Regulatory Impact Statement

Proposed local government financial prudence regulations

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Department of Internal Affairs. It analyses options to implement financial prudence benchmarks for local government.

New Zealand local authorities have had a statutory obligation to manage their affairs in a financially prudent manner since 2002. However, there has been little discussion of what financial prudence means or how it is appropriately measured. The Department has therefore looked to literature on both sovereign and local authority financial management and to related principles set out in the Local Government Act 2002 to help formulate its advice.

Testing the Department's proposals has been limited by:

- the absence of any time series data on local authority finances at a group level;
- the fact that Statistics New Zealand local authority financial statistics do not disclose some information required to test the Department's proposals;
- the absence of any debt default data for New Zealand local authorities (because no local authorities have defaulted since at least World War Two) to provide empirical evidence of financial imprudence; and
- the absence of datasets to measure the size of individual local authorities, other than estimates of usually resident population.

The Department has relied upon data supplied by a small group of volunteer local authorities to overcome these limitations. However, there is a risk that this sample data does not fully reflect the range of local authority situations. The Department has also consulted closely with Local Government New Zealand, the Society of Local Government Managers, and the Office of the Auditor-General in preparing these proposals. This consultation helps to mitigate the risk outlined above, but does not eliminate it.

Given the limited professional discussion on how to measure prudence and the data limitations identified above, there is a risk that regulation of this type could incentivise poor financial management. While the Department has paid particular attention to mitigating risk in its analysis, the Department considers it essential that the impact of the proposed regulations on local authority decision making is.

Notwithstanding these limitations, the Department considers the proposed regulations have the potential to make a significant positive contribution to improving public understanding of local authority finances and improving local authority financial management.

Paul James, Deputy Chief Executive

24 October 2013

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A note on terminology

1. Throughout this document there are references to benchmarks, parameters and indicators. Each word is used with particular meanings which are set out below.

   Benchmark – A specific target measured in a defined way. A benchmark is either met or not met in a particular case.

   Parameter – A specified range measured in a defined way. As with a benchmark, a parameter is either met or not met in a particular case.

   Indicator – A defined measure, but without any specified target. In some places in the text this word is also used in its ordinary meaning as a general signal of something significant.

Executive Summary

2. This Regulatory Impact Statement (RIS) evaluates options for financial prudence regulations for local government. The outcomes sought by the proposed regulations are to:

   - assist in identifying local authorities where further enquiry is warranted in relation to their financial management; and
   - promote prudent financial management by local authorities.

3. These outcomes are consistent with the Government's priorities to responsibly manage government finances and to deliver better public services within tight financial constraints.

4. The proposed regulations will have benchmarks for three components of financial prudence – affordability, sustainability and predictability. The Department of Internal Affairs' (the Department) recommended benchmarks are shown in Table One. The Department also recommends two indicators of affordability. No formal regulation is required for these, but they are important to achieving the intended outcomes and are therefore included so the full proposal is clear.

Table One: Recommended benchmarks and indicators

	Benchmark name	Description
Affordability benchmarks	Rates benchmark	Rates revenue complies with the limits set in the council's financial strategy
	Debt benchmark	Debt complies with the limits set in the council's financial strategy
Affordability indicators	*Rates*	*Rates per rating unit*
	Debt	*Net debt per rating unit*
Sustainability benchmarks	Balanced budget benchmark	Operating revenue, excluding development and financial contributions and revenue from revaluations, exceeds operating expenditure
	Essential services benchmark	Capital expenditure on the five network infrastructure services exceeds depreciation on those five services
	Debt servicing	Interest expense is less than 10% of operating revenue, as defined in the balanced budget

	Benchmark name	Description
	benchmark	benchmark, except for local authorities with projected population growth greater than or equal to New Zealand's projected population growth. For those authorities, the benchmark is 15% of operating revenue
Predictability benchmarks	Operations control benchmark	Net cash flow from operations equals or exceeds budget
	Debt control benchmark	Net debt is less than or equal to forecast debt in the long-term plan

5. The proposed benchmarks have been evaluated against five objectives. These are that the benchmarks:
   - are meaningful across a diverse group of local authorities;
   - avoid risk of unintended consequences;
   - involve low compliance cost;
   - are transparent; and
   - are independently verifiable.
6. Achieving meaningful benchmarks across a diverse group of local authorities is challenging. Each local authority has unique circumstances. Therefore, in interpreting the benchmarking results, it will be necessary to consider those circumstances before reaching a conclusion as to the prudence of the authority's financial management.
7. As a group, the benchmarks have been designed to minimise the risk of unintended consequences. In particular the sustainability benchmarks are designed to identify local authorities which are keeping rates and debt down by taking decisions that may expose future ratepayers to costs that should have been met today.
8. The Department is satisfied that the proposed benchmarks meet the objectives of low compliance cost, transparency, and verifiability.
9. Implementation is proposed to occur through local authority annual reports for 2013/14 and the 2015/25 long-term plans. Both of these documents are audited and this will provide independent quality assurance of the first use of the benchmarks.

Status quo and problem definition

Purpose of the regulations

10. As part of the Government's Better Local Government programme, the Local Government Act 2002 (LGA02) has been amended to allow regulations to be made "prescribing parameters or benchmarks for assessing whether a local authority is prudently managing its revenues, expenses, assets, liabilities, investments, and general financial dealings."[1] This RIS outlines and assesses options for the content of such regulations.[2]

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1 The full statutory authority for these regulations is contained in sections 259(1)(dc) and (dd), 259(3), 259(4), and 259C to 259J of the LGA02.

2 The original RIS for the Local government Act 2002 Amendment Act 2012 can be found at http://www.dia.govt.nz/pubforms.nsf/URL/RISBetterLocalGovernment-

11. Although the LGA02 enables regulations to be made, the Government has decided that regulations will be made. Therefore this analysis does not investigate approaches other than regulations.

Problem Definition

12. Section 100 of the LGA02 requires local authorities to manage their "revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community". However, neither ratepayers, councils, nor the Crown have any structured way of assessing whether any particular local authority is meeting that obligation.

13. The LGA02 requires local authorities to produce 10 year long-term plans, reviewed and extended every three years, and annual reports. These accountability documents include general purpose financial reports (GPFR), complying with applicable accounting standards. The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities states "users of GPFRs are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, to be able and prepared to read GPFRs, and to review and analyse the information presented with reasonable diligence." It also states "information should not be excluded from GPFRs solely because it may be too complex or difficult for some users to understand without assistance."[3]

14. It is doubtful that many ratepayers have the qualities expected of a user of GPFRs. This creates a situation where ratepayers confront an information gap which can only be filled by further commentary. Many people assume, incorrectly, that the Auditor-General fills this gap, and that an unqualified audit report provides confirmation, not only of the accuracy of the data that has been reported, but also approval of the financial plans or performance of the local authority concerned.

15. Financial prudence regulations may help to address this problem. They could do this by producing financial information that evaluates financial position and performance, rather than simply describing financial position and performance. GPFRs are limited to description and do not inherently evaluate financial position or performance.

16. Related to this is an expectation that central oversight of local authorities takes place to avoid extreme situations of imprudent financial management by local authorities. Amendments made to the LGA02 in December 2012 provided a greater range of powers to the Minister of Local Government (the Minister) to intervene in the affairs of individual local authorities. One possible ground for intervention is a failure by the local authority to demonstrate prudent financial management. These regulations will assist the Minister to decide whether intervention may be desirable. They will also provide transparent criteria to stakeholders about what factors the Minister might take into account in making such decisions.

Is imprudent financial management occurring?

17. The Department of Internal Affairs' RIS on the primary legislation enabling these regulations noted that for the local government sector as a whole, rates had increased on average by 6 per cent per annum over the last seventeen years. Since 2002, local authority debt has increased from $2 billion to $7 billion.

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signed.pdf/$file/RISBetterLocalGovernment-signed.pdf. That part of the Bill dealing with these regulations is set out at pp 14 – 16.

3 "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities", International Public Sector Accounting Standards Board, January 2013, paragraph 3.18, accessible at http://www.ifac.org/sites/default/files/publications/files/Public%20Sector%20Conceptual%20Framework%20Ch%20%201-4%20Jan%20%2011%202013%20FINAL.pdf

18. Demonstrating the scale of the problem, if any, at an individual local authority level is difficult. A structured framework is needed to assess the financial prudence of local authority decisions. Without such a framework anecdotal evidence must be relied on.

19. The audit opinions on local authority long-term plans are one indicator of imprudent financial management. Table Two summarises audit reports that have commented on matters that could relate to financial prudence.

Table Two: Summary of audit reports relating to financial prudence

Year	Summary
2006	• Two councils had inadequate information, primarily about infrastructure. This meant that projected expenditure could be materially misstated; • one council assumed that the effect of price changes during the 10 years of the plan was nil. This meant the council could not demonstrate prudent financial management; • one council produced a plan that was not sustainable and therefore not fit for purpose; and • one council adopted a plan projecting successive losses. The council considered the forecasts were financially prudent. The audit report drew attention to the council's position.
2009	• One council had inadequate information, primarily about infrastructure. This meant that projected expenditure could be materially misstated; • one council assumed that the effect of price changes during the 10 years of the plan was nil. This meant the council could not demonstrate prudent financial management; • one council produced a plan that was financially unsustainable and therefore was not financially prudent; • two councils adopted plans that, while prudent, proposed a significant build up of costs to the community after the end of the planning period; and • one council adopted a plan that relied on dividends from a restructured subsidiary to contribute to the council's debt reduction programme.
2012	• One council assumed the effect of price changes during the 10 years of the plan was nil. Supplementary information to address this was incomplete; • six councils adopted financial strategies that had inherent significant risks or relied on significant forecasting assumptions

Source: Reports of the Auditor-General to Parliament on matters arising from long-term plans.

20. Another sign of financial imprudence could be debt growing to abnormally high levels compared to other local authorities. Table Three compares projected debt per capita for the ten most indebted local authorities at the end of the current long-term plans, in 2022. The median forecast debt per capita for all local authorities in 2022 is $1,355.

Table Three: Projected ten most indebted local authorities in 2022

	Projected debt per capita 2022 ($)	Projected population change 2001 to 2021
Auckland Council	7,010	48.1%
Tasman District Council	6,059	24.1%

	Projected debt per capita 2022 ($)	Projected population change 2001 to 2021
South Taranaki District Council	5,485	-5.9%
Queenstown-Lakes District Council	4,885	105.4%
Taupo District Council	4,557	11.0%
Ruapehu District Council	3,852	-17.5%
Waitomo District Council	3,677	-1.2%
Kapiti Coast District Council	3,549	24.9%
Tauranga City Council	3,390	45.0%
Buller District Council	3,231	5.5%

Source: DIA calculation from local authority 2012-22 long-term plans and Statistics New Zealand projected resident populations.

21. There are some important qualifications with this analysis. It could be expected that local authorities with high growth, such as Queenstown-Lakes, Auckland and Tauranga, will have comparatively high debt levels. These local authorities will need to invest in infrastructure to support the growth occurring in their community.

22. Using projected resident populations discriminates against those local authorities with significant holiday home elements in their community. Obvious examples in Table Three are Queenstown-Lakes and Taupo. Tasman, Ruapehu and possibly Tauranga would also be influenced by holiday homes, but to a lesser degree.

23. A further qualification is that looking at debt alone ignores the other half of the local authority balance sheet. The South Taranaki, Taupo and Buller District Councils have large investment funds which offset their apparently high debt levels.

24. Auckland Council's figure is reported on a group basis. This means it includes debt held by subsidiaries and also excludes the commercial value of its investments.

25. Tasman District Council does stand out as having a high projected debt level. The Auditor-General has commented upon Tasman's unusual approach to using debt and has stated that she seriously considered explicitly drawing the attention of the community to this in her audit report on the 2012 long-term plan.[4]

26. The Ruapehu and Waitomo District Councils are both examples of small local authorities with little or no growth. High debt levels in such local authorities may indicate financial stress.

27. In summary, the data suggests there are some local authorities with projected debt levels that could, upon further examination, be considered imprudent.

Key features of the current situation

28. The current environment can be described in the following way:

- the regulatory environment;
- the level of public commentary on local authority finances; and
- the diversity of local authorities; lead to
- no professional consensus on concepts or measures of local authority financial prudence.

4 Auditor-General, "Matters arising from the 2012 long-term plans" December 2012, p. 29.

Regulatory environment

29. Because accounting standards apply to a wide variety of entities, they leave local authorities considerable freedom about how they report. This results in a lack of standardisation in aspects of local authority financial reporting.

30. In some overseas jurisdictions there are:

- direct statutory limits on either local authority rates or debt;
- the ability for higher levels of government to issue directions to any local authority about rate or debt practices; and/or
- the direct ability for ratepayers to constrain rates or debt by recall or referendum.

31. In New Zealand the system relies on public consultation and local authority elections to constrain local authority funding decisions. This creates a greater risk of financial imprudence arising from excessive expenditure occurring.

32. Local authorities are able to offer rates as a security for debt. If they default on debt repayments, lenders can appoint a receiver to levy rates to collect outstanding debt. This creates relatively weak incentives for lenders to carefully scrutinise the risks associated with a particular local authority's planned borrowing.

Public oversight and commentary

33. The LGA02 relies on local authority accountability to, and scrutiny of its affairs by, its community. However, ratepayers have little analytical or comparative information to assess the financial prudence of their local authority's actions and proposals.

34. Commentary on the affairs of individual local authorities is limited:

- only a small number of local authorities have credit ratings, which is one form of financial evaluation of an entity;
- only one commentator ranks and evaluates local authority financial performance using published data;[5] and
- many local authorities experience little direct media scrutiny. Local authorities based outside metropolitan or provincial centres may be primarily covered by weekly community newspapers. These have limited reporting resources.

35. To date the Department has not attempted any comprehensive analysis of the financial prudence of individual local authority proposals or actions.[6] The Auditor-General regularly reports to Parliament on local authority matters, but has only recently begun to consider this area.[7]

Diversity of local authorities

36. New Zealand's local authorities exhibit much diversity, making the identification of financial prudence benchmarks challenging. Elements of diversity include:

- there are three distinct types of local authority – territorial authorities, regional councils and unitary authorities - providing different ranges of services;

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5 The commentator is Larry Mitchell – his products can be seen at http://www.kauriglen.co.nz/larry/

6 The DIA does publish tables of the financial projections contained in Council long-term plans. This does enable interested people to develop their own comparisons. They can be accessed at http://www.localcouncils.govt.nz/lgip.nsf/wpg_URL/Resources-Download-Data-Local-Authority-Long-Term-Plans.

7 "Matters arising from the 2012-22 local authority long-term plans", Part 4, accessed at http://www.oag.govt.nz/2012/ltps-2012-22.

- significant ranges in population size - from the Chatham Islands Council (population 600) to the Auckland Council (population 1,415,550);
- different demographic circumstances - some local authorities are experiencing significant growth, requiring infrastructure investment, while others are experiencing population decline. Some have a strong focus on the visitor industry and have many holiday homes. This requires infrastructure to meet peak demands very much higher than average demand throughout the year;
- different organisational structures - some local authorities, such as the Auckland Council, carry out significant activities through subsidiary companies, while others retain all of their services within the direct control of the council.

No professional consensus on concepts or measures of financial prudence

37. Although local authorities have been required since 2002 to manage their affairs in a financially prudent way, there has been no previous discussion promoted by central agencies or sector organisations as to what that might mean and how financial prudence might be measured.

38. Similarly, with the exception of debt, there has been no development of financial prudence benchmarks within local authority financial reporting. The introduction of liability management policies in 1996 led local authorities to develop prudent debt level benchmarks. However the benchmarks used are very diverse.

39. The balanced budget requirement, first introduced in 1996, may be regarded as a legislative financial prudence benchmark. Accounting practice has never distinguished different classes of revenue and assumes that all revenue is available to meet any operating expense that a local authority incurs. However, local authorities receive revenue which may only be used for capital purposes (development and financial contributions and some subsidies). More recently, accounting practice has evolved to recognise changes in valuation of assets as revenue or expenditure. The result is that a local authority may report a balanced budget but actually have insufficient operating revenue to meet its operating expenses.

Costs and benefits of the status quo

40. The benefits of the present situation are:

    - that there is clear accountability of elected representatives to ratepayers for the decisions they make; and
    - that the political judgement of elected representatives is not constrained by central government expectations or limitations.

41. The costs of the present situation are that, in the absence of any standard measures of financial prudence, there are no accepted financial warning signals to guide councillors or to inform communities of financial risks to local authorities. Potentially this may lead to unwise or imprudent expenditure, excessive debt levels, and subsequent rate rises that might not occur if better information was available. Alternatively this can lead to short-term decisions that put future services at risk and/or shift costs to future ratepayers.

Objectives

42. The desired outcomes from the regulations are to:

    - help showcase best practice and excellence in local authority financial management; and

- assist in identifying local authorities where further inquiry is warranted in relation to their financial management.

43. These outcomes are consistent with the Government's priorities to responsibly manage government finances and to deliver better public services within tight financial constraints.

44. Specific objectives for the regulations are that they:

- *are meaningful across a diverse group of local authorities* – measures have to be robust enough to deliver useful information notwithstanding the varying characteristics of different local authorities;
- *avoid risk of unintended consequences* - measures should not create perverse incentives or distort decision-making. In particular, they should not encourage neglect of network infrastructure or short-term decision-making;
- *have low compliance costs* – measures that require complex data gathering and extensive audit testing should be avoided;
- *are transparent* – measures should use simple calculations from published information using a consistent methodology. The number of benchmarks should be limited so they can readily be explained to a non-expert audience; and
- *independently verifiable* – measures should either come from sources independent of local government (such as Statistics New Zealand), or should be objectively verifiable by independent agencies (acknowledging that forecast information has inherent uncertainty).

45. In achieving these objectives there is a trade-off between delivering meaningful benchmarks reflecting the diversity of local government and the desire for low compliance costs and transparency. In considering options for benchmarks particular attention has been given to avoiding promoting unintended consequences.

46. There are two constraints on achieving these objectives. First, analysis of financial plans and reports cannot prevent poor financial management where decisions are taken outside the planning cycle and the financial consequences only become evident after the event. However, it may help identify this type of poor management earlier and this in turn may lead to earlier corrective action being taken.

47. Second, section 259C of the LGA02 requires the Auditor-General to report on the completeness and accuracy of each local authority's disclosures, in its long-term plans and annual reports, of information required by these regulations. This suggests benchmarks should be objectively verifiable and draw from financial information that is already prepared and audited.

Options and Impact Analysis

48. Because the decision to regulate has already been made, the options analysis focuses on benchmark design. Furthermore, the design choices are not a set of discrete alternatives, for example, option A or option B. Rather they are a range of interactive choices, which need to be blended into a coherent whole.

Assumptions

49. In considering regulatory choices, the Department has made two assumptions. The first is that an outcome that concludes that all local authorities are managing their finances prudently has to be considered possible. Therefore an approach which

simply seeks to rank all local authorities from “best” to “worst” with the presumption that those that are worst are being imprudent is not suitable.

50. The second assumption is that, although the financial prudence regulations are related to a formal system of assistance and intervention in the LGA02, in practice their main effect is likely to be informal. This will arise because the results will be publicly available and therefore there will be active media and stakeholder interest in those results. This will promote debate within local communities and council chambers about how particular local authorities compare with others. A successful outcome would be if published information arising from the regulations helps local authorities make better decisions, thus avoiding the need for Government intervention.

Components of financial prudence

51. Prudence in a financial context is used to convey a sense of financial restraint, but balanced by a sense of weighing up and consideration of both the present and future implications of financial decisions.

52. Commentators on government finance frequently identify subsidiary components when discussing broad concepts such as financial prudence. Many focus on the concept of financial sustainability and break that down into subsidiary elements. Appendix Two summarises five other studies that addressed similar issues and the way in which they conceptualised financial prudence or similar concepts.

53. The Department considers three components of financial prudence can be identified for the purposes of these regulations. These are:

- *affordability* – if elected members act as trustees for their community, then prudence extends from what is prudent for the local authority, as an organisation, to what is prudent for the community as a whole. This needs to include considerations of what the community can reasonably afford;
- *sustainability* – a local authority should manage its finances in a manner which are sustainable in the long-term. This will include having the financial capacity to deal with unexpected events and external shocks; and
- *predictability* – this requirement is already expressed in the LGA02. Section 102 states that the local authority’s revenue and financing policies are to “provide predictability and certainty about sources and levels of funding.” Lack of predictability suggests weak financial management practices within the local authority concerned, especially where projects or programmes go significantly over budget. This would be an indicator of financial risk to ratepayers and could lead to imprudent outcomes.

54. Of these components, the affordability component may be the most controversial. However, it is consistent with international good practice. For example, the International Public Sector Accounting Standards Board includes in its assessment of the revenue dimension of long-term financial sustainability the vulnerability of an entity to “the unwillingness of taxpayers to accept increases in taxation levels”.[8]

Design issues

55. In addition to identifying the components of financial prudence, there are two other design issues that need resolution before selecting individual benchmarks. The Department recommends that benchmarks should:

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[8] International Public Sector Accounting Standards Board, “Reporting on the long-term sustainability of a public sector entity’s finances,” July 2013, paragraph 35.

- measure the absolute state of a local authority's affairs, rather than change; and
- apply to the parent local authority, except in the case of the Auckland Council where they should apply to the council group.

Measures of change or absolute comparisons

56. One design issue is whether measures should focus on change or on the absolute state of affairs in a local authority. Typically the matter of most concern to ratepayers is the change in rates and media headlines invariably focus on percentage rates increases. However, an approach that focuses on limiting change implicitly assumes that the status quo is appropriate. Adopting this approach would punish local authorities that have been thrifty in the past and reward those that have been profligate. This is because a local authority with already high rates would be assessed as being just as prudent as a local authority with very low rates, if they increased rates by the same percentage amount.

57. In addition, given that the purpose of the benchmarks is to help assess the prudence of local authorities' financial management, it is hard to support benchmarks that, for example, assess council A as less prudent than council B when council B's rates are higher than A's. For these reasons we recommend a design approach which focuses on absolute measures, for example, average rates per rating unit, rather than measures of change, such as average rates increase per rating unit.

Parent council or council group measures

58. Local authorities can be complex organisations. Many deliver some services through subsidiary entities. These can be commercial operations, such as port companies, electricity lines companies and civil contracting companies. Alternatively subsidiaries can be not-for profit organisations, such as trusts to run stadiums and museums, or to provide services such as economic development and tourist promotion.

59. Accounting practice requires entities with subsidiaries to report two sets of accounts. "Group" accounts "consolidate" the transactions of the parent entity and its subsidiaries to present reports as if the group was one entity. This involves combining the parent and subsidiary entities' accounts and removing transactions between entities in the same group.

60. Parent accounts report only the financial results of the local authority. Its ownership of subsidiaries is reported as an investment in its balance sheet, and transactions with subsidiaries are included in its revenue and expenditure statement as if it had no ownership interest in the subsidiaries.

61. While local authority annual reports include group and parent financial statements, annual plans and long-term plans are not required to include group financial forecasts. In practice, only the Auckland Council prepares group financial forecasts on a voluntary basis. Auckland Council is unique in that it delivers many core services through council-controlled organisations.

62. Official statistics only collect information about parent entities. There is no official information available to determine how many local authorities have subsidiaries. The Department carried out an analysis of local authority 2011/12 annual reports to obtain an indication of the scale of the issue.

63. Figures One and Two illustrate the number of local authorities with subsidiaries and the scale of subsidiary activity. Only 30 local authorities had no subsidiaries. Nineteen local authorities earned more than 25 per cent of group revenue through subsidiaries and 15 local authorities held more than 25 per cent of group debt in subsidiaries.

Figure One: Proportion of group revenue earned by subsidiaries

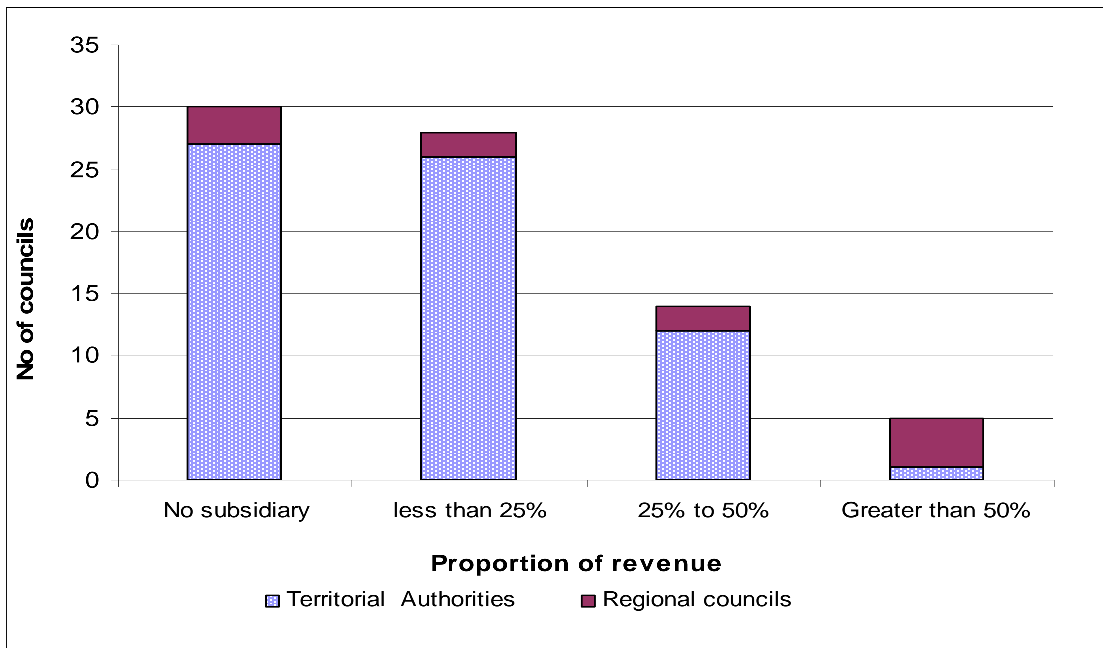
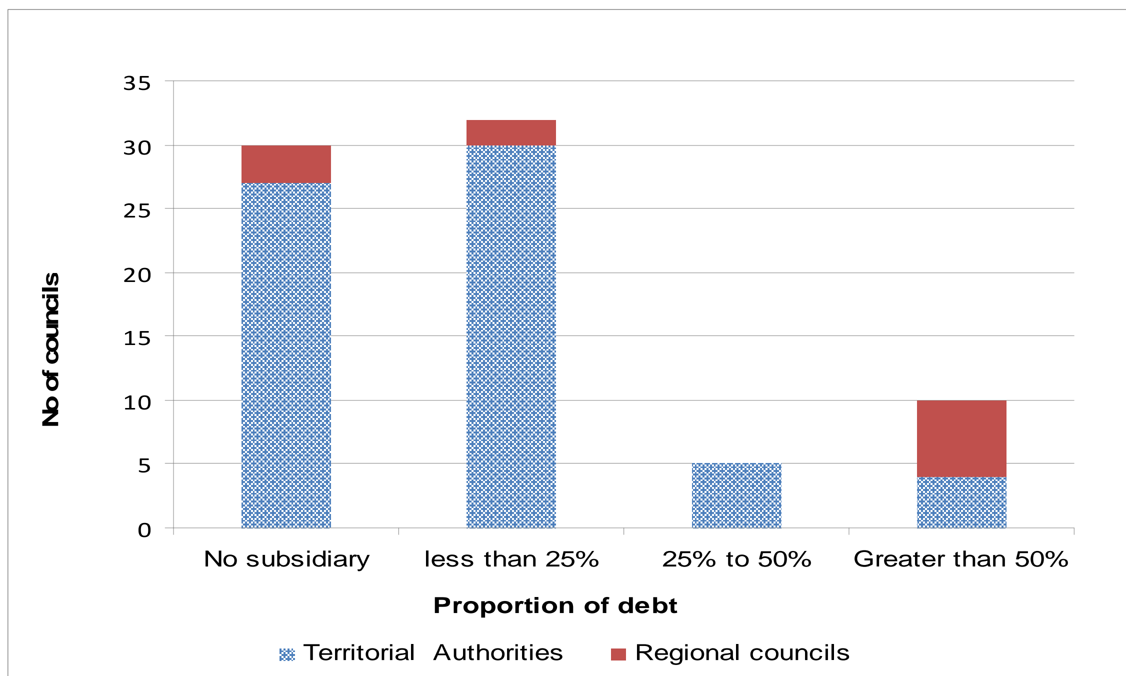


Figure Two: Proportion of group debt held by subsidiaries



Source: DIA analysis of local authority 2011/12 annual reports

64. Underlying this design issue is an issue of perception. What do ratepayers regard as 'the council'. Frequently this perception will be blurred. Often council-owned commercial entities will be perceived as independent of the local authority. Some have had long histories as separate entities in the community – electricity lines companies and port companies for example. Others undertake trading activities well outside the geographic area serviced by the local authority and are not perceived as providing services to the local authority's ratepayers.

65. However, others provide services to ratepayers that are well established as “council” services in the eyes of many ratepayers – museum trusts for example.

66. A further complication is that the financial drivers of a commercial organisation are quite different from the financial drivers of a ratepayer funded entity. What is prudent for a commercial organisation may not be prudent for a local authority. The reverse may apply also – a financial management strategy that is prudent for a local authority may not be prudent for a commercial entity.

67. The Department considered whether it would be practical to apply a ‘partial consolidation’ approach to the regulations. Under this approach, the benchmarks would apply to the parent local authority and any not-for-profit subsidiaries. We concluded this approach was not appropriate for two reasons:

- first, ratepayers and other users of the data would not be able to see how the calculation of the benchmarks was derived from published financial reports. This lack of transparency would undermine the credibility of the results; and
- second, partial consolidation would result in additional compliance costs in both preparing and auditing the results. Effectively, it could require a local authority to prepare and have audited a third set of accounts.

68. Generally, where subsidiaries derive significant revenue or hold a large proportion of group debt, most of the subsidiaries are commercial in nature. In the case of regional councils, for example, port companies are significant. While many local authorities have service delivery subsidiaries, often economic development or tourism promotion organisations, these tend to be small in financial terms.

69. Auckland Council is the exception to this, with significant services being placed in subsidiaries including water services, roads and transport, and regional facilities. Auckland Council derives 34 per cent of its revenue from subsidiaries and holds 31 per cent of its debt in subsidiaries.

70. The Department’s conclusion is that, pragmatically, the measures should apply on a group basis to Auckland Council and on a parent basis to other local authorities. This approach will best align with the way in which local authority services are structured. Should other local authorities shift significant services into subsidiaries in the future, the regulations could be amended to reflect that change.

Choosing Benchmarks

71. In the following section possible benchmarks are discussed and evaluated using the three components of prudence identified earlier. The Department’s recommended benchmarks are shown in Table Four. The Department also recommends two indicators of affordability. No formal regulation is required for this, but they are important to the achievement of the intended outcomes and are therefore included so that the full proposal is clear.

Table Four: Recommended benchmarks and indicators

	Benchmark name	**Description**
Affordability benchmarks	Rates benchmark	Rates revenue complies with the limits set in the council’s financial strategy
	Debt benchmark	Debt complies with the limits set in the council’s financial strategy

	Benchmark name	Description
Affordability indicators	*Rates* *Debt*	*Rates per rating unit* *Net debt per rating unit*
Sustainability benchmarks	Balanced budget benchmark	Operating revenue, excluding development and financial contributions and revenue from revaluations, exceeds operating expenditure
	Essential services benchmark	Capital expenditure on the five network infrastructure services exceeds depreciation on those five services
	Debt servicing benchmark	Interest expense is less than 10% of operating revenue, as defined in the balanced budget benchmark, except for local authorities with projected population growth greater than or equal to New Zealand's projected population growth. For those authorities the benchmark is 15% of operating revenue.
Predictability benchmarks	Operations control benchmark	Net cash flow from operations equals or exceeds budget
	Debt control benchmark	Net debt is less than or equal to forecast debt in the long-term plan

Measures of affordability

72. The Department recommends there be affordability benchmarks for rates and debt. Rates represent the coercive power of the local authority to tax property owners in its district. Because it is a tax rather than an exchange where consumers can determine whether the service is affordable for them, it is the revenue source where risks of unaffordable costs for consumers arise.

73. Debt represents a commitment of future ratepayers' funds. Local authority debt is usually secured by a charge over rates.[9] This means if the local authority defaults on debt repayment, lenders can appoint a receiver to assess a rate to recover the outstanding loans.

74. The question of how rates and debt should be measured is more complex. The Department considered three approaches – a movement approach, a directive approach and a developmental approach.

75. As its name implies, a movement approach would look at changes in rates and debt. The Department does not recommend this approach for the reasons set out in paragraphs 56 and 57.

76. The directive approach would require rates and debt measures that reflected the size of the local authority. For example, these could be rates per resident, per rating unit or per million dollars of rateable value.

77. At present the latter two options are not practical as rating valuation information is not publicly reported. This means there is no data available to allow benchmarks to be set using these bases. However the Department considers that benchmarks set on a per

9 It is not mandatory for a local authority to offer rates as a security for debt, but in practice almost every council does.

resident basis have an inherent bias against districts with many holiday homes. This would include districts such as Thames-Coromandel, Kaikoura, and Taupo.

78. Other issues with the directive approach include risks:

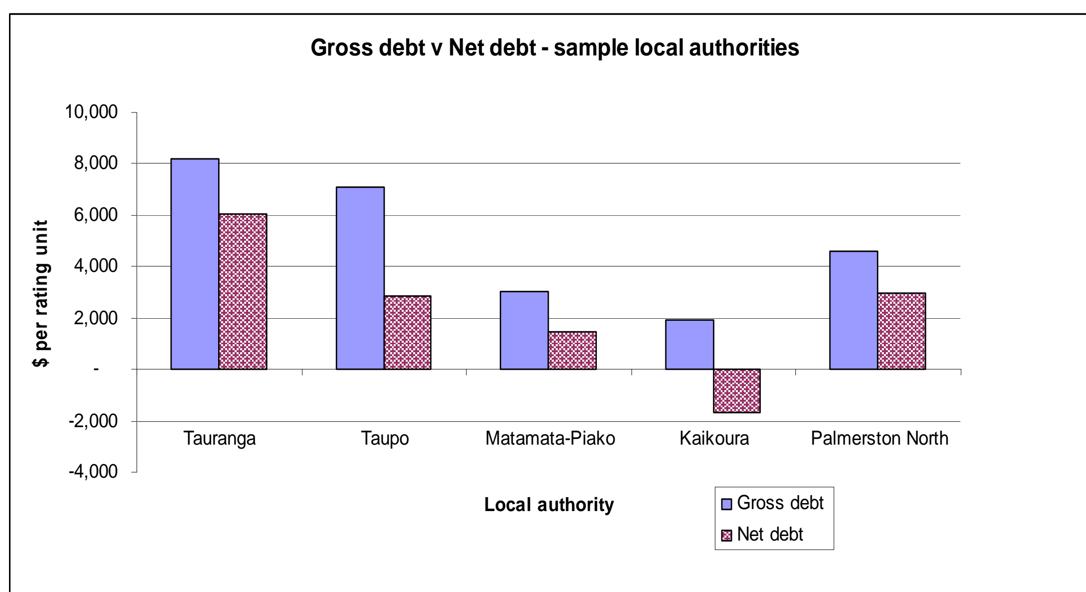
- that any benchmark set becomes a target rather than a limit for local authorities;
- of criticism by local authorities because there is no rational basis for setting the benchmarks; and
- that some local authorities may not be able to meet the affordability benchmarks without breaching sustainability benchmarks, or vice versa.

79. Under the development option, affordability benchmarks would develop over time. Initially the benchmarks would be the local authorities' compliance with the targets in their financial strategies for rates and debt limits.

80. In parallel, the Department would report on common indicators of local authority affordability. The indicators would not have particular targets associated with them. We propose as affordability indicators rates per rating unit and net debt per rating unit. To implement this, the Government is including in the LGA02 Amendment Bill (No 3) a proposal that local authorities must report in their accountability documents the actual or projected number of rating units in the district.

81. Under these indicators, the question of how net debt is defined arises. Gross debt is the total debt owed by the local authority. For a variety of reasons, local authorities may hold assets at the same time as they borrow. For example, at 30 June 2012 the Taupo District Council held financial investments of just over $83 million, originally derived from the sale of council electricity assets, while at the same time having debt of $164 million. Figure Three illustrates the difference for a small sample of local authorities at 30 June 2012.

Figure Three: Gross debt v net debt for selected local authorities



Source: DIA survey of selected local authorities

82. When gross debt is measured, Taupo's debt appears quite high compared to the other local authorities. However, its net debt is unexceptional and less than Palmerston North's. The Department's view is that net debt gives a better indicator of long-term solvency risk than gross debt, but care needs to be taken in identifying which assets

are included in the net debt calculation. Many local authority assets could not be sold, for example parks and roads, and therefore do not improve the long-term solvency of the local authority. It is important that the assets used in the net debt calculation are readily disposable assets.

83. The Department also considered a third indicator of affordability. This measure was payments for services, defined as all operating expenses excluding depreciation and interest expense, per ratepayer. The advantage of this measure is that there is considerable variation between local authorities in their dependence on rates. Having high rates may reflect a lack of other revenue sources, rather than high spending. Payments for services would more directly look at the drivers for rates.

84. The Department does not recommend using this measure. We consider it desirable to keep the suite of measures simple. In trading off greater information versus simplicity, we consider in this case simplicity is preferable. Payments for services will easily be derived from published information in annual plans and annual reports. Therefore, in analysing the benchmarking results, it will be simple to use this measure as part of the context in assessing whether further enquiry is warranted in particular cases.

Sustainability benchmarks

Balanced budget benchmark

85. One indicator of sustainability is that a local authority is not borrowing to pay operating expenses, often referred to as a balanced budget. This is reflected in section 100 of the LGA02 which requires local authorities to budget each year for projected operating revenues to meet projected operating expenses. Section 100 permits local authorities to budget for an operating deficit, provided they have considered specified matters and resolved that it is financially prudent to budget for a deficit. Hence the LGA02 creates a presumption that a balanced budget is financially prudent, but permits a local authority to depart from that presumption.

86. However, changes in accounting practice since the balanced budget requirement was introduced into local government legislation require some modification of the measure to get closer to this objective.[10] Accounting practice treats as revenue:

- increases in asset values arising from periodic revaluations; and
- the value of assets transferred to local authority ownership from property subdivision and development (vested assets).

87. These transactions provide local authorities with no financial resources to meet their outgoings. Therefore, they should be excluded from a balanced budget measure.

88. In addition, accounting does not distinguish between revenue provided exclusively to fund capital expenses and revenue provided to meet operating expenses. In local government the following are potential sources of revenue for capital expenses:

- development contributions under the LGA02;
- financial contributions under the Resource Management Act 1991;
- subsidies provided for capital expenditure; and
- some targeted rates and lump sum contributions made under the Local Government (Rating) Act 2002 exclusively for capital purposes.

89. Therefore a balanced budget test that is directed to ensuring adequate funding of operating expenses will exclude a number of these revenue items. The Department

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10 The balanced budget requirement was first introduced in 1996 as an amendment to the Local Government Act 1974.

favours the following exclusions - vested assets, revaluations, development contributions and financial contributions.

90. The Department does not recommend excluding subsidy revenue from the benchmark. Local authorities routinely receive subsidy revenue for asset replacement, for example for the resealing and reconstruction of roads and bridge renewals. The consumption of these assets is included in operating expenditure through depreciation expense. Excluding the subsidy revenue for replacing these assets while including the depreciation on them would not result in an even-handed benchmark.

91. Separately identifying subsidy revenue for capital expenditure other than asset replacement would add to both compliance costs and complexity and reduce the transparency of the test. Therefore this approach is not recommended.

92. Similarly, the Department does not recommend excluding targeted rates exclusively for capital purposes from the test. This would create incentives to change rating practices for no other reason than to improve performance against this benchmark. It would also result in different results for local authorities that had the same underlying financial performance, simply according to their use of rating tools.

93. Accordingly, a balanced budget benchmark could be to have a positive operating balance (operating revenue minus operating expenditure) excluding revenue from vested assets, revaluations, and development and financial contributions.

94. It should be noted that there is one scenario which could well be perfectly prudent but would fail this test. Occasionally, local authorities make large grants to community trusts to construct major community facilities, such as a community recreation centre. In substance the council is funding the purchase of a community asset, but the accounting treatment may show the grant as an operating expense, and in that year the council concerned is likely to show a large operating deficit. However, this should appear as a one-off blip in an otherwise sustainable set of results.

Essential services benchmark

95. A major risk to long-term sustainability in local authorities is failure to maintain their asset base. Large parts of local authority services are provided through physical assets which are underground and easily taken for granted. To measure whether the asset base is running down, it is necessary to compare the consumption of assets with the amount the local authority is investing in renewing assets.

96. Accountants define depreciation as the systematic allocation of an asset's value over its useful life. Hence depreciation is a measure of asset consumption. By comparing actual depreciation with actual capital expenditure in the past, it is possible to measure whether the local authority has been allowing its asset base to run down. Similarly by comparing projected capital expenditure with projected depreciation it is possible to assess whether the local authority is planning to allow its asset base to run down.

97. Given the long lives of local authority assets, capital expenditure may well be lumpy over time. Therefore this benchmark needs to be assessed as an average over many years to distinguish sustainability risks from annual capital expenditure fluctuations.

98. There are some secondary issues in designing this benchmark. The first is how specific the test should be. If the test were simply total capital expenditure is greater than depreciation, a local authority would have the ability to invest in new assets while neglecting the replacement of others. The most common concern is that some assets like recreation and cultural facilities are more politically attractive investments than other assets like underground assets, that can be taken for granted.

99. Local authorities are required to disclose actual and planned capital expenditure and depreciation for roads, water, sewerage, stormwater and flood protection. The test

could be narrowed to apply to those five services leaving decisions about other assets to local political processes.

100. Appendix One is a table comparing planned capital expenditure to depreciation ratios by territorial authorities in the five specified infrastructure services and for all local authority assets. It does show several local authorities with planned ratios of less than 100 per cent - that is local authorities where depreciation exceeds planned expenditure. It also shows that many of those with low ratios have appreciably lower ratios in the five network infrastructures.

101. Another approach is to compare capital expenditure on replacement of assets with depreciation. From 1 July 2012 local authorities were required to separate their capital expenditure into three classes – expenditure for the replacement of assets, expenditure to improve levels of service and expenditure to service growing demand. A local authority could neglect asset replacement while meeting investment needs to improve levels of service and meet growing demand.

102. This approach is not favoured, because while the distinction is useful, there is an appreciable degree of subjectivity in judging the purpose of the expenditure. It is common for a local authority to carry out capital expenditure which has elements of all three purposes. A local authority might build a new water treatment plant with a higher capacity than the present plant (growth), a better standard of treatment (improved service levels) and which replaces an existing plant approaching the end of its useful life (replacement). Allocating the cost of the new plant between the three purposes is likely to involve a number of judgement calls and if those judgements are to be audited, compliance costs may be excessive.

103. On balance the Department considers that the capital expenditure to depreciation ratio for the five specified infrastructures is the best measure of long term sustainability of local authority investment.

104. It should also be noted that accounting standards permit local authorities to use either the cost or revaluation model of valuing and depreciating assets. Most local authorities use the revaluation model for long-lived assets. Under this model assets are revalued every few years to reflect the value it would cost to replace them. Depreciation under this model is therefore directly related to estimated replacement cost. Currently one local authority, Timaru District Council, uses the cost model for all assets. Under the cost model, assets are valued at their original cost and depreciation therefore bears no relationship to expected replacement costs. For a local authority using the cost model, in the long run capital expenditure would need to be many orders of magnitude greater than depreciation to replace existing assets.

Debt servicing benchmark

105. A third indicator of sustainability is the ratio of interest expense to operating revenue. This ratio shows the proportion of a local authority's revenue committed to meeting debt servicing costs. A high ratio means the local authority has little flexibility to adjust its revenue or expenditure commitments because it must meet debt repayments first.

106. Many local authorities use a ratio of this type in their financial strategies. The ratio could be expressed either as interest to rates revenue, or as interest to operating revenue. The Department proposes a ratio of interest expense to operating revenue. This avoids bias against local authorities which are able to service debt from non-rate revenue sources. For consistency the Department proposes the same definition of operating revenue in this ratio as in the balanced budget benchmark.

107. The Department proposes that the maximum prudent ratio for this benchmark be set at 10 per cent, except for local authorities with projected population growth at or above

the national projected population growth rate. For those local authorities this benchmark would be set at 15 per cent.

108. To determine this proposal the Department carried out two informal case studies of local authorities that have attracted comment from the Auditor-General – Waitomo and Tasman. Both local authorities have comparatively high debt levels. Tasman's debt servicing ratio peaked at just under 9 per cent in the 2010/11 financial year. Waitomo's debt servicing ratio peaked at 10.6 per cent in 2008/09.

109. The Department also used Statistics New Zealand data to test the level of debt servicing by all New Zealand local authorities. This suggested that in the 2011/12 financial year there were seven local authorities with debt servicing ratios exceeding 10 per cent. Two local authorities – Taupo and Tauranga – had ratios close to 15 per cent. We reviewed those authorities' annual reports for that year to confirm the calculation. Tauranga experiences significant growth and Taupo has recently made large infrastructure investments.

110. Finally, the Department compared forecast debt servicing ratios using data from the 2012/22 long-term plans and Statistics New Zealand subnational population projections. It used this data to determine a suitable cut-off point to separate local authorities with significant growth from other local authorities.

Predictability

Operations control benchmark

111. Predictability issues arise in two circumstances. The first is where operating cash flows are poorly managed. This may result in unexpected deferrals of capital works, or using debt to fund capital works which were originally intended to be funded from operating revenue. Ultimately, poor operating cost control may lead to unexpected rate increases.

112. We propose an operations control benchmark that net operating cash flows meet or exceed budget. Unfavourable variances in operating cash flows can arise from at least four sources. These are:

- economic downturns reducing revenue from land development – resource consent and building consent fees, and financial and development contributions;
- delayed roading capital projects leading to subsidy revenue being deferred from one year to another (the subsidy revenue is operating revenue while the capital expenditure is shown under "investing activities" in the cash flow statement);
- natural disasters leading to unbudgeted operating expenditure – the costs of repairing storm damage being the most common example; and
- poor management leading to poor budgeting and/or poor cost control.

113. Only the last of these items is of concern from a financial prudence viewpoint. This suggests that it will be necessary to understand the cause of the result to determine whether any financial prudence issue arises.

Debt control benchmark

114. The second circumstance where predictability issues arise is the control of capital expenditure. Capital expenditure programmes are frequently subject to timing delays. Therefore, reported over or under expenditure on capital works programmes is often related to timing issues rather than to underlying cost issues.

115. We consider the best way of monitoring capital expenditure control is to look past the capital expenditure itself and to monitor local authorities' debt. Major capital projects

inevitably involve a significant level of debt funding, so debt being greater than projected is the most reliable indicator of weak capital expenditure control.

Consultation

116. The LGA02 requires the regulations to be developed in consultation with Local Government New Zealand (LGNZ). In addition to LGNZ the Department established its own advisory group, and has consulted extensively with the Society of Local Government Managers (SOLGM) and the Office of the Auditor-General. To facilitate consultation the Department produced to discussion documents and also shared the draft Cabinet paper and RIS with LGNZ and SOLGM.

117. The Department consulted other Crown agencies and received significant feedback from the Treasury and the Ministry of Business, Innovation and Employment (MBIE).

118. The consultation process showed general acceptance of the Department's overall approach to development of the regulations. Consultation focused on important aspects of the detailed design of the regulations. Key areas discussed are outlined in Table Five.

Table Five: Key feedback from consultation process

Issue	Feedback
Group v parent disclosure	We discussed the pros and cons of group v parent disclosure with SOLGM. There was consensus that while a partial consolidation approach would most accurately achieve the intention of the regulations, the compliance costs and lack of transparency associated with that would outweigh the benefits. The solution of having Auckland Council apply the benchmarks on a group basis and all other local authorities applying the benchmarks on a parent basis was a consensus decision.
Definition of rates	LGNZ and SOLGM raised the issue that if rates per rating unit is to be used as a measure of affordability, then revenue from metered water supplies should be included in the definition of rates. The Department has accepted that advice and recommended that practice be adopted, with consequential amendments to the Local Government (Financial Reporting) Regulations 2011.
Payments to suppliers affordability indicator	The Department's initial proposal was to include a third affordability indicator, payments to suppliers. SOLGM's advice was that this indicator added unnecessary complications. The Department has accepted that advice, noting that this information could be derived from local authority accountability documents, without formal regulation being required.
Balanced budget benchmark	The Department has discussed which items of revenue should be excluded from this benchmark for it to achieve its purpose. Discussion focused on the treatment of subsidy income and on the range of revaluation items which should be excluded from the benchmark. There was consensus that while ideally subsidies for major capital projects would be excluded, providing a clear regulatory definition of such subsidies would be difficult. The presence of such subsidies would be evident in well-presented time series data and therefore are better treated in the results' interpretation rather than in the benchmark itself. SOLGM has concerns about including gains and losses on the revaluation of derivatives in the benchmark. Some local authorities borrow at floating rates and then purchase derivatives to swap the floating rate interest to fixed rates. The local authorities are required to revalue these derivatives annually to a 'tradable' value, which can affect the outturn against this benchmark, even though they are not traded.

	The Department agrees with the concern, but the accounting and regulatory issues are highly technical. We have recommended a delegation to the Minister to exclude these gains and losses from the benchmark during the drafting process, provided the Minister is satisfied that the exclusion can be clearly specified and is transparent.
Essential services benchmark	Both the Treasury and MBIE were concerned about the efficacy of this benchmark. It has two problems. In the case of growth councils the level of investment needed in essential infrastructure is likely to appreciably exceed depreciation, because of the need to increase infrastructure capacity. A growth council could comply with this benchmark by investing in new capacity, while at the same time allowing parts of its existing network to run down. In other cases, there may be long periods where, because of the timing of the original investment in infrastructure, little capital expenditure is required and a level of investment less than indicated by the benchmark would be appropriate and desirable. The Department accepts that the criticism is valid, but in our discussion with these agencies, we were not able to identify a better benchmark. The Department considers a benchmark related to capital investment is necessary to support the revised purpose statement for local government inserted into the LGA02 in December 2012 and to discourage councils from keeping rates and debt down by neglecting infrastructure altogether. Taken individually, all benchmarks have some risk. The efficacy of the regulations relies on the benchmarks working as a cohesive package, and upon careful interpretation of the results, having regard to the context in which each local authority operates. Interpretation of this benchmark will be easier from 2015, when local authorities will include formal infrastructure strategies into their long-term plans. These will provide a useful context within which to consider the implications of each local authority's performance against this benchmark.
Measuring net debt	We discussed with SOLGM the nature of the assets that should be offset against gross debt. The discussion centred on the range of equity investments that should be offset against gross debt when measuring net debt. Equity investments represent the value of local authority shareholdings in companies. These shareholdings range from portfolio investments designed to generate income and spread across a range of companies to single investments in companies held primarily to provide service to the local authority's community. For example, a council contracting company. There are issues about the willingness of the local authority to sell its shareholdings and its ability to value its shareholdings accurately. The Department considers it is extremely difficult to identify a subset of equity investments that should be offset against gross debt. In extreme circumstances, a local authority would be able to sell its shareholdings in almost any company it had invested in. Excluding equity investments from the net debt benchmark would discriminate against local authorities with investment portfolios and/or encourage them to change investment strategies simply to present a better result on this benchmark. Therefore, in this case, the Department stands by its proposal.
Debt servicing benchmark	The Department's initial proposal was for a single benchmark applying to all local authorities. After discussion with LGNZ and SOLGM we agreed this took insufficient account of the need for growing local authorities to borrow more to provide assets for growing communities. The initial proposal also did not allow for the capacity of growing local authorities to service debt from future ratepayers in their districts.

	The Department revised the proposal to set a higher benchmark for those local authorities with projected population growth at or above the national projected population growth rate. This was acceptable to LGNZ and SOLGM.
Presentation of results	There was agreement that presenting the results as time series data was important to providing useful information to stakeholders. In particular presenting the results in time series will identify clearly situations where a current council is dealing with legacy issues in a prudent fashion, as opposed to a current council with plans that are potentially imprudent.
Compliance costs	A particular concern has been to ensure that the regulations do not impose significant compliance costs on local authorities. The consultation has confirmed that the costs of preparing and disclosing the information required for the benchmarks will be minimal for local authorities.

Conclusions and recommendations

119. The Department identified five objectives for the regulations. Table Six summarises our assessment of the proposals against those objectives.

Table Six: Summary assessment of preferred option against objectives

Objective	Assessment
Meaningful across a diverse group of local authorities	We consider that all measures are meaningful across all local authorities, except for the essential services benchmark. Most regional councils are not major owners of network assets. Therefore the essential services benchmark may have little meaning for those councils. We would expect some types of local authority to perform in different ways on some measures. In particular, we would expect local authorities with high growth levels to need, and be able to support, higher debt levels than other local authorities Because of the unique structure of the Auckland Council, the Department recommends that the benchmarks apply to that Council on a group rather than a parent basis. Auckland Council is of a size where comparisons with other New Zealand councils may be of limited value. The Department considers that applying the benchmarks to the Auckland Council on a group basis will, over time, give users a clear picture of trends in the prudence of that Council’s financial management
Avoid risk of unintended consequences	The measures are designed so that, taken as a whole, they discourage poor financial management practice. In particular, they discourage shortsighted practices such as keeping rates low by neglecting infrastructure. On the other hand, they will highlight local authorities incurring unsustainable debt levels or with high rates levels, for which there is no particular cost driver Theoretically, there is a small incentive to shift some council activity into CCOs. The Department considers that other influences will inhibit this outcome

Objective	Assessment
Have low compliance cost	The Department considers this objective fully met. All information used in the measures is already prepared and available to councils. We carried out a trial using the annual reports of two local authorities and found we could obtain relevant data for any financial year in less than one hour. We have had several discussions with LGNZ and SOLGM about the proposed benchmarks. Compliance costs have not been a significant concern in those discussions There are one off costs in explaining the regulations to local authority elected members, staff and auditors and for local authorities to establish the templates within their reporting documents to report on this material. These can be minimised by providing good notice to local authorities of the proposals. Publication of the regulations by the end of March 2014 is highly desirable to allow this to occur before preparations begin for the 2013/14 annual reporting cycle
Transparent	This objective is met to the extent that all measures use publicly available information in council accountability documents The balanced budget measure relies on a calculation that is not obvious to somebody without knowledge of accrual accounting. It will need to be explained to users of the benchmarking information The essential services benchmark also relies on some knowledge of accrual accounting, and therefore will need explanation to users The concept of 'net debt', is not immediately obvious, and as with other measures will need explanation to users
Independently verifiable	This objective is fully met. All information comes from existing accountability documents and is readily audited without great time being taken

120. Overall, the costs of the proposal are low. The information required by the regulations could be readily extracted from existing council plans and reports using a small amount of staff time. Achieving the desired benefits of the proposal, as specified in paragraph 42, is contingent on a credible analysis of the benchmarking results being collated and published. Mere publication by individual councils in their accountability documents will be insufficient to achieve the desired benefits.

121. Analysis of the results would also produce a secondary benefit. As noted earlier in this RIS, there is currently no consensus on how local authority financial prudence should be measured. Ongoing debate and evaluation of the merit of the benchmarks used and the insights gained from them will also be beneficial to stakeholders interested in local government performance.

Implementation plan

122. It is proposed that the first disclosure under the regulations will be in local authority annual reports for the 2013/14 financial year. This disclosure would be retrospective – it would disclose the current and past performance of each local authority against the benchmarks. The first disclosure of prospective performance against the benchmarks would be in the 2015/25 long-term plan.

123. To achieve the desired outcome of the regulations, it will be necessary for the Department to collate, analyse and publish the results. Useful analysis will also require local authorities to be grouped according to common characteristics. These might

include matters such as growth rates, urban/rural mix, population income levels, and dependence on the visitor industry.

124. There are three main implementation risks. The first is that the regulations are misunderstood and incorrectly applied by local authorities. This risk is managed by ensuring that the first two sets of disclosures under the regulations are audited.

125. The second risk is that the regulations do not take sufficient account of the variety of local authority accounting practices or circumstances. This could result in regulations that are unclear or inconsistent with generally accepted accounting practice as applied in local government. This risk will be mitigated by involving local authority representatives and the Office of the Auditor-General in the design of the regulations.

126. The third risk is that the Department's analysis lacks credibility with local government, and therefore is not regarded as helpful for local authorities in assessing their financial management practices. The Department will consult with LGNZ in developing its analytical framework for assessing the results including the characteristics and classifications it will use for grouping purposes.

127. The regulations interact with generally accepted accounting practice which is specified by the External Reporting Board under the Financial Reporting Act 1993. They also interact with the Local Government (Financial Reporting) Regulations 2011. The financial prudence regulations do not offer any opportunity to reduce or remove any existing regulation. It is proposed to align the definition of "rates" used for financial reporting in the financial reporting regulations with the definition in the financial prudence regulations.

128. The LGA02 requires the Auditor-General to report on the "completeness and accuracy" of disclosures made in local authority long-term plans and annual reports required by these regulations. The Department has worked closely with the Office of the Auditor-General in developing the regulations, and will continue to work with the Office of the Auditor-General to ensure that the regulations are well implemented. However, the Department considers that the best outcome for implementation will be achieved by an education programme working with the local government sector to ensure that the regulations are well understood and applied.

Monitoring, evaluation and review

129. The Department will gather comprehensive data from all local authority annual reports and long-term plans for analysis purposes. In addition to using that data to assess whether financial prudence issues exist in any particular local authority, the Department will use this work to evaluate how the sector views the benchmarks and how effective they are in identifying financial prudence issues.

130. The Department is also in regular communication with LGNZ, SOLGM, and the Office of the Auditor-General. The Department will seek feedback from these organisations about the effectiveness of the regulations and whether there are any design flaws in the regulations that need correction. The Department expects to carry out that assessment after the publication of the 2015/25 local authority long-term plans.

Appendix One: Comparison of planned territorial authority investment: depreciation ratios in five specified infrastructures against investment: depreciation ratios across all local authority services – 2012/2022

Territorial Authority	Investment: Depreciation ratio for five specified infrastructure services	Investment: Depreciation ratio for all council assets
Kaikoura District	63%	96%
Waitaki District	68%	72%
Porirua City	69%	94%
Taupo District	77%	102%
Whakatane District	83%	88%
South Waikato District	88%	102%
Kawerau District	89%	84%
Clutha District	91%	93%
Selwyn District	92%	138%
Waimate District	94%	94%
New Plymouth District	96%	106%
Kaipara District	96%	99%
Central Hawke's Bay District	97%	101%
Tararua District	99%	98%
Buller District	103%	101%
Westland District	104%	103%
Gore District	107%	108%
Southland District	107%	105%
Whangarei District	110%	106%
South Wairarapa District	110%	116%
Gisborne District	111%	118%
Hauraki District	112%	117%
Chatham Islands Territory	115%	122%
Dunedin City	116%	113%
Hurunui District	117%	114%
South Taranaki District	117%	112%
Central Otago District	118%	114%
Mackenzie District	118%	120%
Horowhenua District	120%	127%
Ashburton District	121%	136%
Invercargill City	122%	117%
Napier City	122%	116%
Hutt City	124%	124%
Far North District	124%	122%
Wellington City	128%	134%
Hastings District	128%	134%
Nelson City	130%	149%
Matamata-Piako District	130%	124%
Hamilton City	133%	106%

Territorial Authority	Investment: Depreciation ratio for five specified infrastructure services	Investment: Depreciation ratio for all council assets
Masterton District	134%	128%
Grey District	134%	129%
Wairoa District	135%	137%
Thames-Coromandel District	139%	143%
Waipa District	142%	151%
Rangitikei District	142%	135%
Carterton District	144%	128%
Opotiki District	144%	311%
Western Bay of Plenty District	154%	155%
Stratford District	155%	128%
Manawatu District	157%	145%
Kapiti Coast District	160%	187%
Marlborough District	162%	163%
Queenstown-Lakes District	170%	171%
Palmerston North City	173%	137%
Tasman District	180%	167%
Waimakariri District	184%	280%
Waitomo District	198%	176%
Auckland	199%	224%
Tauranga City	202%	175%
Rotorua District	213%	164%
Waikato District	214%	202%
Otorohanga District	Not available	132%
Ruapehu District	Not available	155%
Timaru District	Not available	145%
Upper Hutt City	Not available	92%
Wanganui District	Not available	152%

Source: DIA analysis of 2012 long-term plans.

Note: Christchurch City Council is excluded as it did not prepare a long-term plan for 2012-22.

Appendix Two: Summary of publications addressing concepts similar to "financial prudence"

Publication	Objective	Elements identified
Matters arising from the 2012-22 long-term plans; Office of the Auditor-General, 2012	To use the financial statements to help assess the aggregate effect of uncertainty on three aspects of a local authority's ability to deliver on its objectives	*Stability* of a local authority's activities; *resilience* of a local authority to short term and anticipated events; and *sustainability* – how prepared the local authority is for long-term uncertainties and to maintain itself indefinitely.
Financial sustainability of the New South Wales local government sector; New South Wales Treasury Corporation (Tcorp), 2013	To create a definition of financial sustainability for local government and establish a set of appropriate benchmark indicators	Financial flexibility; liquidity; debt servicing; and asset renewal and capital works.
Local government: Results of the 2011-12 audits; Victorian Auditor-General's report, November 2012	To assess the financial sustainability risk of local councils and the State of Victoria	Indicators reflect short and long term sustainability and are measured by: underlying result; liquidity; self-financing; indebtedness; capital replacement; and renewal gap.
Indicators of government financial condition; Canadian Institute of Chartered Accountants, 1997	To identify a common set of understandable financial indicators that relevant to assessing the financial condition of governments	*Sustainability* – the degree to which a government can maintain existing programs meet existing creditor requirements without increasing the debt burden on the economy; *flexibility* – the degree to which a government can increase its financial resources to respond to rising commitments, by either expanding its revenues were increasing its debt; and *vulnerability* – the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence, both domestic and international.

Publication	Objective	Elements identified
Reporting on the long-term sustainability of a public sector entity's finances; International Public Sector Accounting Standards Board, Exposure Draft 46, October 2011	To provide an indication of the projected long-term fiscal sustainability of the reporting entity over a specified time horizon in accordance with transparent assumptions	*Fiscal capacity* – the ability of an entity to meet financial commitments on a continuing basis over the period of the projections without increasing levels of taxation; *service capacity* – the extent to which the entity can maintain services at the volume and quality provided to current recipients at the reporting date and meet obligations related to an entitlement programs for current and future beneficiaries; and *vulnerability* – the extent to which an entity is fiscally dependent upon funding sources outside its control and the extent to which an entity has powers to vary existing taxation levels or other revenue sources and to create new sources of taxation and revenue.