustainability, is encapsulated in the operating surplus, net financial liabilities, and asset renewal funding ratios, as specified in the *Local Government (Financial Management) Regulations 2011* (see Appendix 1 for a summary description of each ratio). These financial indicators were proposed to be used as the starting point in understanding a council's performance.

3.3 The Model Financial Statements

These financial indicators are specific to the local government sector. Adoption of the Model Financial Statements since 2007-08 results in the financial statements of South Australian councils being prepared in a consistent manner, from both a definitional and detail perspective, allowing tracking of the calculation of the financial indicators through the three principal financial statements (the statements of comprehensive income, financial position, and cash flows). This applies to both historical information and to each council's forward-looking LTFP,[9] allowing linkage of a council's forward-looking projections to its historical performance and position.

[8] Those principles are set out in the Executive Summary and Chapter 5. There were slight amendments to Principles 2 and 5 based on submissions. For Principle 2, the amendments separated out the consideration of existing and new assets. For Principle 5, the amendments clarify that the LGA does not collect data but provides guidance materials.

[9] The Commission notes that the regulation 5(1) of the *Local Government (Financial Management) Regulations 2011* specifies that the LTFP must include a summary of proposed operating and capital investment activities (regulation 5(1)(b)) and estimates and target ranges for all three key financial indicators (regulation 5(1)(c)). To prepare these forecasts, information must be drawn from all three principal financial statements - the statement of comprehensive income, statement of financial position, and statement of cash flows.

3.4 The overarching analytical framework

The existing financial indicators and the Model Financial Statements were proposed as the basis for an overarching analytical framework for the first cycle of the scheme. The Commission noted that the three financial indicators encapsulate each council's approach to its LTFP and IAMP – and hence to financial and service sustainability, cost control and affordability.

Measurement of the financial indicators is consistent on both a forward- and backward-looking basis, given their connection with the Model Financial Statements. It captures a council's actual practical business operations historically and its expected future business operations on the same basis. This provides a picture of how a council seeks to manage its ongoing financial and service sustainability, in the context of its past decisions and the role that general rates, affordability and cost control will play.

The Commission noted that, if future business operations are underpinned by robust, transparent LTFPs and IAMPs that are:

- consistent with each other
- that focus on financial sustainability, cost control and affordability, and
- implemented and appropriately monitored,

then a council will likely exhibit strong future performance with respect to all three financial indicators. The further a council might deviate from those practices, the less likely those outcomes, and the greater the risk to long-term financial and service sustainability, and for ratepayers.

3.5 Implementing the overarching analytical framework

The overarching analytical framework is conceptual. In practice, the Commission proposed bringing together a set of relevant information and an analytical process applied consistently across councils, assisting it to consider the following questions in the context of the statutory provisions of the scheme:

- Are a council's LTFP and IAMP robust, consistent with each other and successfully implemented, with actual performance relative to plans monitored?
- Does the LTFP and IAMP, and the implementation of those plans, ensure the sustainability of the council's long-term financial performance and position?
- What are the implications of the above for a council's long-term financial sustainability and service risk profile, and the consequent appropriateness of the path projected for general rates?

3.5.1 Information used in applying the analytical framework

The Commission proposed to use the following information in applying the analytical framework. Existing information relates to that already in a council's possession, that the Commission reasonably requires under section 122(1j) of the LG Act, or information available from other sources. Revised information relates to information provided under section 122(1e) of the LG Act where a council has made or proposes to make material revisions to its LTFP and IAMP, or other information that the Commission reasonably requires under section 122(1j) of the LG Act.

Table 2: Information requirements for the Draft F&A

Existing information	Revised information
<u>From councils</u> *<u>Quantitative</u>* ▶ Annual Model Financial Statements from 2007-08 ▶ Annual FTEs from 2007-08 ▶ Annual rateable properties from 2007-08 *For the year prior to the Relevant Financial Year (or most current)* ▶ LTFP and IAMP empirical information *<u>Qualitative</u>* *For the year prior to the Relevant Financial Year (or most current)* ▶ LTFP documentation/explanation ▶ IAMP documentation/explanation ▶ CEO financial sustainability report ▶ Audit committee reports on the LTFP and IAMP ▶ How a council measures performance to plans ▶ How a council accounts for affordability ▶ A council's consultation process for its LTFP <u>Other sources</u> ▶ LGFA information on a council's ability to use debt ▶ Historic and forecast CPI ▶ The SEIFA index of economic resources	<u>From councils</u> *<u>Quantitative</u>* ▶ Revised LTFP and IAMP empirical information ▶ Revised FTEs ▶ Revised annual rateable properties *<u>Qualitative</u>* ▶ Revised LTFP documentation/explanation ▶ Revised IAMP documentation/explanation ▶ Council's explanation for material variations ▶ Any other material a council considers relevant

An Information Provision Guideline, which followed the structure of the Model Financial Statements, including a proforma to structure empirical information provision, was provided.[10] The Commission proposed the provision by a council to it of **existing** information by end-August of its Relevant Financial Year, with the **revised** information required by end-September of the Relevant Financial Year.

3.5.2 Questions for the Commission to ask itself in applying the analytical framework

The Commission set out, for information and transparency, 29 key questions that it intended to ask itself in preparing advice. These related to the operating surplus, net financial liabilities, and asset renewal funding ratios, to help the Commission understand any risks or behavioural patterns that might be of use in forming advice to councils, in the context of the statutory terms of the scheme.

[10] The Guideline covered (and will cover) the requirements under section 122(1e), dealing with the manner and form in which the *Relevant Matters* are to be provided by councils, and section 122(1j), dealing with other relevant information that the Commission requires for the performance of its scheme functions.

Table 3: Objectives of the key questions

Financial ratio	Objective
Operating surplus ratio	To understand what is driving a council's operating surplus ratio and the extent to which this indicates potential concerns regarding affordability and cost control risk.
Net financial liabilities ratio	To understand what is driving a council's net financial liabilities ratio and the extent to which this indicates potential concerns regarding financial and service sustainability risk.
Asset renewal funding ratio	To understand what is driving a council's asset renewal funding ratio. This relates to assessing the consistency of the LTFP and IAMP, and the extent to which these appropriately reflect actual asset condition. This has implications for financial and service sustainability, as well as affordability and cost control risk.

3.5.3 The analytical process

The analytical process explained how the Commission would address the 29 key questions, using graphs and accompanying commentary, based upon the existing information.

This approach is, in the Commission's experience, more accessible to stakeholders. It makes clear any trends in a council's actual and expected behavioural patterns, based upon the council's own information and evidence, providing a pictorial baseline representation. This then informs the consideration of the appropriateness of any material changes to a council's LTFP and IAMP, as envisaged under the LG Act.

A worked example of the Commission's internal analytical process and how it links back to the key questions and financial indicators was provided. It included graphs that scale/normalise aggregate information by the number of rateable properties to provide average per rateable property figures. It also included graphs comparing actual and forecast information relative to the rate of change in the Consumer Price Index (CPI).

3.6 Provision of advice

The Commission noted that, for the first cycle, its advice will set out trend information (the baseline), to give context to councils' forward-looking plans, and identify areas that may benefit from further consideration by a council, focussing on:

- the appropriateness of a council's LTFP and IAMP, any material amendments to it, and the proposed path for general rates and other revenue sources
- the long-term financial and service sustainability, cost control and affordability risk considered to exist, based on implementing the analytical framework,[11] and
- any other factors the Commission might consider relevant.

[11] The quantitative long-term trend analysis enables the advice to provide an overarching picture of any potential cost control, affordability, and sustainability risk, based upon actual performance and forecast performance. Further, the advice can use available qualitative information regarding a council's SMP, its current CEO sustainability assessment and its approach to setting rates to identify how any risks identified in the quantitative assessment are managed/mitigated, creating opportunity for councils to consider those matters as needed.

This approach will identify the extent to which there are potential issues with the council's approach to managing cost control, affordability, and sustainability risk. This, in turn, allows the advice to reference the extent to which a council's price path for general rates might be appropriate in that council's overall context.

The Commission also noted that the advice may provide its view on the potential actions a council might take to mitigate/manage any identified risk. At the same time, the Commission observed that the advice cannot require councils to take specific action, nor would the advice approve (or otherwise) specific expenditure, programs, or projects: those being matters for councils' own decision-making processes.

3.6.1 Process

The Commission proposed publishing all advice in full, as anticipated by the LG Act.[12] It also noted that a council provides services subject to limited or no competition to ratepayers in its region. Ratepayers directly contribute to the financing of those services, generally with no other choice of supplier. Their financial contributions are based directly upon the plans developed and implemented by the council.

In those circumstances, the Commission out the view that publication of the advice in full would be in the public interest and not constitute commercially sensitive information. The Commission also noted that, under section 122(1h), a council may, if it chooses to, respond to the advice, with that response also published.

3.7 Scheme costs

Indicative cost estimates for the first four-year cycle of the scheme were provided. The indicative total cost per council over the first four-year cycle was $52,133.

The Commission noted that delivering the proposed analytical framework and the scheme in the manner envisaged in the legislative reforms requires skilled resources. This assures ratepayers, councils and the South Australian Government that the advice provided is based upon an appropriate level of expertise.

It was noted that the costs were indicative, as the cost involved in implementing the scheme will become clearer after the completion of the first cycle of the scheme.

3.7.1 Allocating costs and billing

Two options were proposed for the billing and allocating of cost across councils.

- Option 1: The Commission bills each council directly its share of the costs at the end of the first quarter of the financial year, with one month within which to pay the outstanding bill. Costs are split equally across the 68 councils, given there is no evidence to indicate that it will not take the same amount of effort per council to implement the scheme, regardless of a council's size.
- Option 2: The Commission bills the LGA its yearly total cost, the LGA pays this on behalf of councils, with the LGA splitting the cost between councils on a basis agreed between the LGA and the councils.

[12] Refer sections 122(1h) and 122(1i).

4 Discussion of submission themes

Common themes in submissions were that the Commission's proposed methodological approach went beyond the scope of that envisaged by the LG Act, would be onerous on councils in terms of information provision and resources, would not add any value to existing requirements and processes and would increase the per council costs of the scheme to a level beyond that expected by those who made submissions.

These matters are discussed below on a thematic basis, along with the Commission's response.

The Commission has given consideration to and acknowledges all arguments and submissions made through the consultation process. While it has not adopted all positions put, all submissions have assisted the Commission to consider each of the relevant issues under consideration and to understand the competing viewpoints held.

4.1 Summary of Commission's final position

After consideration of the responses to the consultation, the F&A in its final form broadly aligns with the Draft F&A, with the main changes being:

- The evidence base to be used in the preparation of advice for each council will be developed by the Commission accessing readily available material on the public record, such as via websites, rather than by requiring councils to submit that information (albeit it may ask individual councils for historical information where there are 'gaps' in the public record).
- The Commission will utilise historical information from 2011-12, rather than 2006-07 as proposed in the Draft F&A, in that evidence base.
- The Commission will distribute the annual costs of the scheme amongst councils based on the LGA Membership Fee split, rather than equally distributed across councils, with the Commission annually billing each council separately.

4.2 The scope of the legal framework

Submissions provided views on the legal framework, its evolution and how the Commission should interpret the legislation.

In summary, the Commission's understanding of the central argument put forward is that the Commission can only consider a council's LTFP and IAMP, as they stand and any material variations thereof, when formulating its advice on the *Relevant Matters*. This implies the Commission is constrained to only using the LTFP, IAMP and any identified material variations provided by the council as its information sources, and that the advice can only relate to the *Relevant Matters*.

4.2.1 Consideration

The Commission considers that the legislative framework, as enacted by Parliament on 22 June 2021, is the source of the Commission's powers and functions for undertaking its advisory function. The interpretation put forward in submissions does not account for the following aspects of the legislative scheme:

- In addition to its primary purpose of providing advice to a council on the appropriateness of the *Relevant Matters* in the context of the council's LTFP and IAMP, the Commission also has a discretion to provide advice on any other aspect of the LTFP and IAMP, if it considers doing so to be appropriate having regard to the circumstances of the council (section 122(1f)).

- In providing advice, the Commission must have regard to the objective of councils maintaining and implementing LTFPs and IAMPs (section 122(1g(a)). It must also have regard to the appropriateness of the financial contributions proposed to be made by ratepayers under the LTFP and IAMP and any amendments to those plans (section 122(1g(b)).
- A council must provide all relevant information on the *Relevant Matters* on or before 30 September in the year in which it is to go through the scheme and must do so in accordance with any guidelines determined by the Commission (section 122(1e)).
- Further, having regard to its statutory functions and the circumstances of the relevant council, the Commission may by written notice require a council to submit to it any information in the council's possession that the Commission reasonably considers relevant to the performance of its scheme function, regardless of whether it falls within the ambit of the *Relevant Matters* (section 122(1j)).

The above aspects are important in identifying the actual scope of the Commission's legislative functions, the advice it must (and may) provide and the information upon which that advice can be based. This is broader than the interpretation suggested in submissions. When providing its advice, the Commission will have regard to the importance/value of specific information and its overall relevance and will be mindful of the potential impost on Councils in providing that information.

4.3 Disproportionate focus on rates

Submissions put the view that the Draft F&A had a disproportionate focus on rates, at the expense of other revenue sources.

4.3.1 Consideration

The Commission considers that the methodology places appropriate weight on general rates in the context of the LTFP and IAMP. The legal framework requires the Commission, in providing advice, to have regard to the appropriateness of the financial contributions proposed to be required of ratepayers (which comprises rates and specific service charges).[13]

Under section 122(1g) of the LG Act:

> *(1g) In providing advice under this section, the designated authority—*
>
> *(a) must have regard to the following objectives:*
>
> *(i) the objective of councils maintaining and implementing long-term financial plans and infrastructure and asset management plans;*
>
> *(ii) <u>the objective of ensuring that the financial contributions proposed to be made by ratepayers under the council's long-term financial plan and infrastructure and asset management plan are appropriate</u> and any material amendments made or proposed to be made to these plans by the council are appropriate; and*
>
> (emphasis added)

Bearing that in mind, and to give context to the submissions, it is noted that the Draft F&A set out 29 questions the Commission proposed to use to assess an LTFP and IAMP; of those, five directly relate to operating income sources.[14]

[13] The Commission notes a council can use a range of charging structures. The Commission's advice relates to all financial contributions made by ratepayers, not just rates.

[14] Refer Chapter 5, section 5.3

The presentation of the analytical framework in the Draft F&A included 25 graphs proposed to be used by the Commission to assist *it* in identifying any long-term trends and behavioural patterns in the drivers of the operating surplus, net financial liabilities and asset renewal funding ratios, and a council's asset stock and borrowings.[15] Of those, only two specifically considered rates: one to identify long-term trends in the proportion of rates with respect to total operating income and one relating to long-term trends in average rates per rateable property.

The Commission's focus is on seeking to understand the role that rates have played and are expected to play in councils' plans, which is consistent with the statutory terms of the scheme.

4.4 The use of historical information

Submissions expressed various concerns with the proposed use by the Commission of historical information, such as:

- The information required is beyond the scope of the legislative requirements.
- Requiring that historical information be provided before end-September is beyond the scope of the legislation (councils have until end-September to provide the relevant information).
- Model Financial Statements dating back to 2007-08 are of limited relevance and completing the Excel proforma represents a significant cost to councils and the recreation of information. This contradicts Principle 5 (as set out in the Draft F&A). Further, councils are only required to keep information for seven years.
- If historical data is to be used it should only go back for a shorter period, somewhere between one and ten years, with many submissions suggesting four, on that basis that this is more reflective of existing practices, with the information being of better quality.
- Providing information from 2007-08 in relation to CEO financial sustainability and audit committee reports, and the council's approach to consulting with its constituents, is not relevant.

4.4.1 Consideration

The Commission will use Model Financial Statements dating back to 2011-12 rather than 2007-08, noting that timing is broadly consistent with the commencement of the three financial indicators specified in the *Local Government (Financial Management) Regulations 2011*. In doing so it will explore the data to understand any anomalies, statistical departures, and the reasons for them. This establishes an historical baseline from which to observe any behavioural patterns in a council's historical approach to managing and maintaining services delivered using long-lived assets, when assessing and advising on LTFPs, IAMPs and any material variations proposed.[16]

Since the release of the Draft F&A and the commencement of the relevant section of the LG Act, the Commission has commenced collecting historical information, primarily relating to historical Model Financial Statements, from councils' websites and other public sources, reducing the burden on councils.

As a result, in relation to historical data, the Commission will limit requests to specific councils to address any information 'gaps' in the record from 2011-12 onwards, that the Commission considers relevant when undertaking its function under the LG Act. The Commission will work with councils to verify the information it has collected.

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[15] Refer Appendix 2 for details of the graphs.

[16] Refer section 4.7 below for a detailed discussion on the issue in the context addressing submissions on the asset renewal funding ratio.

This is consistent with the approach adopted by the Commission for councils over the past year in relation to historical operational and performance data for their water and wastewater regulatory activities. That process, which covered much more detailed information sets (financial, operational, usage, and pricing information) than those under consideration in this scheme, provided greater visibility of long-term trends to council staff.

Once the historical information is collected, collated, and verified that task is not required again – the Commission will simply update the relevant information each year as that information becomes available.

The Commission's responses to specific issues raised regarding the provision and use of historical data are set out in the table below.

Table 4: Historical information

Issue	Commission consideration
Requiring historical information be provided before end-September is beyond the scope of the legislation. Councils have until end-September to provide the relevant information.	The end-September date relates to when councils are required under section 122(1e) of the LG Act to provide to the Commission information on *Relevant Matters*, noting that a council can provide this information earlier. The Commission has no discretion to vary this timing. In accordance with section 122(1j), the Commission considers that historical information is required for the performance of its functions under the scheme. This information should be able to be provided earlier by councils (given it is historical in nature) albeit it may be stored or archived. Given the Commission's revised approach to obtaining historical information, the level of effort for councils in providing the information is reduced.
Completing the Excel proforma represents a significant cost to councils. Councils are only required to keep information for seven years.	The Commission now intends to complete this work using its own resources. The Commission will collate this information and liaise with each council to see if any missing information can be obtained (or if there are reasons why it is not available). As noted above, this process has already started. Each Council will be provided with the complete set of its historical information and an opportunity to check and verify it, if it so wishes.
Information from the Model Financial Statements from 2007-08 is of limited relevance. More recent information reflects existing practices, with the information being of better quality.	The Commission will use information from 2011-12 because: ▶ That timeframe is broadly consistent with the commencement of the three financial indicators specified in the *Local Government (Financial Management) Regulations 2011*. ▶ Time series information provides insights into behaviours and practices. This is particularly relevant in the context of operating, maintaining, and renewing long-lived asset stocks, which councils do. ▶ The Commission will take the quality of information into account, noting that all Model Financial Statements have been formally audited and signed-off.

Issue	Commission consideration
CEO financial sustainability and audit committee reports from 2007-08 are not relevant.	For clarification: the Draft F&A proposed to use the *current* CEO financial sustainability and audit committee reports to inform the Commission's understanding of the extent to which the objective of councils maintaining and implementing LTFPs and IAMPs is or will be met (LG Act, section 122(1g)(a)(i)). No historical information on those matters is required. This will be clarified further in any revised information provision guidelines.
Historical information from 2007-08 regarding the council's approach to consulting with its constituents, is not relevant.	For clarification: the Draft F&A proposed using the most current information to inform the Commission's understanding of the extent to which the objective of ensuring that ratepayers' financial contributions are reasonable is or will be met (LG Act, section 122(1g)(a)(ii)). No historical information on those matters is required. This will be clarified further in any revised information provision guidelines.

4.5 Forward-looking information

Submissions put the view that forward-looking information should reflect the information contained in the Uniform Presentation of Finances and the ratios, not that contained within the Model Financial Statements and the ratios.

The LGA, the LGFMG and most councils submitted that the Commission can meet the intent of the scheme through councils' compliance with regulation 5(1) of the *Local Government (Financial Management) Regulations 2011*.[17]

4.5.1 Consideration

The Commission has carefully considered the submissions made and, for the reasons set out below, has decided to largely maintain the approach to the LTFP as set out in the Draft F&A. That is, councils should provide the forward-looking information in a manner consistent with the Model Financial Statements and include forecasts of the number of rateable properties and council FTE. The relevant information relates to information provided under section 122(1e) of the LG Act where a council has made or proposes to make material revisions to its LTFP and IAMP, or other information that the Commission reasonably requires under section 122(1j) of the LG Act for the performance of its functions.

The Commission has accepted that the information relating to the Note 2 breakdown of income, which breaks income down to a lower level of detail than that included in the Statement of Comprehensive Income in the Model Financial Statements, can be removed.

For subsequent cycles of the scheme, forward-looking information requirements will be assessed to identify if they can be changed; however, it remains relevant and appropriate to establish a robust baseline of evidence and information at scheme commencement.

In terms of the submissions urging reliance on the Uniform Presentation of Finances (Note 16 of the Model Financial Statements), the Commission observes that this would result in it assessing information on the following basis.

[17] Refer section 2.2 above.

Table 5: Uniform Presentation of Finances

	Category
	<u>Operating surplus/(deficit)</u>
a	Income
b	Expenses
c	**Operating surplus/(deficit)** (c = a – b)
	<u>Net outlays on existing assets</u>
d	Capital expenditure on renewal and replacement of existing assets
e	Depreciation, amortisation, and impairment
f	Proceeds from sale of replaced assets
g	**Net outlays on existing assets** (g = d – e - f)
	<u>Net outlays on new and upgraded assets</u>
h	Capital expenditure on new and upgraded assets
i	Amounts received specifically for new and upgraded assets
j	Proceeds from the sale of surplus assets
k	**Net outlays on new and upgraded assets** (k = h – i - j)
l	**Net lending/borrowing for the financial year** (l = c + g + k)

This is a simplified form of a cash flow statement, providing a high-level summary only of a council's finances. Were the Commission to adopt it, it is of the view that the following difficulties would arise:

- The Statement of Comprehensive Income in Model Financial Statements splits income into the following sources: Rates; Statutory Charges; User Charges; Grants, Subsidies and Contributions; Investment Income, Reimbursements; Other Income; Net Gain-Equity Accounted Council Businesses.

  Under the Uniform Presentation of Finances, that split would not be known. As such, there would not be sight of the split between general rates and other revenue sources over the terms of an LTFP (which presents difficulties in terms of the statutory objective of ensuring that ratepayers' financial contributions are reasonable (LG Act, section 122(1g)(a)(ii))).

  This, in combination with no information on how the number of rateable properties will change over the LTFP, means the Commission would not be in a position to understand how average general rates per rateable property was expected to evolve.

- The Statement of Comprehensive Income in the Model Financial Statements splits expenses into the following cost categories: Employee Costs; Materials, Contracts and Other Expenses; Depreciation, Amortisation and Impairment; Finance Costs; Net Loss-Equity Accounted Council Businesses.

  Again, under the Uniform Presentation of Finances, that split between the expense categories would not be known, excepting depreciation. As such, there would be no visibility of what is driving any changes in the cost base. Further, it would not be possible to identify how expenses per rateable property was expected to evolve, either in aggregate or by cost category.

- The projected value of the asset stock is not known, nor is the forecast of number of rateable properties. So, it would also not be possible to identify growth in the asset stock value per rateable property that ratepayers will be required to replace/renew over the 10-year horizon of the LTFP and beyond.

- There is no information regarding the role of borrowing in financing the LTFP, nor the extent to which the council will, or will not, hold cash and cash equivalents. This may, however, be partially resolved if the components of the net financial liabilities ratio[18] and borrowings are forecast and accessible.

Overall, the Commission is of the view that, were the approach urged by submissions to be adopted, it would not have access to relevant information which it considers appropriate to rely upon in preparing suitably evidenced-based advice for the purposes of the scheme. The Uniform Presentation of Finances is too narrow to provide a comprehensive picture of any potential sustainability, cost control and affordability risks.[19]

When undertaking this analysis, and relevant to the statutory objective of ensuring that ratepayers' financial contributions are reasonable (LG Act, section 122(1g)(a)(ii)), the Commission noted that *not all* councils identify the implications of the LTFP for general rates per rateable property. The work also suggested that the level of detail provided in LTFPs across councils varies, with ratepayers of different councils having access to differing degrees of information.

The Commission notes that it may well be considered a backwards step if, for the purposes of the scheme, a lesser standard of information provision than that currently attained by some councils be used. Instead, it would be more beneficial to work with those councils whose LTFPs are not based upon the required level of detail for the purposes of the scheme. This will assist ratepayers throughout South Australia having access (over time) to the same level of information (a matter which the Commission considers relevant under section 122(1g)(b) of the LG Act), subject to its relevance for a particular council.

In terms of the target ranges of key financial indicators, while regulation 5(1)(c) of the *Local Government (Financial Management) Regulations 2011* allows councils to set their own target ranges, the Commission has adopted the LGA target ranges as a basis for its analysis. These were established/agreed during the development of the LGA Financial Sustainability Papers (2006-2011). At the same time, the Commission notes that the targets for individual councils may differ for good reason and, when preparing advice for a council, will have regard to any information submitted by a council in that regard.

Finally, the Commission again notes that, for subsequent cycles of the scheme, forward-looking information requirements can be reassessed to identify if they can be changed.

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[18] The net financial liabilities ratio is defined as follows: *Net Financial Liabilities* divided by *Total Operating Income*. Where *Net Financial Liabilities* is *Total Liabilities* less *Current Assets (Cash and Cash Equivalents)* less *Current Assets (Trade and Other Receivables)* less *Current Assets (Other Financial Assets)* less *Non-Current Assets (Financial Assets, excluding equity accounted investments in council businesses)*.

[19] The Commission notes the LGA provided an alternative approach to implementing the scheme based upon adopting the Uniform Presentation of Finances (with a more detailed income breakdown) and the three ratios. For the reasons outlined in Section 4.5.1of this document, the Commission considers this proposal too narrow.

4.6 Removal of council's discretion, indexation, and scaling

The Draft F&A proposed use of the number of rateable properties to provide averages per rateable property for general rates revenue, expenses and the value of the asset stock. It also proposed use of the CPI for real and nominal dollar terms comparisons on a per rateable property basis, in a way that seeks to be accessible and meaningful to stakeholders external to a council, such as ratepayers. While the Commission considered the Local Government Price Index (LGPI), it noted that index was less meaningful for ratepayers.

Submissions put the following views:

- That the use of CPI in the Draft F&A would have the effect of removing council discretion. That is, it has been interpreted that this would require a council to use CPI for its LTFP assumptions. It was submitted that this is inappropriate, as councils might use the LGPI, a Wage Price Index, CPI, or some other assumptions in an LTFP.
- Objection to the use of the phrase 'CPI-constrained' in various graphs within the Draft F&A, again taking this to suggest that the Draft F&A was imposing the use of CPI. This was considered, by some, to effectively be rate-capping, as councils would have to justify proposed increases above CPI.
- That the notion of average rates per rateable property would be confusing to ratepayers. This is because it would not directly correlate to the specific rates charged, as these are based on property valuations and type. As a result, they put the view that excluding this from analysis should be considered.
- That the Adelaide CPI be adopted rather than the Australian CPI.

4.6.1 Consideration

It is critical to note, as explained at the outset, that the Commission's role under the scheme is not regulatory. It cannot define or require any assumptions to be used within a council's LTFP, nor does the Commission's advice endorse any assumptions that a council adopts in its LTFP. The Commission's view therefore is that the use of CPI for reference purposes does not erode council discretion. The approach proposed provides greater transparency for ratepayers and aligns with councils explaining why their plans are in the long-term interests of ratepayers.

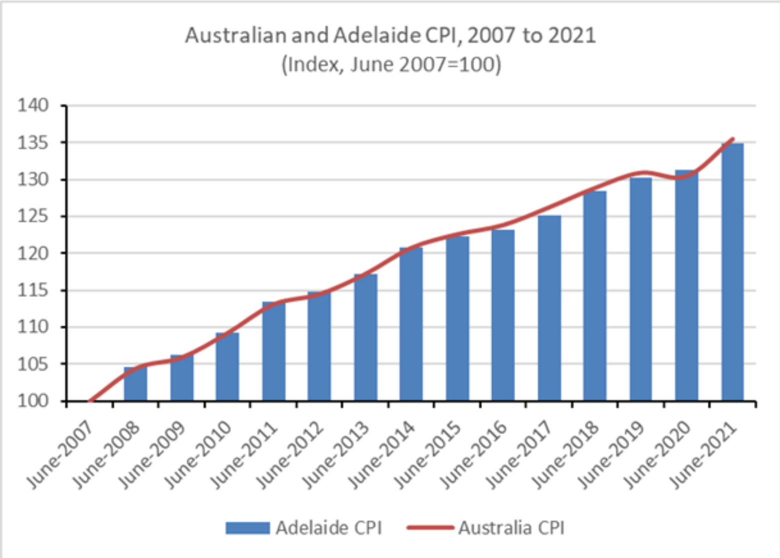
To the extent that there is concern over the use of the term 'CPI-constrained', the Commission will use a different term in the advice, reflecting the CPI path and noting that the CPI metric is of use to ratepayers in considering information.

In relation to the LGPI generally, the Commission will consider using that metric alongside the CPI metric in the advice, where relevant. In doing so the Commission acknowledges that the LPGI seeks to reflect the sector's rate of change in input costs, while noting further investigation would be necessary to assess whether it reflects prudent and efficient costs. Putting both indices on certain charts and graphs within advice may provide a more comprehensive and balanced picture from a council's perspective, while also providing ratepayers with an indication of the extent to which changes in South Australian local government sector costs deviate from CPI, which remains the measure most relevant to their circumstances. This may encourage more transparent and focused discussion on the trade-off between cost control and affordability, in the context of a council's LTFP and IAMP.

In relation to the submissions suggesting the use of average rates per rateable property may be confusing to ratepayers, the Commission agrees that any commentary in the advice should highlight that an average does not reflect any specific ratepayer's actual or forecast charges. In the Commission's experience, the use of averages is well-understood within the community (in relation to costs such as energy and water).

Finally, the Commission intends to use the Australian CPI from a historical and forecast perspective, noting that historically the difference between it and the Adelaide CPI is immaterial and there is no reason suggesting this will change. Also, the Commission considers that Australian CPI is based upon a broader database, undergoes greater scrutiny and there is more forecasting available.

Figure 1: Historical Australian and Adelaide CPI[20]



4.7 Asset renewal funding ratio

The Draft F&A adopted two definitions of the asset renewal funding ratio:[21]

- Depreciation based definition: The asset renewal funding ratio is net asset renewal expenditure divided by depreciation.

Councils used this definition until 2012, at which time they replaced it with the following:

- IAMP based definition: The asset renewal funding ratio is asset renewal expenditure divided by IAMP renewal expenditure.

The Draft F&A proposed utilising both ratios on an annual and cumulative basis.

Submissions put the view that it is not appropriate to use the definition based upon depreciation. This is because councils have moved away from using it and annual depreciation charges need not align with annual renewal/replacement capital expenditure and, cumulatively, they need not align over the LTFP.

[20] Based on the ABS all groups CPI for Australia and Adelaide.
[21] Prior to 2018 this was the asset sustainability ratio.

4.7.1 Consideration

The Commission agrees that annual renewal/replacement capital expenditure does not have to match the annual depreciation charge and that cumulatively they need not align over the LTFP, given the LTFP only covers a ten-year period. The purpose of considering the ratio in both forms over the long term is to obtain an understanding of a council's behavioural approach with respect to:

- the long-term trade-off between capital expenditure on the renewal/replacement of existing assets, capital expenditure on new/upgraded assets and depreciation, and its relationship with sustainability, cost control and affordability risk, and
- aligning the asset lives used in the Model Financial Statements with those used in the IAMP (refer to Box 1 below).

Looking at long-term trends from a historical and forward-looking perspective, develops a picture of a council's behavioural type, both actual and forecast. There are two hypothetical extremes.

- Type 1: A Council primarily focuses on new/upgrade capital expenditure, with depreciation charges used in the financing of this.
- Type 2: A Council primarily focuses on renewal/replacement capital expenditure, with depreciation charges used in the financing of this.

These provide a way of characterising whether a council's behaviour trends towards Type 1 or 2 based on the evidence available. The two approaches to measuring the asset renewal ratio are relevant to informing this.

Type 1 behaviour may provide more or improved services often via new facilities. It channels cash inflows associated with depreciation into financing new/upgrade capital expenditure along with a combination of grants, loan financing and reserves. Cash inflows associated with depreciation otherwise available to manage future renewal/replacement capital expenditure are diverted.

This results in the physical asset stock increasing, so the future replacement/renewal capital expenditure and depreciation charge is increasing. All else equal, to obtain an operating surplus ratio of zero (the breakeven point, given the definition of the ratio used) revenue will have to rise, causing rates and charges to increase, if no other income source is available. Also, for the reasons set out in Box 1 below, an amplification of this may occur if the depreciation charge collected reflects shorter asset lives than those used in the IAMP.

If this behaviour persists it can create a cycle of financing increasing costs through increasing rates and charges.[22] Further, to limit increasing rates and charges, postponing renewal/replacement capital expenditure may occur. Overall, such a cycle may not be in the long-term interests of ratepayers or a council.

Type 2 behaviour focuses on renewal/replacement capital expenditure, rather than upgrades/new assets. This does not result in the same cycle as described for Type 1 behaviour. The existing asset stock does not increase to the same level, with existing service levels maintained. There is less pressure to increase rates and charges to cover rising costs.

[22] South Australian councils do not face the same constraints on revenue generation as companies operating in competitive markets, or revenue/price-controlled companies.

Box 1: Depreciation and IAMP replacement/renewals costs

Considering the asset renewal funding ratio using both approaches is useful because:

- Using both depreciation and the IAMP replacement/renewal capital expenditure approaches for the asset renewal funding ratio, provides a way of considering the difference between the cumulative depreciation allowance collected and cumulative capital renewal/replacement expenditure.
- If this difference widens over the long-term time series constructed, this may suggest the underlying asset lives assumed for calculating depreciation and asset renewal are misaligned. That is, the asset lives used in compiling the detailed breakdown of the asset stock in the asset register do not match those in the IAMP. Why they should differ is not clear, so whether this is the case needs consideration.
- From an asset management perspective, the Commission considers that replacement/renewal capital expenditure in an IAMP should be based on an asset condition assessment (that reflects the size of the council and need not be complex). Asset life alignment means reflecting this in the asset register and the depreciation calculations. Then the asset lives within the asset register feed into the depreciation calculations and match those used in the IAMP. This links the IAMP to financial performance.
- If, for a given asset, the asset life in the asset register is half that used for the IAMP, depreciation will be twice as high, relative to using the asset life associated with the actual asset condition. Other things equal, to obtain an operating surplus ratio of zero, general rates and charges will be higher because they need to cover twice the depreciation than would otherwise be the case. If this persists over time, the gap between cumulative depreciation and cumulative renewal expenditure can widen.

What happens to this additional depreciation-related cash inflow relates to the Type 1 and 2 behaviours outlined and the relative risks associated with each.

So, relating this to the two measures of the asset renewal funding ratio:

- Depreciation-based definition: This provides an indication, through time, of the difference between depreciation and capital renewal/replacement expenditure. This difference can flow into the balance sheet as cash/cash equivalents held, or into the cash flow as capital expenditure patterns across renewal/replacement and upgrade/new capital; or absorbed into operating expenses in the statement of comprehensive income. This relates back to trends in Type 1 and 2 behaviour.
- IAMP-based definition: This compares actual or forecast renewal/replacement capital expenditure with that in the IAMP. Historically, this provides evidence regarding the extent to which a councils' past behaviour meets, or otherwise, its own assessment of the replacement/renewal needs of its asset stock. Going forward, this provides a baseline forecast for the level of IAMP renewal expenditure and forecast renewal/replacement capital expenditure. This allows comparison with actual outcomes. This starts to build up a picture of whether renewal/replacement capital expenditure differs relative to that planned, and the reasons why this might be. Again, this may relate back to Type 1 and 2 behaviour.

4.8 Advice and timing

The LG Act stipulates the following dates within the scheme:

- By end-September of the relevant financial year, councils are required to provide to the Commission all information regarding the *Relevant Matters* (section 122(1e)).
- By end-February of the relevant financial year, the Commission is required to publish its advice for each council (section 122(1i)(a)).

The Draft F&A proposed that the advice is published, in full, with councils provided with the advice relevant to them by end-February. Under the LG Act (section 122(1h)), councils must publish the advice and any response in their annual business plan (in both the draft and the adopted versions).

Some submissions objected to those timings and process. Some put the view that the end of September is too early in their processes to provide information on material changes to a LTFP. Some suggested they should have sight of a draft of the advice for comment on errors of fact, prior to it being published.

Some also suggested that only an Executive Summary of the advice be published in a council's annual business plan, with the entirety of the advice being accessed via a link on the council's website. This submission was made on the basis that it would reduce the size of a council's annual business plan while allowing stakeholders access to the advice.

4.8.1 Consideration

While the Commission notes the submissions made, the dates and requirements are specified under the LG Act and the Commission has no discretion. For example, the suggestion that only an Executive Summary be published by a council appears to the Commission to be inconsistent with both section 122(1h) and section 122(1i) of the LG Act.

The Commission supports actions by councils which simplify annual business plans for ratepayers and, in that light, will make its advice as easy to understand and use as possible. This will include the use of graphical information and clear and simple language and expression.

In relation to the suggestion that a draft be available to councils for comment, given that the scheme is new for all parties, the Commission intends to work collaboratively with individual councils across the five-month period between end-September and end-February. This will support quick resolution of simple queries and provide councils with opportunities to provide feedback and input throughout the advice preparation process.

This approach will also provide Commission and council staff the opportunity to establish or strengthen working relationships – including education in both directions on matters relevant to the scheme's operation. This may have the effect of increasing the efficiency of operations over time and hence a positive impact on the costs of the scheme.

Finally, in terms of the opportunity to respond to the advice, the Commission notes that this is already provided for under the LG Act (section 122(1h)), under which councils must publish any response to the advice in their annual business plan.

4.9 Using the first cycle as a pilot and developing baselines

Some submissions put the view that the first cycle (or first year) of the scheme should be treated as 'pilot' in nature. It was submitted that the Commission should develop baselines and identify issues surrounding a council's LTFP and IAMP that could be considered for the subsequent cycle.

4.9.1 Consideration

The Commission agrees that it is important to establish a baseline for understanding, reviewing, and advising on a council's LTFP and IAMP. In that sense, the first cycle of advice will set a baseline, with advice in subsequent cycles able to draw on that baseline. However, the Commission has a legal obligation to give advice which meets the scheme's requirements, including in the first cycle.

4.10 Commission costs and approach to billing

In the Draft F&A, the indicative cost per council of the Commission administering the scheme was $52,133 across the first four-year cycle of the scheme.[23] This was based upon the total costs being allocated equally across 68 councils. Various issues were raised regarding this in submissions.

Some submissions did not consider it appropriate to transfer the costs of the scheme to ratepayers and that the Commission was not required to do this based upon the legislation. Other submissions considered it more appropriate that the State Government cover the costs of the function.

If the costs are to be passed on, submissions considered the cost per council excessive and driven by the fact that the Draft F&A over-scopes the Commission's role, thereby attracting greater costs than necessary on an ongoing basis. Submissions also considered that the development and set-up costs should not be passed on to councils, nor should the indirect costs. Only the direct costs associated with applying the scheme to a specific council could be passed on to that council. Submissions also stated that the cost should be in the region of $20,000 per council (a figure it attributed to the former Minister for Local Government); most councils were of similar views.

Submissions from smaller councils also focused on the fact that the cost per council disproportionately impacted them, relative to larger councils with more ratepayers. Meanwhile, submissions from some larger councils were more supportive of an equal split of the costs across councils. Various councils suggested costs might be split more equitably using a per rateable property basis, or some measure of the size of the council.

In terms of billing, the preference was for the Commission to bill each council separately. Some submissions also considered that a council should only be invoiced after being provided with the advice and the invoice should detail the charges (this related back to the position that a council should only be charged the direct costs relating to developing that council's advice).

4.10.1 Consideration

The Commission's costs in performing its functions under the scheme fall into two categories, which are covered by the broad term 'costs' in section 122(1k):

- Set-up and development costs: These relate primarily to the upfront and ongoing work taking place in 2021-22 and 2022-23 to develop the analytical framework used and the systems and capability to support it.
- Operational costs: These relate primarily to the annual costs of implementing the scheme. These primarily comprise staff and Commissioners costs but also include an allocation of overheads and other operating expenses.

The various matters raised in submissions are addressed below.

Councils bearing the Commission's scheme costs

Under section 122(1k) of the LG Act, the Commission may recover from a council (as a debt due from the council) the costs reasonably incurred by the Commission in performing its scheme functions in

23 Refer Chapter 3, Table 4.

relation to that council. In performing those functions, the Commission necessarily incurs costs, both direct and indirect (including scheme establishment costs).

While the decision to recover costs from a council is, under the LG Act, discretionary on the part of the Commission, absent any other funding source it will need to exercise that discretion. At this time, the Government has not indicated that it proposes to otherwise fund the Commission's scheme role and functions.

Whether a council chooses to pass its allocation of the Commission's costs on to ratepayers, either in part or all, is ultimately a decision for that council.

Quantum of costs
In terms of the quantum of costs, the Commission has reviewed the indicative cost estimates in the Draft F&A, based upon a greater understanding of the ongoing requirements of operating the scheme. Estimated indicative costs for each of the first four years of the scheme, is now as follows:

Table 6: Commission's indicative costs for the first cycle to the scheme

2021-22 prices	2022-23	2023-24	2024-25	2025-26
Draft F&A				
Set-up and development costs	$157,667	$157,667	$157,667	
Operational costs	$768,000	$768,000	$768,000	$768,000
Draft total yearly costs	$925,667	$925,667	$925,667	$768,000
Draft total yearly cost per council	$13,613	$13,613	$13,613	$11,294
Draft total cost per council				$52,133
F&A				
Set-up and development costs	$157,667	$157,667	$157,667	
Operational costs	$688,674	$688,674	$688,674	$688,674
Total yearly costs	$846,341	$846,341	$846,341	$688,674
Total yearly cost per council	$12,446	$12,446	$12,446	$10,128
Total cost per council				$47,466

Indicative cost estimates for set-up and development costs remain unchanged, while estimates of operational costs have reduced by approximately $79,000 per year.

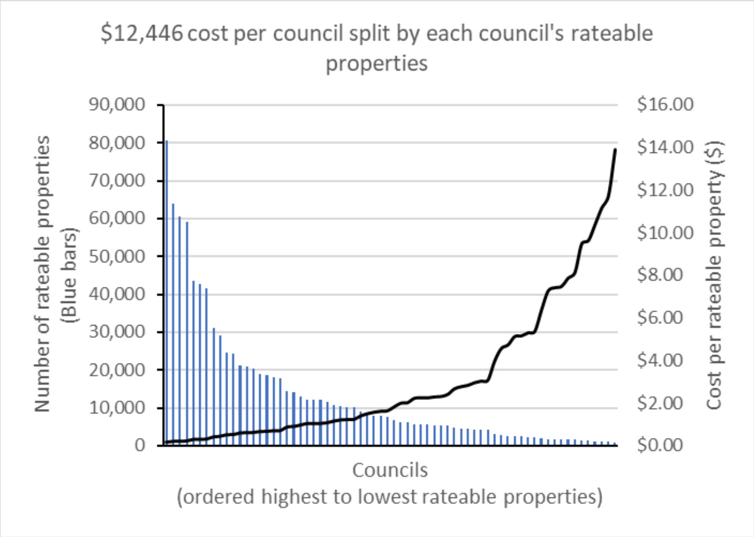
At this stage, the Commission can only proceed based on its best estimates of expected effort and cost. In particular, the degree of interaction with each council is unknown.

Cost distribution amongst councils

The Commission has considered the submissions addressing the proposed distribution of costs across councils as set out in the Draft F&A, which was on an equal basis, given that neither the Commission nor councils currently understand the regulatory effort which will be required for each council.

The Commission acknowledges that this approach results in smaller councils being disproportionately impacted, because of the scale effect resulting from the distribution of rateable properties across South Australia, as shown in the graph below.

Figure 2: Cost per rateable property based on the Draft F&A proposal[24]



Given the focus on this matter in submissions, the Commission has further considered the cost distribution methodologies below.

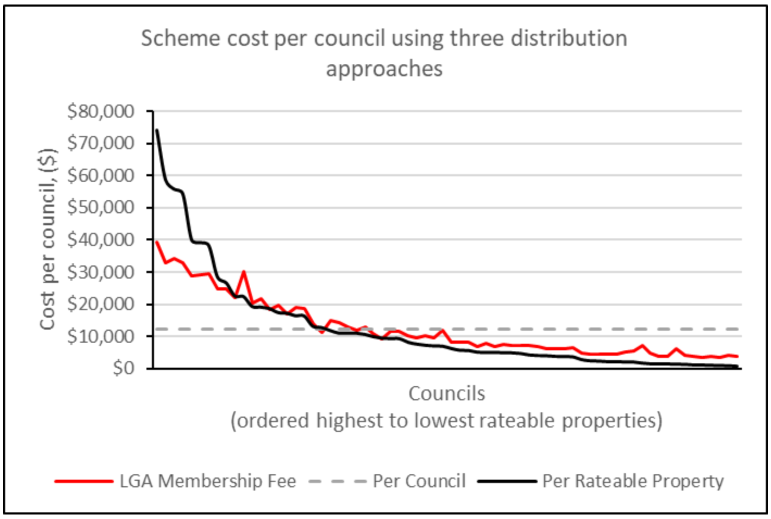
Table 8: Cost distribution methodologies

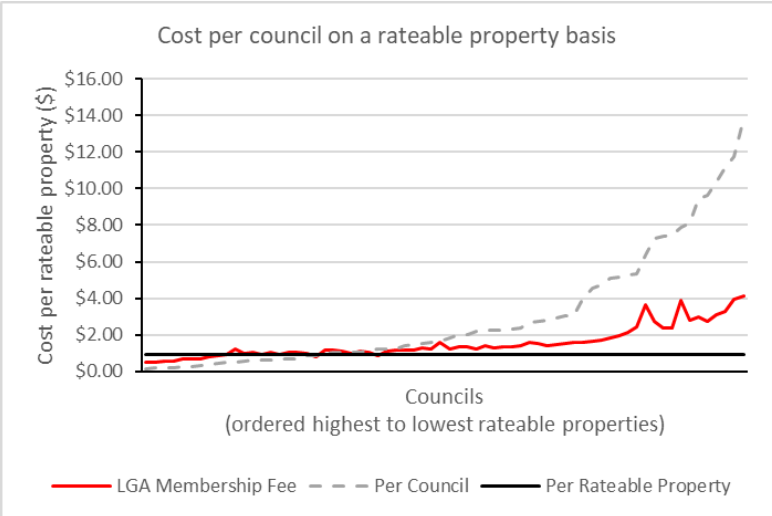
Option	Description
Option 1: Equal split of the costs	Each council would contribute an equal amount to recovering the cost of the scheme. This reflects the proposal in the Draft F&A.
Option 2: Split based upon number of rateable properties	Each council would contribute an amount to recovering the cost of the scheme in proportion to its number of rateable properties.
Option 3: Split based on LGA Membership Fee allocation[25]	Each council would contribute an amount to recovering the cost of the scheme in proportion to its share of the LGA Membership Fee. The LGA Membership Fee is split between councils based upon an agreed methodological approach that accounts for each council's population size and operating income.

The graphs below summarise the implications of each of these cost distribution options for each council, with councils in descending order based on their number of rateable properties.

[24] Rateable property information obtained from the LGGC database for 2019-20.
[25] Allocations obtained from the LGA Draft Annual Business Plan 2021-22, obtained from the LGA website.

Figure 3: Assessing alternative cost distribution methodologies





The first graph in Figure 3 shows that splitting the costs equally across councils gives a constant cost per council (the grey dotted line on the first graph in Figure 3). The second graph in Figure 3 identifies the scale effect of each cost distribution approach on a cost per rateable property basis. If costs are split equally across councils, smaller councils bear more cost on a rateable property basis than larger ones (the grey dotted line on the second graph in Figure 3).

In contrast, splitting costs based upon the number of rateable properties (Option 2) results in a constant per rateable property cost, with larger councils bearing a significantly higher overall cost, relative to splitting costs equally across councils.

Option 3, splitting the costs based upon each council's proportion of the LGA Membership Fee, provides a balanced option between these two extremes that is based upon an already agreed methodological approach between councils.

Given this, the Commission will adopt Option 3.

Billing

The Commission notes differing preferences were expressed through submissions. The Commission will adopt annual billing and will bill each council directly.

5 Framework and Approach

The Framework and Approach that the Commission will adopt for the preparation of advice under section 122 of the Local Government Act 1999 comprises the following elements.

5.1 Scheme overview

Under the scheme, a council must, on or before 30 September in the relevant financial year for the council, provide to the Commission all relevant information on the following matters (the *Relevant Matters*) in accordance with guidelines determined by the Commission (if any):

- material amendments made or proposed to be made to the council's long-term financial plan (LTFP) and infrastructure and asset management plan (IAMP) and the council's reasons for those amendments
- revenue sources outlined in the funding plan (being a component of the LTFP), and
- any other matter prescribed by the regulations.

Following the provision of information by a council, the Commission, on or before 28 February in the relevant financial year for the council:

- *must* provide advice to the council on the appropriateness of the *Relevant Matters* (as defined above) in the context of the council's long-term financial plan and infrastructure and asset management plan, and
- *may*, if the Commission considers it appropriate having regard to the circumstances of a particular council, provide advice in relation to <u>any other aspect</u> of the council's long-term financial plan and infrastructure and asset management plan.

In providing advice under this section, the Commission:

- *must* have regard to the following objectives:
  - the objective of councils maintaining and implementing long-term financial plans and infrastructure and asset management plans, and
  - the objective of ensuring that:
    - the financial contributions proposed to be made by ratepayers under the council's long-term financial plan and infrastructure and asset management plan are appropriate, and
    - any material amendments made or proposed to be made to these plans by the council are appropriate.
- *may* have regard to any information or matter the Commission considers relevant (whether or not such information or matter falls within the ambit of the matters defined as *Relevant Matters*).

A council must ensure that the advice provided by the Commission under the scheme, and any response of the council to that advice, is published in the council's annual business plan (both the draft and adopted annual business plan) in the relevant financial year and each subsequent financial year (until the next relevant financial year for that council).

The *Relevant Financial Year* is the year in which a council goes through the scheme. The first cycle of the scheme is four years long, with 17 councils going through the scheme annually, based on the current Schedule.

5.2 Principles

In undertaking its functions under the scheme, the Commission will comply with the statutory requirements and, in doing so, will have regard to the following principles:

Principle	Reason
Principle 1: Monitoring, not regulating	The scheme relates to monitoring, not economic regulation. As such, the design focuses on providing evidence-based and useful advice. The objective being, through time, to develop a record of a council's performance, relative to its long-term planning, and its response to advice, as the basis for changing behaviours and outcomes over time. The scheme does not provide the Commission with powers to enforce compliance measures, set service standards or regulate any council's rates. In those respects, it differs from other States' council rates regulation frameworks, such as those in Victoria and New South Wales.
Principle 2: Long-term planning focus	While councils can provide a diverse range of services, they are generally delivered through infrastructure and operations that require long-planning. In relation to existing infrastructure assets, in the absence of significant shocks outside of a council's control, its long-term plans would not be expected to exhibit significant variation through time (replacement/renewal expenditure should not materially vary due to political cycles, or short-term transient operational or financial concerns). For new assets, it is important that these are planned for, implemented, and managed on that same long-term basis.
Principle 3: Materiality	Focus will be given to key overarching targets and measures. Otherwise, the underlying analysis may become unduly complex/disaggregated, with key observations diluted through unnecessary detail.
Principle 4: Simplicity	The scheme will be as simple as it practically can be and be capable of being applied across the diverse range of councils within South Australia.
Principle 5: Leveraging existing information and evidence	The Local Government Grants Commission (LGGC) collects data and the Local Government Association (LGA) provides guidance material regarding financial and service sustainability. As such, a significant amount of underlying information and a standard accounting framework exists - this will underpin the analytical framework. In accordance with the legislative framework, if demonstrable gaps in information become apparent that are of relevance to the operation of the scheme, it may be necessary to collect further information in relation to this.
Principle 6: Consistency of application	The scheme will be applied consistently across councils in terms of the underlying processes and analytical framework. Advice across councils will only be similar if all the inputs into the analytical framework (both quantitative and qualitative) result in similar advice being warranted.
Principle 7: Transparency	The implementation of the scheme requires transparency in processes and approach. Each council will be provided with the information and calculations upon which the advice relating to it has been based.

5.3 The Commission's analytic questions for itself

In preparing advice for the purposes of the scheme, the Commission will have regard to the following base set of questions, noting that further questions may arise as the scheme commences practical operation.

Area	Key questions
Operating Surplus Ratio	To understand what is driving a council's operating surplus ratio and the extent to which this indicates potential concerns regarding affordability and cost control risk. Operating surplus ratio ▶ *Question 1: How has the council's operating surplus ratio performed historically?* ▶ *Question 2: How is the council's operating surplus ratio projected to perform?* Underlying variables: Total operating income and total operating expenses ▶ *Question 3: What trends in total operating expenses and total operating income are contributing to this performance?* Underlying variables: Total operating income ▶ *Question 4: What are the trends in the sources of operating income?* ▶ *Question 5: What are the trends in operating income per rateable property?* ▶ *Question 6: How do the trends in operating income per property compare to CPI growth?* ▶ *Question 7: Is there any indication of affordability risk existing or emerging?* Underlying variables: Total operating expenses ▶ *Question 8: What are the trends across operating expenses categories?* ▶ *Question 9: What are the trends in operating expenses per rateable property?* ▶ *Question 10: How do the trends in operating expenses per property compare to CPI growth?* ▶ *Question 11: Is there any indication of cost control risk developing or emerging?*
Net financial liabilities ratio	To understand what is driving a council's net financial liabilities ratio and the extent to which this indicates potential concerns regarding financial and service sustainability risk. Net financial liabilities ratio ▶ *Question 12: How has the council's net financial liabilities ratio performed historically?* ▶ *Question 13: How is the council's net financial liabilities ratio projected to perform?* Underlying variables: Net financial liabilities and total operating income ▶ *Question 14: What trends in net financial liabilities and total operating income are contributing to this performance?*

<table>
<tr><th>Area</th><th>Key questions</th></tr>
<tr><td></td><td>Underlying variables: Net financial liabilities
▶ Question 15: What trends in total borrowings relative to total liabilities are contributing to this performance?
▶ Question 16: What trends in cash and cash equivalents are contributing to this performance?
▶ Question 17: Is there any indication of financial sustainability risk developing or emerging?
The more detailed trends in total operating income are considered as part of the analysis of the operating surplus ratio.</td></tr>
<tr><td>Asset renewal funding ratio</td><td>To understand what is driving a council's asset renewal funding ratio. This relates to assessing the consistency of the LTFP and IAMP, and the extent to which these appropriately reflect actual asset condition. This has implications for financial and service sustainability, as well as affordability and cost control risk.
Asset renewal funding ratio
▶ Question 18: How has the council's asset renewal funding ratio performed, and how is it projected to perform, based on the IAMP expenditure approach?
▶ Question 19: How has the council's asset renewal funding ratio performed, and how is it projected to perform, based on the depreciation approach?
▶ Question 20: To what extent do the two approaches result in an alignment of the asset renewal funding ratio calculated?
Underlying variables: Asset renewal/replacement expenditure, IAMP renewal/replacement expenditure and depreciation
▶ Question 21: What trends in asset renewal/replacement expenditure and IAMP renewal/replacement expenditure are contributing to the performance of the asset renewal funding ratio, based on the IAMP expenditure approach?
▶ Question 22: What trends in asset renewal/replacement expenditure and depreciation are contributing to the performance of the asset renewal funding ratio, based on the depreciation approach?
▶ Question 23: How is any difference explained within the council's LTFP and IAMP?
Underlying variables: Asset renewal/replacement expenditure
▶ Question 24: What are the trends contributing to the asset renewal expenditure?
▶ Question 25: What are the trends in renewal/replacement expenditure relative to new/enhancement expenditure?
Underlying variables: IAMP renewal/replacement expenditure
▶ Question 26: To what extent does the IAMP renewal/replacement expenditure relate to an up-to-date assessment of actual asset condition?
Underlying variables: Depreciation
▶ Question 27: What is contributing to the trend in depreciation?</td></tr>
</table>

Area	Key questions
	▶ *Question 28: Is IAMP renewal/replacement expenditure reasonable given the trend in depreciation and the response to Question 26?* ▶ *Question 29: Overall, based on the assessment of the asset renewal funding ratio, is there any indication of financial and service sustainability, cost control or affordability risk developing or emerging?*

5.4 Information requirements

The Commission has formed the view that, until otherwise advised, the initial information requirements which it considers reasonably necessary for the performance of its functions under the scheme are as follows.

5.4.1 Guidelines relating to submission by councils of information on *Relevant Matters* – section 122(1e)

For the purposes of section 122(1e), the Commission will issue a guideline explaining how the following matters must be provided by a council on or before 30 September in the year in which the council goes through the scheme:

- material amendments made or proposed to be made to the council's long-term financial plan and infrastructure and asset management plan and the council's reasons for those amendments
- revenue sources outlined in the funding plan (being a component of the LTFP), and
- any other matter prescribed by the regulations.

The guidelines will require the following explanations relating to those matters, to inform the Commission's understanding of them (where available):

- Quantitative
  - Revised LTFP and IAMP empirical information and explanation
- Qualitative
  - Revised LTFP documentation/explanation
  - Revised IAMP documentation/explanation
  - Council's explanation for material variations
  - Any other material a council considers relevant to assist the Commission to perform its statutory scheme functions

5.4.2 Other information reasonably required for the performance of the Commission's statutory scheme function – section 122(1j)

The Commission will require the following in terms of other information to support its statutory scheme functions:

- By no later than 15 August in the year in which a council is to go through the scheme, unless otherwise advised in writing by the Commission (eg, in cases where the Commission already has the relevant information in its possession) the council must provide to the Commission a copy of its current long-term financial plan, infrastructure and asset management plan, CEO financial sustainability report and audit committee report.
  - This will be used by the Commission to understand the nature, scope and form of a council's current plans, to assist it to understand the *Relevant Matters* (once submitted on or before 30 September) and therefore to prepare the advice.
  - The 15 August date is consistent with the timing by which a council must adopt new plans (if it proposes to do so).[26] If a new plan is not proposed for adoption, a council should still submit current plans unless those have otherwise been provided to the Commission.
- Where advised in writing by the Commission, a council may be required to provide other supporting or clarifying information at any time to assist it in the performance of its scheme functions. For example:
  - Where there are gaps in the public availability of historical information to be used by the Commission to form a baseline for the purposes of preparing advice, the Commission may seek that information directly from a council.
  - Where further qualitative and quantitative information is required in relation to assessing revised LTFPs and IAMPs, such as, but not limited to, information on the implications of the revisions across the line items of the Model Financial Statements, information on forecasts of the number of rateable properties and forecasts of FTEs.

5.4.3 Billing

The Commission will bill individual councils a proportion of the Commission's scheme costs based on the outcomes of the methodology adopted by the Local Government Association in respect of its membership fees. It will adopt annual billing and will bill each council directly.

[26] The Commission notes a council must adopt a new LTFP annually but can do so anytime in that period. Similarly, a council needs to update their IAMP once every 4 years.

Appendix 1: The financial indicators

The table provides details of the operating surplus, net financial liabilities and asset renewal funding ratio.

Overarching financial indicators specified by the LGA

Financial Indicator	Description
Operating surplus ratio	**Explanation:** The operating surplus ratio relates to a council's financial performance. **Definition:** The *Operating Surplus (Deficit)* is defined as: *Total Operating Income*[27] *less* *Total Operating Expenses*[28] The *Operating Surplus Ratio* is defined as: *Operating Surplus (Deficit) ÷ Total Operating Income* **Application:** Applied historically in the context of audited financial statements, and to forward-looking LTFPs. **Target:**[29] The LGA considers that, on average, over time, an operating surplus ratio of between zero and ten percent is appropriate. **Interpretation:** A positive ratio indicates the percentage of operating income available to help fund proposed capital expenditure, or to reduce debt (if this represents an appropriate long-term strategy).

[27] Total Operating Income comprises: Rates; Statutory Charges; User Charges; Grants, subsidies and contributions; Investment income; Reimbursements; Other income; Net gain – equity accounted Council businesses.

[28] Total Operating Expenses comprises: Employee costs; Materials, contracts & other expenses; Depreciation, amortisation & impairment; Finance costs; Net loss – equity accounted Council businesses. An Operating Surplus Ratio of zero would, therefore, cover all of these costs.

[29] While regulation 5(1)(c) of the *Local Government (Financial Management) Regulations 2011* allows councils to set their own target ranges for each of the key financial indicators, the Commission has adopted the LGA target ranges as a basis for its analysis. These were established/agreed during the development of the LGA Financial Sustainability Papers (2006-2011).

Financial Indicator	Description
Net financial liabilities ratio	**Explanation**: The net financial liabilities ratio relates to a council's financial position. **Definition**: *Net Financial Liabilities* are defined as: *Total Liabilities* *less* *Current Assets (Cash and Cash Equivalents)* *less* *Current Assets (Trade and Other Receivables)* *less* *Current Assets (Other Financial Assets)* *less* *Non-Current Assets (Financial Assets - excluding equity accounted investments in council businesses)* The net financial liabilities ratio is: *Net financial liabilities ÷ Total Operating Income* **Application:** Applied historically in the context of audited financial statements, and to forward-looking LTFPs. **Target**: The LGA considers a ratio of between zero and 100%, but possibly higher in some circumstances, is appropriate. Also, councils that provide Community Wastewater Management Services (**CWMS**) are likely to need to have a higher level of net financial liabilities.[30] **Interpretation:** A reducing ratio over time indicates that a council's capacity to meet its financial obligations from operating income is increasing, but this can be at the expense of intergenerational equity.

[30] Paper 9, p.8.

Financial Indicator	Description
Asset renewal funding ratio[31]	Explanation: The asset renewal funding ratio relates to a council's asset management performance. Definition: Since 2013, the asset renewal funding ratio has been defined as: *Asset Renewal Expenditure ÷ IAMP Renewal Expenditure* Where *IAMP Renewal Expenditure* is that required according to the IAMP. Prior to 2013, the asset renewal funding ratio (then known as the asset sustainability ratio), was defined as: *Net Asset Renewal Expenditure ÷ Depreciation* Where: *Net Asset Renewal Expenditure* *=* *Expenditure on Renewal/Replacement of Assets* *less* *Sale of Replaced Assets* Application: Applied historically in the context of audited financial statements and relevant IAMP, and to forward-looking LTFPs and the current IAMP. Target: The LGA considers a ratio greater than 90% but less than 110% appropriate. Interpretation: A ratio in line with the target indicates that existing assets are being renewed and replaced in line with a council's IAMP. A ratio outside of these bounds conveys the converse.

[31] While the definition of this ratio changed in 2013, it continued to be known as the asset sustainability ratio until 2018.

Appendix 2: List of the Draft F&A graphs

The Draft F&A included the following graphs.

Financial indicator	Draft F&A graphs
Operating surplus ratio	▶ Operating surplus ratio, including LGA target bands *(Yearly and cumulatively, on council actuals/forecast basis)* ▶ Total income and total expenses *(Yearly and cumulatively, on council actuals/forecast basis)* ▶ Total income *(Yearly, on council actuals/forecast and a 'CPI constrained' basis)* ▶ Income proportions *(Yearly, split by rates and other income, on council actuals/forecast basis)* ▶ Average rates income per rateable property *(Yearly, on council actuals/forecast and a 'CPI constrained' basis)* ▶ Total expenses *(Yearly, on council actuals/forecast basis and a 'CPI constrained' basis)* ▶ Expenses by expenditure category[32] *(Yearly, on a council actuals/forecast basis)* ▶ Average expenses per rateable property *(Yearly, on council actuals/forecast and a 'CPI constrained' basis)*
Net financial liabilities ratio	▶ Net financial liabilities ratio, including LGA target bands *(Yearly, on council actuals/forecast basis)* ▶ Total income and net financial liabilities *(Yearly, on council actuals/forecast basis)* ▶ Total liabilities and total borrowings *(Yearly, on council actuals/forecast basis)* ▶ Cash and cash equivalents at year-end *(Yearly, on council actuals/forecast basis)*

32 Categories as per the Model Financial Statements.

Financial indicator	Draft F&A graphs
Asset renewal funding ratio	▶ IAMP based asset renewal funding ratio, including LGA target bands *(Yearly, on council actuals/forecast basis)* ▶ Net asset renewals and IAMP expenditure *(Yearly, on council actuals/forecast basis)* ▶ Depreciation based asset renewal funding ratio, including LGA target bands *(Yearly, on council actuals/forecast basis)* ▶ Net asset renewals expenditure and depreciation *(Yearly, on council actuals/forecast basis)* ▶ IAMP based renewal/replacement gap *(Cumulatively, on council actuals/forecast basis)* ▶ Depreciation based renewal/replacement gap *(Cumulatively, on council actuals/forecast basis)* ▶ Total capital expenditure *(Yearly, on council actuals/forecast basis)* ▶ Total capital expenditure by category[33] *(Yearly, on council actuals/forecast basis)* ▶ Total capital expenditure proportion by category[34] *(Yearly, on council actuals/forecast basis)* ▶ Value of the asset stock *(Yearly, on council actuals/forecast basis)* ▶ Value of the asset stock per rateable property *(Yearly, on council actuals/forecast basis)*

[33] Categories as per the Model Financial Statements.
[34] Categories as per the Model Financial Statements.

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